

Visegrád countries: Could they be the pioneers of the change of the Central and Eastern model of capitalism?

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Abstract

The economic convergence of the Central and Eastern European EU member states has slowed down since the 2008 global crisis. The institutional analysis of the region projected that convergence potential of Central and Eastern European capitalism would be limited. This paper shows that characteristic features of the model (FDI based modernization, sustainability of competitiveness based on reduced social protection, weak innovation system etc.) have not changed since the crisis. In Central and Eastern Europe the stable Visegrád countries (Czech Republic, Poland and Slovakia) suffered the smallest losses during the crisis. It is due not to institutional changes but to the advantageous composition of FDI, their proximity to Germany and their previous disciplined economic policy. However it is a good initial position to change their economic institutional settings to be able to upgrading their position in the global value chain. The paper summarizes the complexity of required changes to get into core countries from semi periphery. The puzzle of slow growth in the Czech Republic indicates the real danger that the current situation will persist in the long run.

Keywords: varieties of capitalism, Central and Eastern Europe, Visegrád countries, convergence

JEL-codes: E02, P16, P52.

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Introduction

The 2008 global financial and economic crisis is a milestone in the history of the European economic integration and the member states' economies. At the beginning of the crisis the Central and Eastern European countries (CEEC) were very severely hit by the recession but they have recovered relatively quickly comparing to other member states. The paper analyses how the institutional changes carried out during the crisis influence the Visegrád countries' competitiveness. In the first section the Central and Eastern European model of capitalism and its convergence prospects are examined. The second part outlines the economic impact of the crisis and the institutional changes of different areas (product markets, innovation system, financial system, labour market, industrial relations, social protection and education) in the Visegrád countries. Finally, I summarize the chances of the change of Central and Eastern European model of capitalism in the Visegrád countries.

1. The Central and Eastern European model of capitalism

More than twenty years have passed since the systemic change in Central and Eastern Europe. Eleven countries from this region have become part of the European Union. It has only been between two to ten years since their accession, but their economic incorporation began soon after the changes in their political regimes. It can be assumed that stable social and economic frameworks have developed that are suitable for analysis. Recently, there have been several attempts to compare the CEEC with existing models, but these comparisons either include only a few countries or use a more limited list of features and data than the varieties of capitalism literature does when analysing older capitalist states (Estrin et al. 2007, Hancké et al. 2007, Lane and Myant 2007). These studies compare the CEEC (or one group of them) with the Mediterranean countries or the Continental states, or even with coordinated market economies. Other works identify the features of the Anglo-Saxon or Liberal model in some countries (e.g., Cernat 2006, Buchen 2007, Feldmann 2007, King 2007, Knell and Srholec 2007, Lane 2007, Mykhnenko 2007, Blanke and Hoffmann 2008, Csaba 2009). Nölke and Vliegthart (2009) suggest a new dependent market economy model but limit it to the Visegrád countries. Bohle and Greskovits (2012) distinguish three groups within the CEEC, the neoliberal Baltic States, the embedded neoliberal Visegrád states and Slovenian neocorporatism. Beginning in the late 1990s, Bulgaria and Romania have also advanced towards the neoliberal pattern of economic and welfare state policy.

None of the abovementioned studies conducted a detailed empirical analysis to compare the institutional arrangements of the old member states (OMS) and the CEEC. Therefore, in my previous research, I examined six socio-economic sectors: product markets, labour markets, financial systems, social protection systems, education and R&D and innovation, using 112 indicators (Farkas 2011). I constructed a database using data from Eurostat, the European Central Bank, the World Bank, and the Fraser Institute. Unfortunately, three new member states, Cyprus, Malta and Croatia had to be omitted because several data points were missing. The basic methodologies used to achieve this were cluster analysis and multidimensional scaling. The classification of the member states produced by this analysis is nearly identical to that using the old models of capitalism reported in the literature, apart from the missing Anglo-Saxon model (Table 1). In this paper, I focus on the Visegrád countries and therefore do not have space here to explain the smaller differences concerning the classification of the OMS. According to my research, the old models need to be supplemented with the Central and Eastern European model.

Table 1. Clusters of EU-25

Northwestern	Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, United Kingdom
Mediterranean	Greece, Italy, Portugal, Spain
Nordic	Finland, Luxembourg, Sweden
Central and Eastern European	Bulgaria, Czech Republic, Estonia, Poland, Hungary, Latvia, Lithuania, Romania, Slovakia, Slovenia

Source: Farkas (2011:29)

The cluster analysis indicated that the differences between the CEEC and OMS were more significant than the differences within the CEEC groups. Only Slovenia was a borderline case, and it seemed to move from the CEEC group to the Continental group prior to the crisis. Table 2 summarises the similarities with previously existing models and shows that the individual sub-systems could not be classified within the existing models.

If we examine the elements of the Central and Eastern European model thoroughly, we find that these can be traced back to three main aspects: a lack of capital and management knowledge, weak civil society and the effect of the EU and other international organisations that influenced the CEEC.

The lack of capital made foreign capital investment necessary. However, as this investment occurred in parallel with prompt liberalisation, protectionism was not an option, as has been the case in emerging economies at other times or in other regions, owing to the economic paradigms dominant in the Western countries and the level of European integration achieved by the OMS. The lack of capital also made the creation of bank-based financial systems inevitable, as a substantial share of foreign capital inflows went into the financial sector, into banks.

The operation of labour markets and industrial relations in the CEEC differs from that in both the Anglo-Saxon and the Mediterranean countries, as civil society is weaker and trade union density is lower. Absent the legal harmonisation within the EU, the position of employees would be even weaker. Higher or lower levels of social protection and welfare distribution in the CEEC are highly correlated with relatively weaker or stronger civil society or traditions of social protection institutions.

The system of R&D and innovation can be properly understood by considering certain background information: the domestic-based, internationally competitive business sector that is the driving force of innovation systems in the Nordic and Continental countries is missing. State-induced R&D cannot fill this gap.

Table 2. The Central and Eastern European model compared to the most similar models of the OMS

Institutional area	Most similar model of the OMS
Product markets	Situated in between the Continental and Mediterranean models. The product markets in the former are less flexible, while those in the second model are more flexible. Foreign investment explains the high technical development level in the CEEC.
R&D and innovation	Mediterranean model: low R&D expenditures with limited involvement by the business sector. Export and employment levels are below the EU average in the high-technology sector
Financial system	Bank-based Continental model (the financial systems of the Mediterranean countries can be described by the Continental model in this area) but at a significantly lower level of development.
Labour market and industrial relations	The labour market does not have that dual character typical of the Mediterranean and Continental models (insiders do not have a stronger position in the labour market relative to outsiders). This feature makes it similar to the Anglo-Saxon model, but the labour market in the Central and Eastern European model is less flexible. The similarities in industrial relations are also ambivalent. As in the Mediterranean model, the state interferes in industrial relations, but the relationship between employers and employees in collective bargaining is nearly free of conflict. Only Slovenia could be classified in the group of Continental countries.
Social protection	Three countries (Hungary, Poland and Slovenia) belong to the Continental model. The others are closer to the Anglo-Saxon model, but as in the case of the structure of the financial system, the traditions of Continental social security remain.
Education	There are no clear models in the area of education as were observed in other sub-systems. However, the CEEC exhibit similarities with Continental education systems. Slovenia was the only one to fall into the group of – mainly Nordic – countries with the most successful education systems.

Source: Farkas (2011) p. 29

If the development of the Central and Eastern European model was not accidental but a response to prior conditions, then there is no reason to assume that this is only a temporary situation that will develop towards one of the European models of capitalism, rather than a set of institutions that can continuously reproduce itself. Overall, the development model of the CEE countries undoubtedly led to successes both in terms of GDP and of final consumption (which better expresses the prosperity of the population). However the present institutional frameworks are only adequate for a growth path that perpetuates asymmetric mutual dependency between the old and new member states.

The previously advantageous foreign direct investment (FDI) based modernisation caused the CEEC to be particularly vulnerable during the crisis when capital inflows fell. In 2009, the rate of decline exceeded the EU average in every new member state, except for Poland. Scrutinising these countries, it becomes apparent that the severity of the recession unambiguously depended on the degree of pre-crisis economic imbalances. Three Central European countries, the Czech Republic, Poland and Slovakia, did not accumulate notable imbalances prior to the crisis, contrary to Hungary, Slovenia, the Baltic States, Bulgaria and Romania.

These differences are reflected in the accumulated losses and gains between 2009 and 2013 in GDP and private final consumption (Table 3).

Table 3. Accumulated losses and gains between 2009 and 2013 in the CEEC comparing to 2008

Losses/gains of GDP 2009-2013, comparing to 2008 at constant prices in the share of 2008 GDP		
1	Poland	0,443
2	Slovakia	0,056
3	Czech Republic	-0,107
4	Bulgaria	-0,186
5	Romania	-0,263
6	Hungary	-0,276
7	Estonia	-0,279
8	Slovenia	-0,388
9	Lithuania	-0,432
10	Croatia	-0,481
11	Latvia	-0,672

Source: Author's own calculation by AMECO database

Despite these differences several long-term projections strengthened the limited convergence prospects in the CEEC. The European Commission prepares a report every three years about the expected long-term economic impacts of ageing societies, published under the title of the Ageing Report. In this Report they forecast the evolution of potential GDP. The working group of the Committee builds the model on the neoclassic growth model and uses the production function in its econometric model. The Report in 2009 (European Commission 2009) did not calculate with the effects of the crisis, nevertheless, a continuously worsening potential GDP growth rate has been projected within the entire EU until 2060. In the post-socialist countries, the reduction of the growth rate seemed greater than in the entire EU, which was triggered in the model by the expectedly greater decrease in the number of population. Naturally, it always has to be added that the model does not take the future institutional and political changes into account. The Report of 2012, which was published in 2011, could built in only partially those effects of the crisis which are deteriorating the growth potential but still, the data have shown the further worsening of the prospects for convergence. It is remarkable that in case of the model for fifty years, they were calculating with the convergence in the labour productivity growth rate, instead of the convergence in productivity levels. In a foot-note the explanation is provided, namely for achieving the latter, such a huge growth rate should have been assumed for the short- and medium-term which was not plausible (European Commission 2011:126).

Halmai and Vászary (2012:319) calculated the expected per capita potential output at purchasing power parity in the various countries, based on the model of the Ageing Report and the result of this was that 80 percent of the EU-27 average would be achieved or exceeded only by the Czech Republic, Slovakia and Slovenia in 2060 from among the post-socialist countries which is already a reality in case of the Czech Republic and Slovenia. The Report made by the EBRD (2013:17) does not depict a more exhilarating picture, either. Their forecast until 2035 projects the decreasing growth rate of total factor productivity. Labour

productivity measured in GDP per worker relative to EU-15, in 20 years' time will still remain between 60-80 percent, only the Czech Republic and Slovakia exceed 80 percent. The Report made by the IMF (2014) also draws our attention to the fact that the convergence of the post-socialist countries has been decelerating since the crisis. All studies and reports have regarded the re-launching and accelerating of structural reforms as the potential way-out. The question arises whether the changes of the institutional arrangement during the crisis promoted the convergence potential of the Visegrád countries.

2. Impact of the 2008 global crisis in the Central and Eastern European member states²

2.1. Poland

Although the Polish economy had already been integrated into the European market well before the country became an EU member formally, the accession in 2004 gave new impetus to both exports and the inflow of FDI. As a result, the current account deficit did not reach 7 percent even when it was at its lowest level in 2008, and public debt remained under 50 percent. Nevertheless, the Polish economy started to show the signs of overheating with increasing current account deficit and inflation as of 2006 and it was the crisis that put an end to this. In 2009 the inflow of FDI and exports drastically declined in Poland as well. The growth of the Polish economy dropped from 3.9 percent (in 2008) to 2.6 percent. In 2009-2010 domestic consumption and the investments of the public sector became the engines of growth. The favourable position of the Polish economy can be attributed to several underlying factors. The exchange rate of the zloty stabilised at a lower level, which facilitated Polish export. The Polish market is less open compared to the markets of other smaller CEE countries, which also helped the Polish economy. The fiscal policy did not have much room to manoeuvre, in spite of the fact that they managed to reduce the general government deficit to 1.9 percent in 2007. Therefore the implemented anti-crisis plan was only 0.7 percent of GDP in 2009 (OECD 2010e:34). However, government deficit exceeded 7 percent in 2009 as well as in 2010. With the help of the support received from the EU and the investments made for the purpose of the European Football Championship in 2012, fiscal policy was able to compensate for the decline in private investments. Taken this slow consolidation into account, it is expected to reach the Maastricht criteria in 2015. Government debt did not exceed the 60 percent ceiling determined both in the Maastricht Treaty and the Polish Constitution.

The stability of the financial sector had a beneficial effect on the economy as well. The Polish financial supervisory authority intended to curb foreign currency lending by issuing a recommendation in 2006. Due to the prudent regulatory policy and the conservative business models of the banks, the amount of foreign currency debts remained moderate. The Polish financial supervisory authority made the conditions of such lending stricter. Nevertheless, the risk was still considerable because in 2012 more than 30% of the outstanding loan portfolio still comprised foreign currency loans (mainly housing loans in Swiss francs). The negative consequences started to manifest as of January 2015 when the Swiss National Bank announced that it would no longer hold the Swiss franc at a fixed exchange rate with the euro. The Swiss franc started to soar. The proportion of non-performing loans is not insignificant: according to the Polish definition it was 8.8 percent in 2012 and it was on the rise. The capital adequacy ratio for the banking sector is appropriate in the establishment of which the parent banks of the banks which were foreign-owned in more than 60 percent took part as well (EC SWD 2013e:14). Property prices increased markedly before the crisis but their starting point was low, and during the crisis there was only a moderate decrease in house prices. The

² In Chapter 2 the online database of Eurostat has been used in all cases where the resource of data does not indicate otherwise.

internal as well as the external indebtedness of the private sector was low, and there was no considerable change during the years of the crisis.

Poland is able to improve its external competitiveness continuously. During the crisis Poland's global market share remained stable and in 2013 it exceeded the average of the previous five years by 2.1 percent. Real effective exchange rate (REER) deflated by unit labour cost (ULC) depreciated by nearly 9 percent in 2012-2013, which ensured that cost-competitiveness enhanced. There was a positive change in the composition of Polish export in terms of technological intensity but its extent was below that of the other Visegrád countries (OECD 2010e). Geographical specialisation is very favourable because there has been a huge demand for Polish import since the beginning of the 2000s in the Russian, Ukrainian, Czech, Slovakian and Lithuanian markets. During the crisis Polish exports grew more rapidly – in case of several product categories – than global imports. Experts of the European Commission has pointed out that Poland sustained its comparative advantage in low and medium-low technology goods, and at the same time it lacked comparative advantage in medium-high and high technology goods (EC SWD 2014g:21).

It is obviously reflecting the weaknesses of the innovation system. According to the innovation scoreboard of 2014, Poland is the last country among the moderate innovators and the country could not use its favourable economic position during the crisis for improving its status. Expenditures of the private sector accounted for 0.33 percent of GDP and those of the public sector amounted to 0.56 percent of GDP (European Commission 2014c:83). The inadequate performance can be attributed to the low amount of expenditure as such, the lack of a comprehensive strategy, which would be independent from the successive parliamentary terms, the lack of coordination between the relevant ministries, the fact that cooperation is fragile between the actors of the R&D realm and the business sector and the lack of capital-intensive domestic enterprises (Kasperkiewicz 2012).

Presumably, competitiveness would be enhanced if the privatisation plan initiated in 2008 would be accomplished. The economic weight of the Polish government remained greater than its competitors' because its ownership is present in the network industries, moreover, in 2008 in the expressly competitive sectors of the economy there were indeed over 200 firms in manufacturing, and more than 100 mining companies publicly owned. The planned privatisation has not been accomplished yet, and the government classified 50 firms as strategically important intending to keep these under majority state ownership and to maintain control (Égert – Goujard 2014).

Due to the favourable results of growth, the unemployment rate is lower than in the pre-crisis period but it is still around 10 percent. Data concerning employment are biased by shadow economy in Poland as well, the size of which is estimated to be 24 percent of GDP (Schneider and A.T. Kearney 2013:4). The most serious problem is labour market segmentation. The use of fixed-term employment contracts is rather widespread, and – firstly – the transition from these to permanent employment is rare – secondly – almost one third of them are concluded in the form of a civil law contract, which provides less protection. This situation is particularly disadvantageous for the young: in 2013 68.6 percent of them were employed with fixed-term contracts. According to the PISA surveys, public education in Poland has developed considerably with students achieving above average results in all areas. However, labour market data show that there is still a mismatch between skills and labour market needs therefore reforms aiming at higher education and tertiary education are currently on their way (EC SWD 2014g:17-19). Due to the economic growth, public spending on education in real terms was higher in 2011 compared to 2008 and as a proportion of GDP it decreased from 5.7 percent to 5.6 percent (EACEA 2013:4,7).

As far as labour relations are concerned, the crisis did not bring about changes, and trade union density continued to decrease, in 2013 to 10 percent. Although Solidarity had a

historical significance, the strength of the trade unions declined in the same way as it happened in the other CEEC. Solidarity was organised at corporate level in the state socialist system, which made the decentralisation of concluding the collective agreements easier after the change of political system. During the crisis there were not many strikes, 50-80 on a yearly basis, mainly in the public sector, partly due to the privatisation plans. The institution of tripartite negotiations was known in Poland as well and in 2009 the social partners managed to make an agreement on crisis management. The number of negotiations has decreased since, and the government made a decision on the minimum pay without negotiating (Krzywdzinski 2012, Eurofound 2014).

The phenomenon of working abroad also contributed to the decrease in unemployment. The number of temporary migrants reached its peak at 2.27 million in 2007, then their number decreased and stagnated at 2-2.1 million. There are 1.2 million Polish people who have got migratory experience and they returned to their country of origin. The majority of them are pre-accession migrants (Kaczmarczyk 2013:113-15). In Poland there has always been a tradition of international emigration. Kaczmarczyk (2013) is not concerned about the return of temporary migrants and considers post-accession migration as a solution which drained the excess labour force of young, skilled workers from the underdeveloped regions. He also points out that the problem rather lies in the fact that these young people leave Poland after completing their education, without gaining any experience in the domestic labour market, but their labour market position abroad is not good either because they are overqualified for the jobs they are taking. Thus their reintegration in Poland upon return can be very difficult, which would require well-tailored migration policies.

Not even Poland can be indifferent about keeping the younger generations in the country since the increasing costs of ageing is placing a burden on the Polish economy as well. It is difficult to phase out the special pensions schemes for miners and farmers because of the potential political conflicts which accompany such measures. In 2013 the government enacted the partial reversal of the systemic pension reform started earlier in order to consolidate budgetary expenditures. In 2014 there was a one-off asset transfer worth around 9% of GDP from the second pension pillar (private pension funds) to the first pension pillar, and the possibility is given for further transfers from the second pillar (EC SWD 2014g 2014:7).

The indicators of social inequality slightly decreased during the crisis due to the growth of the Polish economy, but the rate of severely materially deprived was 11.9 (above the EU average) in 2013. Social expenditures are around 18-19 of GDP since the outbreak of the crisis, which shows no change compared to the previous years.

2.2. The Czech Republic

The Czech Republic also had its share from pre-crisis prosperity; within 2004 and 2008 its economy grew at a pace of 5.5 percent on average, similarly to Poland. The peak was reached in 2006 at 6.9 percent then in 2008 it slowed down to 2.7 percent meaning that the crisis hit the country in a descending branch of a cycle. The extent of the recession, -4.8 percent, was more favourable than the Slovakian or the Hungarian data, but since then, 2012 and 2013 also saw a recession (-0.8 percent and -0.7 percent, respectively), which – apart from the Mediterranean countries – was only characteristic of Slovenia, Croatia, Finland and the Netherlands.

Adaptation to the crisis was supported by both the monetary and the fiscal policies. The central bank reduced the rate of interest on several occasions. The depreciation of the Czech koruna facilitated the export even if not as persistently as that of the Polish currency did. In 2009-2010, an incentive package was approved in the amount of 2.2 percent of the GDP (OECD 2010a:40). Due to the decrease in revenue and the operation of the automatic

stabilisers, the deficit leaped to 5.5 percent in 2009 therefore consolidation started already in 2010. They managed to force back the budget deficit to 1.3 percent by 2013. A slight increase is expected in the coming years but the deficit probably remains around 1.5-2 percent and the state debt is fluctuating around 45 percent.

The Czech banking system did well during the crisis. Since the beginning of the 2000s, prudent regulation, the creation of reserve and supervision – fortunately – have been developed gradually, in more steps. As early as January 2008, financial supervision was already functioning within the Czech National Bank i.e. the same regulation was applied for the entire financial system, which was able to manage the mutual interdependence of the various elements (banks, insurance companies, savings cooperatives) during the crisis. Since the rates of interest were low, the households were not tempted to borrow in foreign-currency-based loans; the 20 percent proportion of loans denominated in foreign currency taken out by companies was the lowest in the region. No housing bubble developed either. The banks (foreign-owned almost in 90 percent) were pursuing conservative business policy and the majority of the companies were connected with one bank only, which made risk management considerably easier (OECD 2010a:33-34). The proportion of non-performing loans is stably around 5 percent, the capital adequacy ratio concerning the banks is around 15-16 percent, their profitability is high – in spite of the recession in the real economy – it was the second highest in the EU, in 2013 (EC SWD 2014c:16, 41).

Products of machinery and transport equipment products account for almost half of the Czech export exerting a highly beneficial effect on the competitiveness of the economy; nearly one-third of their export is directed to Germany. Although the proportion of non-EU countries has grown within the export in recent years, the proportion of the EU countries is still above 80 percent. After the external shock in 2009, the recession which occurred in 2012-13 was mainly due to the decline in internal demand, and the boosting of export performance is expected to bring recovery. The assessment of the performance of the Czech economy is controversial. On the one hand, after 2009 the export continuously grew in terms of volume and value as well, but the pace of the growth slowed down by 2013. The Czech Republic suffered a 7.7 percent loss in its share in total global exports during 5 years, before 2013. This is not an outstanding value compared to the other old member states but it can be seen that only the performance of Hungary is worse (-19.2 percent) from among the Visegrád countries, which are the peer competitors of the Czech economy; Slovakia's loss is only 2.2 percent, and Poland's share increased by 2.1 percent. The ULC based REER increased in the Czech Republic after the 1990s due to the convergence process similarly to Slovakia, Hungary, and then Poland from 2004. However, after the currency depreciation in 2009, a more significant and more persistent decrease in REER followed in Poland and Hungary. Although during the crisis the Czech economy's reaction was less flexible in applying cost reduction than its competitors', this is not the cause of the real problem.

Catching up with the EU average had modest results in terms of per capita GDP and it practically did not take place between 1995 and 2007 in terms of individual final consumption, which is expressing the material well-being of a person. It seems that during the crisis a persistent recession was needed to stir up the interest of the European Commission and in February 2014 ECFIN DG as part of its series of conferences held on the individual countries finally put the investigation of the growth in the Czech Republic on the agenda. What struck me as odd was that apart from this conference I could not find a study in literature which would undertake investigating the 'mystery' of the Czech economy. I have used the word deliberately because if we compare the potentiality of the Czech economy and its actual growth – I think it is not far-fetched to speak about a mystery. Based on the average rate of growth in the period between 1993 and 2012, it would take 428 years for the Czech Republic to catch up with Austria in terms of per capita GNI. What is amazing though, is that

all conditions necessary for fast economic growth according to economic literature are at their disposal: per capita FDI is the second highest in the region; the savings rate is the first; the macroeconomic environment and the financial system are stable; all key internal and external macro indicators show long-term balance; the labour force is qualified; its geographical location, the proximity of Germany is favourable; social stability is also given (Švejnar – Uvalic 2013, Švejnar – Semerak 2014). The position of the Czech Republic in the various rankings of competitiveness is different. Although its ranking at the World Economic Forum got lower during the years of the crisis, according to the Global Competitiveness Index, in 2014-2015 again, only Estonia was better from among the post-communist countries (Schwab 2014:13). In the World Bank's Doing Business ranking the Czech Republic took the 75th place in 2014, overtaking only Croatia but in 2015 it is in the 44th place (World Bank 2013, 2014). The IMD World Competitiveness Yearbook was ranking 60 countries and in 2014 the Czech Republic took the 33rd place, it was the 2nd, following Estonia, from among the post-socialist countries. Thus unfortunately the international rankings cannot help us in solving this mystery. The presentations of the participants of the above referenced conference available on the internet could not reveal anything convincing, either. Those factors which are usually brought forward (weaknesses of the institutions, primarily those of public administration, corruption, unfavourable demographical processes and the problems of the educational system) – as we can see later – show neither individually, nor jointly, those attributes which would explain why the performance in terms of convergence is lagging behind the CEE competitors.

OECD experts have pointed out that, on the one hand, the Czech economy is deeply integrated into the German supply chain, and on the other hand, the Czech companies exporting final products use mainly import intermediate products and only few ones of Czech origin. The Czech Republic is among those OECD countries where the service content of gross exports is low – similarly to all other Visegrád countries –, in particular, it is also among those countries which have the lowest domestic content, similarly to Slovakia and Hungary. A skill upgrade of the labour force and increasing the services content of the end-product would ensure the production of higher added value. A more competition friendly business environment would be necessary in order to support the domestic drivers of growth (OECD 2014a:27). It can be said also in case of the Czech Republic that besides the network industries – where the insufficiency of the competition is generally characteristic of Europe – the state owns a considerably large number of companies which are operating in the private sector. What is even more problematic that in selecting the members of the companies' management the political considerations prevail over the professional ones and the efficient and transparent supervision of the companies' operation is not duly ensured. Nevertheless, the product market regulation and the state's role do not implicate larger difficulties, according to the OECD indicators, than in Poland (see OECD 2014a:49-81 and Égert – Goujard 2014). As regards corruption, in the ranking of Transparency International the Czech Republic takes the 57th place together with Croatia; Poland, Slovenia, Hungary and the three Baltic countries have gained more favourable places.

As far as research and development is concerned, the Czech Republic is among the moderate innovators, only Slovenia and Estonia have better places from among the post-socialist countries, and the latter ones are listed among the innovation followers in the innovation scoreboard of the EU. In the Czech Republic, during the crisis the expenditures on R&D increased, in 2012 the public sector spent 0.87 percent of GDP, the business sector spent 1.01 percent of GDP on R&D, which approximate to the 2.07 percent average of the EU. Within the business sector 60 percent of the funding comes from a few large foreign companies. A shortcoming of the innovation system can be found in the low level of cooperation between scientific research and the business sector. Projects were launched by the

government in the framework of its innovation policy in order to facilitate cooperation, but these projects have not delivered the expected results. The efficiency of the innovation policy is impeded by the fragmented institutional system and the very broad scope of the support actions (EC SWD 2014c:23-24).

The employment rate in the Czech Republic is 70 percent, which is outstanding in the region, and it was maintained during the crisis as well. In order to be able to maintain employment, in 2009 partial employment was made possible, with reduced wages, for maximum a year. In 2011 with the amendment of the Labour Code further liberalization of the labour market took place. The unemployment rate was about 7 percent and expectedly it is going to get back to the average 6.6 percent as it was before the crisis. From the viewpoint of employment, the situation of the Roma population is critical, the unemployment rate is estimated to be above 50 percent among them (EC SWD 2013c:24). Schneider and A.T. Kearney (2013:4) indicates a significantly lower level of shadow economy – 16 percent of GDP, in the Czech Republic – than in the other post-socialist countries, which is conceivable if we take the high employment rate into account. Czech authors estimate a 20 percent level on the basis of data from 2008 (Lichard et al. 2012:11).

The efficiency of the labour market has been impaired by the fact that the evolution of the wages did not follow the structural change of economy. With the exception of the managers, the proportion and dispersion of wages among the occupations and within the occupations did not change much, except for the high private return on tertiary education degrees. Therefore, the proportion of wages does not indicate what kind of qualification would be needed from those who are entering the labour market. Minimum wages are determined in the collective agreements above the legal minimum (OECD 2014a).

During the crisis the low level of income disparities increased only minimally, and the data tables of Eurostat show that indicators started to return where they had been before the crisis moved them out. The situation of the Roma population is critical though, one-third of them are considered socially excluded (EC SWD 2014c:21). The number of severely materially deprived people was 6.6 percent in 2013, which remains under the EU average (9.6 percent). The low level of disparities is partly explained by small and stable wage differences (as mentioned above), because the expenses of social protection remained low, below 20 percent, even during the crisis.

Such evolution of the wages is especially interesting since wage bargaining is decentralized and they cover about one-third of the employees. Trade union density is continuously on the decline, in 2013 it was estimated to be 13.5 percent. Strikes on the level of the companies are very rare, between 2011 and 2012 there were demonstrations with the support of the trade unions against the government reforms concerning the pension and healthcare system and against other measures which were curbing other welfare benefits. Since 1990, there has been a forum for tripartite negotiations under the name of Council of Economic and Social Agreement (Rada hospodářské a sociální dohody,) but this is strictly for consultation purposes, without legally binding force (Eurofound 2014). The cooperative labour relations could not develop, not even through the foreign companies. According to the surveys, the majority of the leaders of the large German and Austrian corporations did not strive to implant those direct and indirect participation models into the Czech circumstances, which were highly appreciated at home. This happened only then and there, where the German trade unions or workers' councils fought it out. In the financial sector, the Anglo-Saxon corporate managements applied direct participation methods but their purpose was precisely the crowding-out of the trade unions (Meardi et al. 2013).

During the crisis, in the Czech Republic also, it became inevitable to interfere with the welfare system but curtailing the welfare benefits was not of significant size. Nevertheless, in addition to budgetary consolidation restructuring, aging itself would explain why the

conditions of retirement had to be changed. By 2020, the compulsory retirement age will be 65 or higher, with the exception of a few countries, but in the Czech Republic it is 63 years and 8 months. Measures taken during the crisis inhibited the increase of the pensions in the first pillar only between 2013 and 2015, improved the operation of the voluntary third pillar, and a new, funded second pillar was introduced as well. Only few have entered the latter because the missing social consensus makes its future uncertain. In 2013 a new type of early retirement was introduced as well, which does not help curbing the expenses related to aging (EC SWD 2013c: 15-16).

The Czech education system is quite complex. According to the PISA report of 2012 the results of the Czech students are average in mathematics and reading, a bit above average in science, only Estonia, Poland and Slovenia are better from among the post-socialist countries within the EU. This result was achieved with relatively low expenses, the public spending on education (4.9 percent of GDP) was lagging behind the EU average by 0.4 percentage points in 2011 as well, although the difference got smaller compared to 2008 (EACEA 2013:7). At the same time, in higher education there was a huge increase: the number of students enrolled in state universities has risen by 32 percent since the mid-2000s and the number of students has dynamically grown in the private educational institutions as well. Between 2006 and 2012 the ratio of people with higher education qualification in the age group between 30 and 34 grew from 13.1 percent to 25.6 percent. Higher wages related to the degree show that there is a demand for people with higher education but the fact that the budget of the state universities grew only by 6 percent during the same period gives rise to concerns, in terms of quality. The other problem to be solved is the improvement of vocational training, which has been chosen by an extremely high proportion (70 percent) of the students involved in upper secondary education. The training programmes for those who do not continue their studies in higher education are less and less suitable for meeting the requirements of the labour market (OECD 2014a:35-37).

After this review of the institutions having influence on economic growth, let me return to the mystery of the Czech economic growth. More than half a decade has passed since the beginning of the crisis and this period seems to confirm what has already been prognosticated by the characteristics of the Central and Eastern European model. Convergence built on FDI at a certain level of development can only be continued if the domestic economy is also able to integrate into the global chain but in order to achieve this, it is important to improve the quality of the institutional system (including the public administration, the innovation system and educational system). The Czech Republic did not show worse performance in these areas than its competitors but since it started from a higher level of development than its competitors, its performance was not enough for achieving more dynamic economic growth.

2.3. Slovakia

In Slovakia the dynamic growth of the 2000s reached its peak at 10.7 percent in 2007. During the global economic crisis its economy shrunk only in 2009, by 5.3 percent. However, in the other years there was no recession but even a modest growth could be detected. The Slovak government – similarly to the other countries – intended to mitigate the effects of the crisis by way of fiscal measures. When the accepted fiscal stimulus package was actually implemented, its impact on the government budget amounted altogether only to 1.0 percent of GDP in 2009 and 2010 (OECD 2010g:33). Before the crisis, Slovakia, which was preparing for the adoption of the euro, curbed public spending. However, it did not accumulate reserves – similarly to other countries – thus there was no room for manoeuvre in terms of discretionary revenue measures. Automatic stabilisers were more dominant and together with the decreasing revenues they led to a 7.9 percent deficit. As the result of the consolidation

measures, the general government deficit was brought below the Maastricht deficit level in 2013. Since the outbreak of the crisis public debt has almost doubled, reaching 54.6 percent in 2013. In the next three years it is expected to be between 54-55 percent. In 2011 fiscal discipline was strengthened by a new regulation and the Fiscal Responsibility Board was set up.

The Slovak financial system is very similar to the Czech system – it proved to be stable during the years of the crisis. The proportion of foreign ownership exceeded 90 percent, deposits were high compared to loans therefore the banks were not in need of foreign funding and were pursuing a conservative lending policy. Capital adequacy ratios of the Slovak banks were already over 16 percent in 2013 and their profitability has been steadily on the increase since 2011. Foreign currency denominated loans taken for the purchase of houses were almost non-existent. The ratio of non-performing loans is around 5 percent. (EC SWD 2014y:44). Property prices soared rapidly before the crisis mainly because interest rates decreased before entering the euro area, the disposable income of the households however, increased. The supply side i.e. the construction industry did not grow at the same rate as it did in Estonia or in Slovenia. Altogether it can be said that the Slovak property market was not as overheated as it was in a lot of other EU member states but there was a significant correction in the prices during the crisis. The debt of the private sector was relatively low before and during the crisis, similarly to the Czech Republic and Poland.

In terms of per capita FDI, Slovakia is the fourth – following Estonia, Czech Republic and Hungary – from among the post-socialist EU member states and this did not change during the crisis (Hunya 2013:40). The inflow of FDI was considerable, consequently it did not cause any problems that the current account deficit was around 7 percent during the years before the crisis. After the shock in 2009 the internal demand declined but exports started to increase rapidly and the current account ran a surplus of around 2 percent in 2012 and the European Commission's forecast calculates with a surplus of 0-1 percent annually, until 2016. It is Slovakia from among the Visegrád countries where transport equipment and machinery represent the greatest proportion of export. Although the Slovak export towards non-EU countries has increased, the EU countries are accounting for around 85 percent of exports for Slovakia (ECFIN DG 2014h:21). Slovakia has tight trade linkages with Germany but the Slovak export shares to Germany are only around 20 percent compared to the Czech export shares of above 30 percent (Fidrmuc and et al. 2013:16). By 2013 Slovakia's five-year global market share in terms of export has decreased only by 2.2 percent, which demonstrates the competitiveness of the Slovak export quite well. The competitiveness of the Slovak export has not changed although REER had appreciated steadily before the crisis and during the crisis depreciation was more moderate than in Hungary or in Poland. Increasing productivity and the slowing rate of wage growth helped maintaining cost-competitiveness. The fact that productivity was increasing during the crisis was partly because the less skilled or less productive employees were dismissed first. What made Slovakia's situation even more difficult was that the adoption of the euro took place exactly in 2009, which meant – on the one hand – protection for the open and small Slovak economy, but at the same time the country did not have the opportunity to make use of the currency depreciation during such a critical period. According to Fidrmuc et al. (2013) Slovakia entered the euro area with a probably overvalued exchange rate.

As regards the sustainability of competitiveness, there are three factors deserving attention. Since the crisis FDI inflow has declined, although FDI was considered the source of technological convergence in the Slovak economy. Pavličková (2013) provides a detailed analysis of the product structure of the Slovak exports between 1999 and 2011. She points out that the Slovak economy has gained strength – in terms of price-competitiveness as well as in quality competition – in manufacturing road vehicles (mainly automobiles) and other

transport equipment but this is mainly concerns the assembling activity of components, the added value of which is rather low. Slovakia's competitiveness has improved in manufacturing telecommunications equipment as well. At the same time, there has been no improvement in the export of technology-driven products with higher added value; the structure of exports remained as it had developed in the second half of 1990s. According to Pavličková (2013), the problems presented partly by the innovation system, partly by the labour market and the educational system are to be blamed for the current situation and she also refers to certain factors that are related to the government. These problems altogether explain why Slovakia moved downward and dropped 6-15 places in the international rankings measuring business environment in 2014. These problems are also cited by the analysis prepared by the European Commission on the assessment of the national reform programme: poor quality of legal regulation and weak law enforcement, frequently changing legislation, corruption and clientelism in particular in public procurement (EC SWD 2014y). In Transparency International's Corruption Perception Index Slovakia performed poorly: only Romania and Bulgaria scored lower in 2013.

In light of the above it can be said that the issues of critical importance are the improvement of legislation, the quality of public administration and the development of the innovation system. In the Innovation Scoreboard of the EU Slovakia is among the moderate innovators. According to the Innovation Union Scoreboard 2014 Slovakia performs poorly in terms of the indicators for expenditures, R&D results, economic applications and effects. R&D expenditures account for 0.82 percent of GDP – although there was an increase in 2012 – and R&D expenditure in the business sector is 0.34 percent (European Commission 2014c:67, 83).

The education system still does not receive enough attention, 4 percent of GDP was spent on government education expenditure in 2011 (the EU average is 5.3 percent). However, it can be said that it increased if it is compared to the 3.5 percent in 2008 (EACEA 2013:7). In the PISA surveys in 2012, the Slovak students performed below average; their results were worse than the earlier ones. The proportion of those aged 30-34 with tertiary education has increased by more than 10 percentage points since 2008 to 26.9 percent in 2013. Youth unemployment rate has been persistently high (33 percent in 2013), which means that there is a mismatch between qualification and labour market needs. The problems of vocational training are expected to be solved in Slovakia as well by introducing the dual system (similarly to other countries), the preparation of which is under way (EC SWD 2014y:19-21).

Unemployment rate had continuously declined during the five years preceding the crisis and it reached its lowest point in 2008 at 9.6 percent. In 2009 firms received compensation from the government for reducing the working hours but the unemployment rate exceeded 12 percent, then 14 percent in 2010, and it has not changed much since. 70 percent of the unemployed are long-term unemployed. The Slovak employment rate has never went over 70 percent, it has always been around 65 percent. The underlying factors are difficult to detect and the effects of the crisis make it even more difficult to tackle the related problems. There are great regional differences within the country with the central and eastern parts lagging behind in particular, and these differences are reflected in the unemployment rates of the various regions. The regional inequalities are closely associated with the problem of integrating the Roma population. Their employment rate is particularly low, around 20 percent. The Roma employment gap is the highest in Slovakia in the region, nevertheless, they account for more than 9% of the population (EC SWD 2012c:17).

Additionally, unemployment rate is also decreasing more slowly than the GDP started to increase because the Slovak economy specialized very strongly in capital-intensive, cyclically sensitive sectors. There is a risk here: if the economy does not start to grow

dynamically, unemployment may become structural. The centre-right government of Iveta Radičová intended to make the labour market more flexible thereby improving employment thus the government modified the Labour Code accordingly, in 2011. After the election in 2012, the centre-left government of Robert Fico enacted provisions which changed the protection of the employees, strengthened the rights of the trade unions and approximated the different types of tax related to the various employment forms (EC SWD 2012c, Sikulová – Frank 2013).

The shadow economy has influence on the Slovak labour market as well. Estimations as to the extent of the shadow economy are very much different from each other. Schneider and A.T. Kearney (2013:4) estimate that the size of the shadow economy is only 15 percent of GDP, while according to Lichard et al. (2012:11) it is 28.6 percent, based on data from 2008. Although a year passed between the publication dates of the studies, it cannot explain the significant difference. In any case, the low level of employment suggests that the shadow economy is extensive.

Trade union density in Slovakia decreased further during the crisis, from 20 percent in 2007 to about 15 percent in 2012. There are few strikes, there were three genuine strikes between 2005 and 2010, and one symbolic warning strike in 2011. Collective agreements are concluded mainly at the company level, but there are multi-employer agreements as well, which can be extended to other employers according to certain rules. There are frequent changes in the regulations on whether or not the employer's consent is needed for the extension (Eurofound 2014). Maintaining a certain level of flexibility is important also because uniform collective agreements would not make it possible to set out wages which are reflecting the differences in regional development.

Expenditure on social protection benefits was only 16 percent of GDP before the crisis, and 18 percent in recent years. Due to the effects of the crisis the austerity measures affected rather the public sector's wages and the expenditures of the central government. The at-risk-of-poverty rate and the indicators for inequality increased a bit but the EU 2020 poverty indicator did not. The rate of the severely materially deprived is about 10 percent. In the social field, major changes to the pension system were adopted in 2012 due to the ageing of the population and the resulting problems of sustainability. The deficit of the first, pay-as-you-go pillar was compensated by temporarily reducing the contribution rate of the second pillar from 9 percent to 4 percent and the funds were rerouted towards the first pillar. Pension savers were allowed to opt out of the second pillar and voluntary participation was reintroduced for new labour market entrants, who can decide whether or not to participate. Calculation of the pensions from the first pillar was made stricter and the pension regimes for special categories such as the armed forces and police were also curbed (EC SWD 2013j:13-14).

2.4. Hungary

In Hungary the 2010 parliamentary election brought a change of government. The right-wing government started to move along a path – evoking a lot of conflicts – which was different from the one usually taken by the governments of the region after the change of political system. Therefore the processes of the last one and a half decades are detailed below, in this section. Hungary is the only from among the post-socialist EU members which could not gain anything from the pre-crisis prosperity, and in 2007 economic growth was as low as 0.5 percent. The public debt had been on the increase since 2002 (it was 51.9 percent in 2001 and 65.9 percent in 2007), which was in line with the government deficit moving between 6.4 percent and 9.4 percent between 2002 and 2006. The effects of the austerity measures started after the 2006 parliamentary elections were felt first in 2007 when the deficit went down to 5.1 percent. High public debt was coupled with high external indebtedness, increasing from

66 percent of GDP in 2004 to 120 percent of GDP at the end of 2008, and the majority of this was private debt. The state debt accounted for 40 percent. This was the reason why investors' confidence was shaken in the Hungarian securities in spite of the results of fiscal consolidation after the outbreak of the global financial crisis and it became more and more difficult to sell the Hungarian government bonds.³ The Hungarian forint depreciated by 25 percent in October 2008. At this point Hungary required international loan, thus a combined credit package of EUR 20 billion was granted by the IMF, the World Bank and the EU in November 2008 (OECD 2010d: 20-22). The government had to continue fiscal consolidation thus they could not mitigate the effects of the crisis. The Hungarian economy shrunk by 6.6 percent in 2009, which was considerably greater than the decline suffered by the Czech or the Slovak economies. 2014 is the first year when it can be expected that the rate of growth would exceed 3 percent and then it would move between 2-2.5 percent. In spite of the fact that the government deficit is kept under 3 percent, government debt is going to remain between 75-76 percent in the years to come.

Hungarian people got disillusioned with the policy pursued by the socialist-liberal governments during two terms between 2002 and 2010, and Fidesz was elected by a two-third majority. Eight years passed and it was again Viktor Orbán who formed government. Notwithstanding domestic backup, the new government soon had to experience that the EU did not support its economic policy, thus the government could not stimulate the economy by temporarily loosening the budget. When they had been in opposition, Fidesz attacked viciously those austerity measures of the centre-left government which affected the households. If they had continued such measures it would have rapidly led to their losing face. Therefore the government imposed special taxes to those sectors of economy which were mainly in foreign ownership. They did not want to give up their intention to introduce the 16 percent flat personal income tax. The earlier mandatory private pension pillar served the purpose of making up for the loss in revenue and paying back the IMF loan. This second pension pillar was de facto eliminated in 2011, which meant a one-off revenue in the amount of 9.7 percent of GDP (EC SWD 2012a:12).

The Hungarian banking sector – similarly to the CEEC – was not exposed to toxic assets and the banks (the majority of them in foreign ownership) could rely on the help of the parent banks when the international markets were showing the signs of drying up. Since the privatization there had been considerable growth in profits in the banking sector but profitability has been declining since 2007. Events took a dramatic turn when the Hungarian forint depreciated drastically against the Swiss franc, and the greatest part of residential housing loans were denominated in Swiss franc. Foreign currency borrowing became widespread after 2003 – when home-loan subsidies for loans in forint was tightened (it was no longer sustainable for government budget) – and there were over-optimistic expectations that Hungary would soon enter the euro area. The interest rates were high on forint loans so it seemed a good idea to obtain foreign currency loans: the households borrowed mainly in Swiss francs. Foreign-owned banks were ready to offer foreign currency-denominated loans and later the domestic banks followed suit. The Hungarian banking system does not appear to be concentrated at first sight but competition is weak in retail market. This could be observed in case of the loan contracts: it was the households which were to take risks dominantly (OECD 2010d).

The national bank and the Hungarian Financial Supervisory Authority sounded a note of caution but they could not do much since they did not have any possibilities for action due to the legal regulation. The government ignored such warnings and did not want to limit the

³ On the functioning of the financial market during the crisis in the Central-East European countries see Kiss – Kosztopulosz (2013).

financial possibilities of the households in this field, especially that there were fiscal austerity measures as of 2006. After the outbreak of the crisis the successive governments started active regulation. After 2011 the conditions for obtaining foreign currency loans were as strict as if it had been prohibited. It could not be helped though that at the end of 2011 65 percent of residential loans were denominated in foreign currency, accounting for 20 percent of GDP. Its amount was double the Polish or the Romanian volume of loans (and in case of Romania, loans were at least denominated in euro) (Hudecz 2013:273).

During the crisis the amount of payment soared and the general economic environment of the firms was unfavourable therefore the portfolio quality of the banks declined and the proportion of non-performing credits or shorter maturity delinquencies elevated as well. As of 2010, the centre-right government put huge burden on the banking sector in its activity of fiscal consolidation and solving the problems of FX borrowers, partly in the form of extra taxes, partly in the form of the controversial scheme in 2011 allowing for an early repayment of households' FX mortgages at a fixed exchange rate well below the relevant market rate. The effect of such measures are estimated to be around 1¼-1½ percent of GDP. As of mid-2010 the aggregated balance sheet of the commercial banking sector had been decreasing and came to a halt in 2013. The banking sector was loss-making in 2011-2012, but this loss has been borne disproportionately by the banks. Those banks are suffering the greatest loss which were the most active in providing household loans (ECFIN DG 2014h:38-40). Foreign-owned banks reduced their Hungarian exposure, in 2012 foreign ownership of the banking system decreased to exactly 50 percent of total assets of the Hungarian banking sector (EC SWD 2014e:54). In 2013 the Hungarian Financial Supervisory Authority was integrated into the central bank in order to be able to avoid, in the future, those macropudential problems which occurred in the mid-2000s. FX loan conversion into forint is expected to take place in 2015, using the central bank's official exchange rate on 7th November 2014. The commercial banks were allowed to obtain the currency necessary for performing the conversion scheme and the National Bank of Hungary provided the amount from its reserves. In view of the surge of the Swiss franc in January 2015, it can be said that for all actors this conversion has been an option by which an even worse situation can be avoided.

The difficulties and problems the Hungarian economy has to tackle are not restricted exclusively to the financial system. By 2013 Hungary had suffered a 19.2 percent decline in terms of export share during the preceding five years. Higher value was registered only in case of Croatia from among the post-socialist EU members. Pre-crisis current account deficit was quite considerable – around 7 percent – which was eliminated as of 2009 by the fact that import decreased even at a greater extent than export. Since then a minimal surplus can be detected as a result. In 2013 the current account ran a 3 percent surplus. Although since its decline in 2009 export has been on the increase (its rate is slow but continuous), the data on export market share indicate that the problem is with the Hungarian economy's competitiveness. The reason for this cannot be found in price-competitiveness because REER deflated by ULC depreciated steadily during the crisis. The Hungarian export structure is favourable: the share of high-tech products is one of the highest in the EU. The key drivers of exports are machinery and manufacturing transport equipment, their unit value has been the highest from among the Visegrád countries since the beginning of the 2000s; as for the other sectors, Hungary is on a par with the other Visegrád countries. But the decline in competitiveness can be felt in these sectors as well. The productivity of the Czech and Slovak manufacturing sector exceeded that of Hungary as early as the mid-2000s. As far as product upgrading is concerned, the Hungarian economy is lagging behind its peers. FDI stock in manufacturing was lower in 2011 as it had been in 2000. In 2011-2012 significant improvements were made in the automobile subsector and in 2013 the negative trend of losing export market shares turned around. Nevertheless, it could not change the fact that investment

rate is the lowest in Hungary from among the Visegrád countries. Hungary is highly integrated into the world economy with three-quarters of exports going to the EU member states but the domestic value added content of exports is relatively low. Around 75 percent of exports are produced by foreign-owned companies but the Hungarian SME sector remains to be connected only to some extent, the spillover effects are low, and the dual structure of the economy survived. The innovation system should be enhanced in order to increase domestic value added (ECFIN DG 2014h:20-26).

Hungary is among the moderate innovators in the Innovation Union Scoreboard in 2014, taking the fourth place – following Slovenia, Estonia and the Czech Republic – from among the post-socialist EU member states and occupying the 20th position if all member states are taken into account. R&D expenditures increased from the pre-crisis 1 percent of GDP to 1.3 percent of GDP in 2012. This increase can be attributed to the business sector, in 2012 0.85 percent of expenditure was provided by the business sector (European Commission 2014c:5, 82). Innovation activity is very much concentrated in terms of space and actors alike; innovation is concentrated around mainly Budapest, and around some foreign-owned firms (ECFIN DG 2014h).

The problems of the Hungarian economy's competitiveness and its duality have been known to the successive governments. The centre-right government, which came to power in 2010, drew the conclusion that recipes aiming at building a traditional, more perfect market (e.g. Pina 2014) are not suitable for solving the problems, and what is needed is a more powerful countenance and presence of the government. Although the special sectoral taxes were introduced because there was the obligation of fiscal consolidation – which were extended to and imposed on the financial as well as the energy, telecommunication and retail sectors – the government interferes further than that in the economy. Head of the Hungarian government, Viktor Orbán is convinced that energy prices necessary for competitiveness cannot be reached by strengthening competition alone, but by government-driven price regulation. Obviously these measures are inseparably intertwining with the intention of holding on to political power. In 2013 residential energy prices were reduced by 20 percent, which was like a trump card for Fidesz: in 2014 they won the parliamentary elections again. The government handles FDI in a selective manner and concludes “strategic agreements” with those industrial companies which they consider economically desirable. Not only does the government interfere with and intervene into economy as a regulator to an extent and in a manner which is unusual in the EU member states but it also intends to increase state ownership in those fields which are considered to be of strategic importance (primarily the energy sector, public utilities and the banking sector). In order to achieve this aim, the government would go the any lengths and it does not hesitate to make financial sacrifices or to come into conflict with foreign owners. Between 2010 and 2013 the value of state shareholdings doubled (Voszka 2013:1292). This economic policy has made the Hungarian economy's renown even worse internationally, which can be detected in the positions obtained in the various rankings of competitiveness (e.g. Schwab 2014:13, World Bank 2014:4), but for many Hungarians having disappointed in the capitalist transformation, this economic policy meant certain security and justice against the banks which made huge profit before the crisis, the energy companies, which were in monopolistic position and the commercial chains, which used their dominant positions against their domestic suppliers.

In the first years of economic transition the number of the working population decreased by 30 percent, and the majority of those elderly or Roma or low skilled workers who became unemployed could not enter the labour market again thereby were in need of the social protection system. Low level of unemployment became persistent. The crisis further deteriorated the situation and the unemployment rate, which had been around 7 percent, increased above 10 percent as of 2009. The new role taken by the government can be traced in

how they handle the problem of unemployment. According to the centre-right government, the welfare states typical of Western-Europe cannot be sustained therefore the welfare system has to be replaced by the work-based economy, known as the workfare system. The activity rate started to rise due to strict measures addressing early retirement, disability pension and certain parts of the social assistance system and as the result of further liberalisation of the Labour Code in 2012. The government's public work scheme is supposed to make up for the missing jobs in the private sector (EC SWD 2014e:23). In 2015 the average number of employed in the scheme was about 200 thousand. This has been the first time since the change of the political system that they managed to push the employment rate above 63 percent – with the help of this scheme – which is still well below the EU average (68.4 percent). The unemployment rate decreased to 10.2 percent in 2013 and it is expected to go below 8 percent in 2015. The indicators for employment are improved by the fact that during the crisis – with the opening of the German and Austrian labour markets – temporary migration speeded up. A research found that at the beginning of 2013 there were 335,000 Hungarian citizens (aged 18-49) who had permanent residence in Hungary but were staying abroad. Those who move abroad are younger and more qualified than the residents in Hungary (Gödri et al. 2013:43-44). When the question of employment arises, the size of the shadow economy has to be taken into account as well. According to Schneider and A.T. Kearney (2013:4) it is not insignificant – 22 percent of GDP – in Hungary. According to Bublik and Tóth (2013:25) informal income of the Hungarian population amounts to 17-18 percent of GDP.

Although the government considers public work a temporary solution due to the structural problems it is not likely that the market would be able to replace it soon. The employment of the low skilled is invariably a challenge because the newer and newer generations of the young leave school without appropriate qualifications. In the Roma population (about 6 percent of the total) the employment rate does not reach 30 percent (OECD 2010d:135). The government wishes to centralise the structure of public education with the intention of elevating the standard of education (in a uniform manner) to a higher level. However, for the time being, what is known is that the 2012 PISA survey gave account of the performance of the Hungarian students as being below average (EC SWD 2014e). According to EACEA (2013:7) public spending on education was 5.3 percent of GDP in 2008, and data for the years after 2008 are provided on a provisional basis: for 2011 it is 5.2 percent of GDP. According to data provided by Eurostat, the 5.1 percent in 2008 decreased to 4.7 in 2011. Dual training was introduced in 2013; it remains to be seen whether it proves to be successful, or not. The reforms concerning higher education came to a standstill before the 2014 parliamentary elections. Although the government remained in power, the already elaborated conception was abandoned and at the end of 2014 a new proposal was put forward for discussion and accepted in 2015.

The trade unions did not play an important role in the profound changes implemented by the Orbán cabinet in terms of economic and social policies, although there were a few strikes and demonstrations. Trade union density is only 11 percent. Collective agreements have shifted to company level. The forum for tripartite conciliations, the National Interest Reconciliation Council, where negotiations were held on the general increase in gross wage, was reorganized and converted into the National Economic and Social Council as of 2011. The members of this council included not only the representatives of the employer and employee organisations but other civil organisations (associations for large families, disabled people, etc.), representatives of the Churches and it became a professional advisory board (Eurofound 2014).

In the social assistance system the austerity measures mentioned earlier have not represented the only important change since 2010. The population of Hungary started to decrease earlier than in the neighbouring countries. In this rapidly ageing country family

policy is in the centre of attention but the most important means applied are the tax advantages, from which only those can benefit whose income is higher. In the region only Hungary (and Slovenia) spend a few percentage points more than 20 percent of GDP on social protection but this had been on the decrease and it was 21.8 percent in 2012. As the result of persistently modest growth, low level of employment and the flat personal income tax introduced in 2011 the social inequalities increased and the indicators of poverty deteriorated. In 2013 almost one-third of the Hungarian population was below the EU 2020 poverty criteria, and the proportion of severely materially deprived people was 26.8 percent, which means that the Hungarian situation is far more serious than in the other Visegrád countries. Based on its economic performance it can be said that Hungary drifted away from the path the other Visegrád countries were taking in the second half of the 2000s. As the result of the changes which have been going on since 2010, the role of the government has come to the forefront to such an extent, and centralisation has been performed at such a level in the spheres of public administration, economy, education, healthcare etc. that currently Hungary's institutional system is also different from that of the other Visegrád countries. Only time will tell whether or not the government has been right in hoping that with the help of the changed institutional system the country will reach the level of economic performance of the Visegrád countries again.

Table 4 Changes in the institutional system in the Visegrád countries

	Product markets	R&D, innovation system	Financial system	Labour market	Industrial relations	Social protection	Education
Before 2008	liberalised, FDI significant in tradable sectors	innovation system weaker than EU average	bank based predominantly foreign owned	liberalised at EU level meagre role of active labour policy	meagre role of trade unions	below the EU average but higher than in the other post-socialist EU members	no characteristic model
Characteristic institutional and regulatory features after 2008							
Poland	forced, slow privatisation FDI significant in tradable sectors domestic value added relatively low	moderate innovator	prudent regulation stable banking system continuous adjustment of house prices	segmented labour market	weakening of union density	hesitating pension reform weakening of the second pillar	significant improvement in PISA results reforms in vocational training and higher education to improve employability
Czech Republic	FDI significant in tradable sectors domestic value added relatively low	moderate innovator	prudent regulation stable banking system	no change	weakening of union density	hesitating pension reform	average PISA results huge quantitative growth in higher education enrolment
Slovakia	FDI significant in tradable sectors domestic value added relatively low	moderate innovator	prudent regulation stable banking system continuous adjustment of house prices	flexibility enhancing regulation, later stricter employment protection legislation	weakening of union density strengthening of the legal position of trade unions	pension reform restrictions in the first pillar weakening of the second pillar	PISA results below average substantial quantitative growth in higher education enrolment

Table 4 Changes in the institutional system in the Visegrád countries (continued)

	Product markets	R&D, innovation system	Financial system	Labour market	Industrial relations	Social protection	Education
Hungary	FDI significant in tradable sectors domestic value added relatively low strengthening the role of the state as owner and regulator sectorial extra taxes in services	moderate innovator	foreign currency house loans weigh on banking system, regulatory tightening after the crisis, extra taxes continuous adjustment of house prices	further liberalisation	weakening of union density	reduction of social protection elimination of the second pillar in the pension system	PISA results below average centralisation of public education to ensure standard quality introduction of dual vocational training hesitating higher education reform

Source: Author's compilation

Conclusions

The essential elements of the Central and Eastern European model of capitalism have not changed since the 2008 global crisis in the Visegrád countries (Table 4). The liberalized product markets have been maintained in Poland, the Czech Republic, and Slovakia. Recently the Hungarian government has been experimenting with “unorthodox” economic policy. It increases its share in companies regarded as of national strategic interest and builds the network of state-owned firms especially in public utilities, energy sector and banking.

There is no significant change in innovation systems and their relative positions in the EU. Even Poland which did not suffer from the contraction of the economy did not utilise this advantage to accelerate the development of R&D. Financial systems are stable in the region, parent banks ensured capital to maintain capital adequacy ratio required by Basel rules.

The crisis increased unemployment all over in the EU. The Visegrád countries – like others - responded to this challenge by liberalization their labour market even further. In the industrial relations the decentralisation of collective bargaining has become a general trend. Union density has fallen further. Almost everywhere social protection has been reduced due to fiscal consolidation. In ageing societies of the Visegrád countries the tightening of pension benefits has taken place. The distance between the level of the Northwestern and Central and Eastern European social protection has not diminished. Education systems have not received a strategic role or their development is controversial.

To sum up, the Visegrád countries’ modernization is still built on FDI and they are able to sustain their competitiveness by relatively low wages and low social expenditure. The economic growth rate seems to remain lower than before the crisis but the economic convergence to EU average is continuing – contrary to the Mediterranean countries.

However the limits of the model have become more and more obvious. The catching up of one of the most developed post-socialist member states, the Czech Republic has stalled since 2007; in Hungary the search for alternative economic policy solutions is a kind of answer to the disappointment of population which expected an Austrian type of social market economy. The Visegrád countries are already highly integrated into world economy but further catching up with core countries and the maintenance of their competitiveness require increasing the importance of domestic value chain. One of the most important lessons from the last two decades is that the positive FDI spill-over effects are limited in market transactions. Failing to bridge the productivity gap between foreign and domestic companies makes catching-up impossible (Farkas 2013). Earlier this relationship was left out of account but recently both the EU Commission and OECD analysts have recognised that comprehensive reforms are necessary to develop an internationally competitive domestic economy because it is not an automatic result of the FDI-based modernisation. This is also a prerequisite to get closer to the model of European social market economy in the CEEC. Recently the authors of these analyses took into consideration that the convergence potential of the model is limited, if the export capacity of the companies in the CEE countries is closer to the lower end of the value chain. The criteria for persistent convergence are to move upwards in the global value chain, to strengthen the indigenous growth drivers, to improve the quality of the institutions and to develop education and the innovation system.

The three countries which suffered the smallest loss during the crisis – Poland, Czech Republic and Slovakia – enjoy some advantages (favourable composition of FDI, good geographical location, fiscal discipline). However it is an open question whether they will be able to use their advantages and break through the limits of the Central and Eastern European model of capitalism and they follow a different development path.

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