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Lessons from Reforms in Central and Eastern Europe in the Wake of the Global Financial Crisis

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Abstract

The response of the ten new eastern members of the European Union to the global financial crisis has valuable lessons of crisis resolution for the euro area. These countries were severely hit by the crisis in the fall of 2008 and responded with extensive reforms. Crisis made the unthinkable possible. This paper outlines the main reform measures that the ten Central and East European (CEE) countries carried out. It then quantifies to what extent the CEE countries resolved the macroeconomic crisis and explores the effects of the reforms on future growth prospects. The fourth and major section discusses how the political economy of the crisis resolution actually worked. Finally, the author examines what lessons euro area countries can learn from the crisis resolution of the newest members of the European Union.

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INTRODUCTION

In the fall of 2008, several of the ten new eastern members of the European Union were severely hit by the global financial crisis, and they responded with extensive reforms. Many lessons can be drawn from their political economy and reforms, which can be summarized in the dictum: Crisis made the unthinkable possible.

Central and Eastern Europe (CEE) had gone through an impressive systemic transformation since the magical year 1989. The dominant slogan was, "We want a normal society," by which people meant democracy, a market economy based on private ownership, and the rule of law. A second desire was for a "return to Europe," which meant not only the European Union but also European values, institutions, and of course standard of living.

Poland and Hungary were the pioneers in postcommunist transition. Both undertook radical deregulation in 1990, as measured by the European Bank for Reconstruction and Development (EBRD) transition index. In 1991, Czechoslovakia undertook an even more radical market reform. Its division into two countries, the Czech Republic and Slovakia did not impede the economic reforms significantly in either state. By 1992, these four countries were full-fledged market economies. Hungary was the only postcommunist country never to face very high inflation. As a result it never carried out a radical fiscal adjustment but had as large public deficits and debt as it could bear for many years (Åslund 2007, chapter 4). Slovenia carried out its successful transition to a market economy within Yugoslavia, and when it slipped out of that federation, it was already the most highly developed postcommunist state.

In August 1991, the three Baltic states—Estonia, Latvia, and Lithuania—became independent. In 1992, they faced a massive financial crisis caused by the collapse of the Soviet Union. All three countries had inflation just below 1,000 percent that year. They responded by launching radical market economic reforms, which were most radical in Estonia, arguably the most far-reaching market reforms in any postcommunist country, while Lithuania followed closely. Latvia's deregulation was insufficient and bred a group of oligarchs who thrived on rent seeking arising from foreign trade regulation. Yet by 1994, this group had carried out such radical structural reforms that they matched Central Europe as full-fledged market economies in spite of much more difficult initial conditions.

Romania and Bulgaria started with fewer reforms. In Romania, communists stayed in power, while Bulgaria suffered from severe polarization, complicating its reforms. Their half-hearted initial reforms led to their financial crises in 1996–97, which caused hyperinflation in Bulgaria, leading to its adoption of a currency board and radical reforms. Both Romania and Bulgaria have had lasting problems getting corruption and organized crime under control.

In 2004, the first eight CEE countries were admitted to the European Union.[1] Among them, Hungary stood out for poor fiscal discipline and large public debt. In 2007, Bulgaria and Romania followed suit. Their problems were legal and a lower level of economic development, being the two poorest EU countries. All the accession countries were compelled to carry out substantial, additional structural reforms during the accession process, promoting real economic convergence. Inflation abated, though stayed higher than in Western Europe. Almost 80 percent of GDP arose from the private sector, according to EBRD (2011). Economic growth has been substantial in the whole region, with the late reformers catching up in the 2000s.

In 2008, several of the ten CEE countries were in a state of severe overheating. This was especially true of the three Baltic countries, Estonia, Latvia, and Lithuania, but also of Bulgaria and Romania. A standard credit boom and bust cycle ensued, which led to a current account crisis. By contrast, the Central European countries did not suffer from much overheating. Poland, the Czech Republic, Slovakia, and Slovenia had no particular crisis, while Hungary's problem was long-lasting fiscal laxity. From 2005 to 2008, inflation surged everywhere and hit double digits in Bulgaria, Estonia, Latvia, and Lithuania. In particular, wages and real estate prices soared, rendering these countries less competitive, which further undermined their current account balance. With the onset of the financial crisis in late 2008, output plunged and unemployment soared. Three countries—Hungary, Latvia, and Romania—required emergency programs from the International Monetary Fund (IMF).

The positive surprise is that after two years, the crisis in the region abated and economic growth returned to all countries after decisive and successful crisis resolution. What lessons can the rest of the European Union, and especially Italy, draw from the resolution of this financial crisis? A big issue was whether to devalue or not, but since no country altered exchange rate policy and devaluation is not an option for euro area countries, I discuss currency issues only in passing in this paper.

By 2010, CEE countries overcame their crises (with the exception of Hungary) but Southern Europe entered a serious fiscal crisis, which remains severe. These crises were somewhat different in their nature. The CEE countries had primarily a current account crisis, while the South European countries have primarily a public finance crisis. Some of them have too large public debts (Italy), some have too large budget deficits (Spain), and some have both (Greece and Portugal). Yet both these crises are financial and the ultimate victory is to regain investor confidence and competitiveness. In this paper I examine what lessons South European countries can learn from the crisis resolution of the newest members of the European Union.

In order to understand what has happened and what broader lessons can be drawn, I first outline the main reform measures that were carried out. The second section quantifies to what extent the CEE

1. The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.

countries resolved the macroeconomic crisis. The third section explores the effects of the reforms on future growth prospects. The fourth and major section discusses how the political economy of the crisis resolution actually worked. Finally, I conclude with some thoughts on wider implications for the euro area and Italy.

The most radical and successful changes took place in the three Baltic countries, particularly in Latvia but also in Lithuania and slightly less so in Estonia. Therefore, I pay special attention to the policy changes of these three countries, regardless of their small size. A conclusion of importance for euro area countries is that devaluation was neither necessary nor beneficial for regaining competitiveness. On the contrary, if a country maintained a fixed exchange rate, it was forced to undertake more structural reform. The political economy was highly professional but not miraculous, increasing its relevance for the euro countries.

MAJOR ANTICRISIS MEASURES

None of the four countries with pegged exchange rates—Latvia, Lithuania, Estonia, and Bulgaria—devalued, although they had the biggest current account deficits. Instead, they pursued "internal devaluation," cutting wages and public expenditures, which rendered their cost levels competitive and allowed them to turn their large current account deficits swiftly into substantial surpluses. Depreciation is a much overadvertised cure in current macroeconomic discourse.

The anticrisis measures consisted of large fiscal adjustment, primarily substantial public expenditure cuts, and only minor tax increases. In order to cut production costs, substantial wage cuts were undertaken, foremost in the public sector but also in the private sector. Where public expenditure cuts were large, they drove substantial reforms in public administration, health care, and education, which promoted growth. Other such measures were deregulation of labor markets, while the social safety nets for the poor were safeguarded, though social benefits for the middle class were trimmed.

Especially the three Baltic countries, but also Bulgaria, Hungary, and Romania, undertook radical fiscal adjustments in early 2009. They were remarkable in three regards: They were big, highly front-loaded, and consisted of three-quarters of expenditure cuts rather than revenue measures. If policies had not changed, the IMF assessed that in 2009 Latvia would have reached a budget deficit of 18 percent of GDP, Lithuania 16 percent, and Estonia more than 10 percent of GDP. Therefore, these countries undertook that very year gross fiscal adjustments of 13.9 percent of GDP in Latvia, 8.8 percent of GDP in Estonia, and 8 percent of GDP in Lithuania (Purfield and Rosenberg 2010, 17–18).

The Baltic fiscal adjustments were concentrated to the first half of 2009, and virtually all confidence indicators (interest rates and credit default swap [CDS] rates) peaked during that half year. While Latvia carried out 60 percent of its needed adjustment in the first year (out of a total adjustment of 16 percent of the GDP suggested by the IMF), Greece did less than 30 percent of its required adjustment in 2010 (6 percent of GDP out of a total fiscal adjustment of 20 percent of GDP as assessed by the IMF) and seems condemned to many years of declining output. Expenditure cuts were preferable to tax hikes because expenditures could be reduced much faster than revenues could be raised, and people do not appreciate tax hikes when they receive fewer public services and transfers. They wanted the government to exercise belt-tightening when it had to do so.

Large cuts in public expenditure had the added advantage that they had to be selective, which made them drive structural reform, such as slashing red tape, thus facilitating growth. The Latvian government targeted three sectors for far-reaching structural reforms, namely public administration, health care, and education.

Administrative reforms with severe cuts in the state apparatus surprisingly turned out to be politically easy, because most people wanted fewer bureaucrats and less bureaucracy. The Latvian government closed down half of its 75 state agencies. Eventually, no fewer than 23,000 or 29 percent of its civil servants were dismissed. The average public wage was cut by 26 percent in one year. The ministers set an example by accepting salary cuts of 35 percent. Other appreciated measures were a ceiling for the salaries of managers of state corporations, not to mention the firing of 1,000 out of the 5,000 employees of the State Revenue Service (Åslund and Dombrovskis 2011). Lithuania similarly cut public wages by 20 percent.

By contrast, wage cuts throughout the economy were hard and unpopular. Wage cuts were smaller in the private than in the public sector, but they were substantial. By the end of 2009, average earnings had fallen from the peak by 11 percent in Latvia, 9 percent in Lithuania, and 6.5 percent in Estonia (Purfield and Rosenberg 2010, 24).

Latvia already had a master plan on optimization of the hospital network. A country of 2.2 million, Latvia had far too many hospitals—a Soviet inheritance of more hospital beds than medical care. Therefore, the government decided to close 35 out of 59 hospitals by 2013 to the benefit of the people's health. The country would still have 24 hospitals, which is plenty by any international standard.

The situation was similar in education. During the boom years reforms that were politically unpopular could not be implemented. Given that the population had declined by 15 percent since independence, and birth rates remained low, Latvia had too many schools and teachers. It had one teacher for every seven students—the highest ratio in Europe—with the European average ratio at one teacher per 12 students, which is still very high due to sharply falling birth rates in many countries. In order to encourage saving and efficiency, the government introduced the principle that education funding should be based on a fixed amount per pupil in each category to downsize the number of schools and raise the pupils to teacher ratio gradually to the average European level. More than 100 schools were closed, and 2,400 teachers were laid off in 2009. Latvia also had too many institutions of higher learning, and none of them outstanding, suggesting the need for rationalization and quality improvement. Lithuania undertook a similar reform of higher education, tying financing to students.

The tax system has gone through a long-term structural change, switching the tax burden from incomes and profits to consumption and property to stimulate work and enterprise, while the total tax burden increased marginally. The number of taxes remains small. Many countries raised excise taxes and eliminated loopholes in the value-added tax (VAT). The worst hit crisis countries, Latvia, Lithuania, Hungary, and Romania, were forced to raise their VAT by a few percentage points. The largest hike was in Romania, where VAT increased by 5 percentage points from 19 to 24 percent. Property taxes were raised in a few countries, notably Latvia and Romania, but the Romanian Constitutional Court aborted the Romanian property tax.

Income taxes have not been raised anywhere. The flat personal income tax stays popular. When the crisis hit, six of the ten countries had flat income taxes, ranging from 10 percent in Bulgaria to 23 percent in Latvia. Now their number has expanded to eight as the Czech Republic introduced a flat income tax of 15 percent in 2008, and the Hungarian government adopted one of 16 percent in 2011. In general, personal taxes have gradually been reduced. Lithuania has done so most radically, slashing its flat personal income taxes from 33 percent in 2006 to 15 percent at present.

Corporate profit taxes are similarly low, from 10 to 19 percent, and they have barely changed. Exceptionally, Lithuania hiked its corporate profit tax for one year in 2009, but this was generally recognized as a mistake and was reversed one year later. This tax structure with low flat income taxes and equally low or even lower corporate profit taxes offers people and entrepreneurs excellent incentives for work.

Most of the CEE countries have a reasonable business environment, but virtually all of them tried to improve it further during the financial crisis. The easiest reforms were deregulation of markets. The Baltic countries had largely liberalized their markets for goods, services, and capital, but with the guidance of the World Bank's ease of doing business index they advanced further.

Several countries also carried out substantial liberalization of their labor markets, removing restrictions on flexible work arrangements, and unemployment has fallen fast from high peaks, for example, from 20.7 percent in Latvia in the first quarter of 2010 to 14.4 percent in the third quarter of 2011. Most governments have established substantial job support programs with EU funds. The two goals of increasing employment and social safety have been reasonably balanced.

The single big failure during the crisis has been reversal of pension reform. Public pensions have expanded at the expense of private pension schemes and their share of GDP has risen, as dictated by equity concerns and fiscal necessity. Their respective Constitutional Courts revoked pension cuts in Latvia, Romania, and Lithuania. The country that advanced the most with entitlement reform during the crisis was Hungary, which even decided to raise the retirement age. Governments need to proceed with pension reform, restoring the funding of the second, private pillar of the pension system and eliminating plentiful early pensions. Such efforts have started. In June 2011, the Lithuanian parliament legislated a gradual increase of the retirement age to 65 for both men and women to render the public pension system financially sustainable (IMF forthcoming).

THE MACROECONOMIC CRISIS HAS BEEN OVERCOME

We are interested is two kinds of outcomes. First, has CEE got the macroeconomic situation under control? Second, have these countries developed conditions for a return to high economic growth? In the ensuing figures, Greece, Italy, Spain, and Portugal (the South Europeans) are offered as comparators. The three Baltic countries are often treated as one group, since they moved together, as are Slovakia and Slovenia, which have the euro; Bulgaria and Romania were similar in many ways and function as one group. Poland, the Czech Republic, and Hungary moved in parallel with their floating exchange rates.

Throughout the CEE region, swift economic adjustment took place from the beginning of 2009. The current account crisis that erupted in the fourth quarter of 2008 was settled in the middle of 2010, when economic growth had returned to all countries. The region as a whole lost two to three years of economic expansion, which was unfortunate but no catastrophe, considering the region's excellent growth from 2000 until 2008. In 2011, all the CEE countries grew significantly. By comparison, the South Europeans had much less growth before the crisis, though less of a decline in 2009, imbuing them with less of a sense of crisis (figure 1).

Seldom has the world seen such rapid shifts in the current account. The swing was the greatest in Latvia, where the current account went from a deficit of 13 percent of GDP in 2008 to a surplus of 9.4 percent in 2009—no less than 22 percent of GDP in a single year. Estonia and Lithuania also switched from big deficits to significant surpluses, while most other countries ended up close to balance. Admittedly, these improvements on the current account were mainly caused by austerity, but they proved possible. By 2010, no CEE country had a current account deficit larger than 4.5 percent of GDP, and the countries worst hit by the crisis displayed surpluses. Greece and Portugal, by contrast, still had current account deficits of 10 percent of GDP in 2010 (figure 2).

Inflation, which had hit double-digits in the Baltic states and Bulgaria in 2008, fell sharply in the deflationary climate of the global recession because of minimal credit issue. In 2011, most countries had moderate inflation of 3 to 4 percent (figure 3). The CEE countries have temporarily seized control of their price development, but inflation remains a concern, because so many prices are set internationally, especially for very small and open economies. The much-discussed fear of deflation turned out to be insubstantial. One country, Latvia, had deflation of 1 percent for one year (2009). As a consequence, the worry about a deflationary cycle turned out to be equally insubstantial. On the contrary, the real danger is high inflation.

CEE budget deficits were small in 2007 but increased because of the financial crisis, though not as much as in Western Europe. The average unweighted budget deficit of the ten CEE countries rose from 2.8 percent of GDP in 2008 to 6.6 percent of GDP in 2009, and it contracted minimally to 5.6 percent of GDP in 2010. Most countries are intent on reducing their budget deficits to 3 percent of GDP or less by 2012. This stands in stark contrast with Southern Europe, where budget deficits swelled to 10.6 percent of GDP in 2009 and stayed at 8.6 percent of GDP in 2010, with Italy as the big positive exception (figure 4).

Public expenditures rose as a share of GDP. Before the crisis, the EU-15 had average public expenditures of 46 to 47 percent of GDP. Central Europe had almost as high public expenditures, but their average was boosted by Hungary. The three Baltic states saw their public expenditures rise as a share of GDP from 35 percent in 2007 to 45 percent in 2009, while Central Europe experienced a marginal rise to 46 percent of GDP. Bulgaria and Romania had far lower public expenditures, peaking at 38 percent of GDP in 2010 (figure 5). In the crisis year of 2009, public expenditure as a share of GDP surged because of contracting GDP, soaring pension costs, and other social costs related to rising unemployment. Still, CEE largely abstained from state subsidies so common in Western Europe during the crisis. In Italy, Portugal, and Greece, public expenditures were high from the outset and have stayed excessively high, close to 50 percent of GDP in 2010. Unlike CEE, Southern Europe does not have such a clear ambition to reduce public expenditures.

Based on these criteria (GDP growth, current account balance, inflation, budget balance, and public expenditures), one can claim that CEE, with the exception of Hungary, has overcome the macroeconomic crisis. The region has sound economic growth, although much lower than before the crisis. The current account is reasonably close to balance. Budget deficits are moderate and set to fall further. Only Hungary has a public debt that exceeds the Maastricht limit of 60 percent of GDP, while most CEE countries have public debt of about 40 percent of GDP.

HAVE CONDITIONS BEEN CREATED FOR HIGH FUTURE ECONOMIC GROWTH?

Our second inquiry is whether conditions have been created for high future economic growth. By and large, the CEE countries had already advanced further in structural reforms than other countries at their level of economic development, which was a reason for their prior fast economic growth (except Hungary with its large public debt and high public expenditures).

A first measurement of structural reform is ranking on the World Bank's ease of doing business index. Among the CEE countries, Latvia has taken the lead, advancing to number 21 among 183 countries, while Estonia ranks 24 and Lithuania 27. Since Latvia ranks 60 in the world in terms of GDP per capita in purchasing power parity, this indicates substantial potential for further growth. Romania is doing the worst, ranking 72, but Italy ranks 87 and Greece 100 (figure 6). Typical recent reform measures have been to make it simpler to register property, to resolve insolvency, to pay taxes, to start a business, and to enforce a contract.

As a consequence of improved business conditions, corruption is abating. Transparency International's Corruption Perceptions Index offers a similar ranking, but the levels are slightly worse for CEE, reflecting that corruption changes more slowly than deregulation. Bulgaria and Romania rank equally poorly as Greece and Italy (figure 7).

The large structural adjustments of the CEE countries have had considerable, but varied, impact on real unit labor cost, which has been brought down by both nominal wage cuts and various forms of rationalization. Since 2008, the real unit labor cost has fallen in six of the ten CEE states. It fell most of all in Latvia by 16.4 percent from 2008 to 2011, followed by 11.7 percent in Romania, 9.5 percent in Lithuania, and 9.1 percent in Hungary (figure 8). Naturally, this means greatly improved competitiveness for these countries.

The real effective exchange rate (REER, based on unit labor cost) offers a revealing composite picture. The overall message is that either nominal or internal devaluation can work, but labor costs must be checked either way. The differences in development from 2008 to 2010 are amazingly large. Two countries stand out, Latvia and Poland, where REER fell by 17 and 12 percent, respectively. Also Hungary, Lithuania, and Estonia saw significant falls. By contrast, in Bulgaria, Slovakia, and Slovenia, the former with a fixed exchange rate and the latter two with the euro, REER rose by 9, 5, and 5 percent, respectively (figure 9).

Considering other factors, the three Baltic countries and Poland appear set for significant and steady economic growth, while Bulgaria, Slovakia, and Slovenia have ended up with too high a cost level, and Hungary suffers from other problems, primarily a large public debt and poor government credibility. The variations over 2008–10 were great, and the Baltic countries have shown how much can be accomplished without devaluation.

The most impressive effects of the crisis resolution are the most surprising. Exports have taken off in the four countries with fixed exchange rates. The latest available figures are for the first half of 2011, in which the Baltic countries and Bulgaria increased their exports by a stunning 29 to 42 percent in comparison with the first half of 2010. Romania formed an intermediary case with growth of 27 percent, while exports of the other five countries expanded by 14 to 20 percent. Spain, Portugal, and Italy all saw their exports grow at a rate of 15 percent, similar to that of Poland or Slovenia (figure 10). Export expansion led the recovery of output in all countries, and it was driven by a similarly rapid increase in manufacturing.

This result leads to one major conclusion: Contrary to conventional wisdom, depreciation is neither necessary nor beneficial to kickstart exports. Paradoxically, the country with the largest REER decline—Poland—experienced the smallest export expansion. Most of the explanation is that Poland never had any economic decline and thus had little free capacity.

A priori, this conclusion appears illogical. Depreciation should reduce export prices, and with normal price elasticity exports should increase. Such reasoning, however, would be incomplete. The actual choice was not between depreciation and a stable real exchange rate, but between nominal or internal devaluation. As we have discussed above, the countries with fixed exchange rates undertook far greater structural adjustments than those with floating exchange rates. Nominal devaluation spared Poland, Hungary, and the Czech Republic from the need to undertake more radical structural reforms.

Similarly, Slovakia and Slovenia, which enjoyed ample liquidity thanks to being members of the Economic and Monetary Union, did not face the same pressure to carry out major structural reforms and wage cuts as the countries with currency boards that had to defend their fixed exchange rates with little access to liquidity. This reasoning boils down to Janos Kornai's (1980) old argument about the impact of hard budget constraints. Export expansion was proportionate to the contraction of domestic demand, which was the greatest in the Baltic countries and Bulgaria.

The countries that have reached the highest export and GDP growth are Estonia and Lithuania followed by Latvia, while the three other crisis countries—Romania, Hungary, and Bulgaria—have had slower recoveries. The first three have been the leaders in structural reform during the crisis, which appears the most likely reason for their significantly better performance. The latter three focused more on austerity and less on structural reforms, which not surprisingly seems to have generated less growth.

The pattern is clear. The countries with fixed exchange rates undertook both more fiscal adjustment and structural reform, which resulted in faster export and output growth. These observations offer considerable hope for the countries in the euro area in need of structural improvements. The frequent claim that devaluation is necessary for increased competitiveness is simply not true.

For future growth, investment in human and physical capital is vital. Given the level of development, an investment ratio of 25 percent of GDP or slightly more would appear appropriate. At the peak of the boom, CEE investment ratios were if anything too high, ranging from 23.5 percent of GDP in Hungary to 40 percent of GDP in Latvia. These ratios plummeted during the crisis from 37 percent of GDP in the Baltics in 2007 to 16.5 percent of GDP in 2009. Yet, with economic recovery investment is resurging and seems likely to converge around 25 percent of GDP in the near future. Investment development in Southern Europe has very closely followed that in Poland, the Czech

Republic, and Hungary (figure 11). Investment needs to recover and if it does, it should be sufficient to sustain a significant growth.

The only real worry is that public expenditure has risen far too high. In Central Europe and the Baltics, public expenditure as a share of GDP has risen to 45 to 46 percent, and it needs to be brought down to 35 to 40 percent of GDP to allow for sound economic growth (Sachs and Warner 1996, Tanzi and Schuknecht 2000). Fortunately, most CEE governments have such ambitions.

THE POLITICAL ECONOMY OF POLICY REFORM IN CRISIS

How was it possible to carry out these necessary and successful measures? The political economy of policy reform is a fine art, with a substantial literature. The question is how it is most feasible to do what is necessary to accomplish the reforms needed to resolve an economic crisis and achieve desired economic growth. For our purposes, John Williamson's *The Political Economy of Policy Reform* (1994) offers an excellent overview.

A clear chain runs from the eruption of crisis through idea, political breakthrough, political leadership, expertise, operative policy formulation, and parliamentary support to implementation. In addition, international assistance is useful. No chain is stronger than its weakest link. The Baltic crisis resolution offers an example of virtually all the relevant elements and they were all well handled. No fewer than 13 standard elements were apparent in the Baltic crisis resolution. All of them are of a broader, general nature.

1. There was a *real sense of crisis*. The deeper the crisis, the greater the crisis consciousness, and the more structural reform was likely. The three Baltic countries experienced large falls in GDP—from peak to trough of 25 percent in Latvia, 20 percent in Lithuania, and 18 percent in Estonia. These disasters shook everybody, facilitating major adjustments. Nobody would argue for decline for the sake of reform, but often only crisis seems to bring about necessary reform (Drazen and Grilli 1993).

European countries that carried out major reforms did so after major crises, for example, Denmark from 1982, Holland from 1987, Sweden and Finland from 1991, and all the CEE countries from 1989. Pessimistically, nobody seems to learn from others' suffering but the optimistic view is that most learn from their own failures.

During the recent crisis, the cause of the huge slumps was predominantly external—the international liquidity freeze. In the fall of 2008, the Baltic economies hit a wall because of a "sudden stop" of international finance, which forced them to sharply increase their national saving and cut both investment and consumption.[2] In 2009, the exports of Slovakia and the Czech Republic declined

2. This notion was coined by Dornbusch, Goldfajn, and Valdés (1995) and Calvo (1998).

the most with 16.5 and15.8 percent, respectively (Bakker and Gulde 2010, 22). The Baltic countries, Slovakia, and the Czech Republic could all blame their output decline on external factors. Politically, it is easier for a small country to motivate major adjustment because its vulnerability to forces beyond the nation's control is so evident.

2. The crisis brought about *new thinking* based on new principles. Admittedly, the ideas that broke through during the CEE crisis—mainly to trim public expenditures and make the public sector more efficient—were not new, but they ran counter to old vested interests. The issue is not to find new, original ideas but to accept the ideas that made sense. Reformers gained popularity for their reforms by attacking the cronyism of the elite at the expense of the population.

Little could be accomplished without new lucid *ideas*. John Maynard Keynes's (1936/1973, 383–34) concluding words in his *General Theory* remained true:

> the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. … I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.

Serious reforms are always controversial, because the vested interests of the old elite are usually the root of the problems. The old elite will suffer from reforms, and it will not take its loss lying down but deploy its media in opposition to reform. As John Williamson (1994, 26) observed, reforms need "the will and ability to appeal directly to the public and bypass vested interests." Hence, in a severe crisis when radical new thinking is required, no consensus is possible and it is a waste of time to seek it. Moreover, to search for an early consensus means refraining from using the best ideas at hand. As Jeffrey Sachs (1994, 505) put it: "In deep crises, there simply is no consensus to build upon, only confusion, anxiety and a cacophony of conflicting opinions."

3. Crisis resolution required *new leadership* in most countries. Eight of the ten CEE countries changed government during the crisis. The only two surviving governments were the center-right governments in Estonia and Poland. Estonia could rightly blame external factors and the incumbent government acted resolutely, while Poland escaped crisis because of good policy. Leaders who had taken a country into a crisis were not likely to be able to carry out the radical changes that were needed to undo their previous policies and salvage the nation.

Usually, a government change preceded reforms, because a new government that is forced to fight a crisis has different objectives than a pre-crisis government. Ordinary politicians are usually good at horse-trading and compromises, but for crisis resolution, the opposite, namely visionary leadership and determination, is needed. "Successful domestic reform depends on vigorous political leadership" (Sachs 1994, 503).

The search for a new leader was often an iterative process, rendering political instability beneficial for finding an adequate leader. When reforms were ripe, people mostly voted for them. The common presumption that voters would throw out governments that pursued severe austerity programs or presided over large contractions of output proved incorrect. Since the main problem was the old elite, democracy was not an obstacle but the best means for beating them. Voters showed a strong desire for competent crisis management and fiscal responsibility.

During the crisis resolution in Latvia, the oligarchic parties that had dominated that country for two decades were defeated in two parliamentary elections in 2010 and 2011. Also, the ardent Estonian reform government won parliamentary elections after its reforms. Voters in Bulgaria, the Czech Republic, and Slovakia opted for more reformist governments after the crisis had taken hold. They all won elections by promising stricter fiscal policy. From October 2008 until December 2010, there was only one exception in eastern European Union, namely Hungary, where the government that carried out the austerity program lost the ensuing elections. Arguably it did so because the technocratic government was formally socialist and it was blamed from an old history of alleged corruption of the Socialist Party.

4. *Expert policymakers* came to the fore during the crisis resolution. Examples of such outsiders include Poland's Finance Minister Jacek Rostowski, who was a British professor of economics in Hungary, Bulgaria's Finance Minister Simeon Djankov, who was chief economist of the International Finance Corporation in Washington, and Latvia's Finance Minister Andris Vilks, who was chief economist of a Swedish bank in Latvia before joining the government. Such policymakers from outside the usual political circles were helpful for effective action because they have different knowledge and another perspective, not being prisoners of the old political game.

In a financial crisis, certain economic problems have to be resolved. Otherwise nothing else will function. For instance, hyperinflation is a common slayer of democracy as Germany and Central Europe showed in the inter-war period. Therefore, economics must be given primacy over law and constitutions. Consequently, economists rather than lawyers dominated successful crisis governments. Crises are times when laws and constitutions are changed to set up new institutions and reform the old ones.

5. *A comprehensive operative program for reform* was usually worked out immediately after a new government has been formed. It must be consistent and credible but simple. It should be short and readable but contain all essential policies. Such a program should preferably be presented within one month from the formation of a new government because any delay arouses broad public criticism. For example, in December 2008, the new Lithuanian government presented such a program one week after its formation.

The success of the economists lay in their preparedness to formulate simplified policy advice because reform requires simplicity and lucidity rather than nuance. In a crisis, leaders must focus on key concerns and not get distracted by side issues, which detract from policy focus and cause unnecessary strife. They must concentrate on repairing the main pillars of the economy.

6. *Parliamentary support* was necessary, because in virtually all democracies all major decisions on budgets and taxes must be legislated by the parliament. Yet the parliamentary support could be minimal. The Latvian and Lithuanian governments were multi-party coalitions, which at times could barely muster a majority. The Latvian government lost parliamentary majority in the summer of 2010 and was forced to an early election in the fall of 2011, one year after the last election, but it won renewed confidence, as it ran the election against oligarchs and cronyism. Currently, only one CEE country has a majority government—Hungary—and it is the least reformist.

Frequent arguments about a need for political stability and large parliamentary majorities for successful reform seem to lack all empirical basis. This was true also during the postcommunist economic transformation when the most successful reform countries, the Baltic countries and Poland, changed government every year (Åslund 2007). Reform is usually a matter of fighting vested interests, which tend to mend fences with any incumbent government after a few years.

7. *Measurement* was vital for policy focus. Whatever is measured can be accomplished. Macroeconomic measurements have been well established for many years, but until the late 1990s business environment and corruption were not measured. Then multiple methods were developed to reduce corruption, and it has started declining in numerous countries. The World Bank's ease of doing business index greatly helped Latvia and Lithuania to reduce bureaucratic impediments in the crisis, not to mention Bulgaria, whose finance minister is its author.

8. *International support* and *sufficient finance* were important. International organizations set standards, provide relevant policy advice, evaluate outcomes, and provide financing. The IMF remains the key international financial institution. It has several vital features: It is technocratic and the bearer of a limited number of key principles for macroeconomic stability. It has strong professional staff and well-trimmed procedures for the swift resolution of a financial crisis and for policy review. Moreover, the IMF can deliver a large amount of financing fast without any legislative decision.

Hungary, Latvia, and Romania received the early international support they needed. IMF and EU funds to these non-euro EU countries were offered at interest rates of 3 to 3.5 percent a year, which was essential for their avoiding a debt trap. The bilateral financing for Latvia was useful as a safety line, but the interest rate would have been about 6 percent a year. None of these countries needed to use all the international support offered, but it served the important function of convincing markets that the governments had got the crisis under control. As Lawrence Summers has written, "Program announcements that are vague and try to purchase stability on the cheap are more likely to exacerbate problems than to resolve them."[3]

Yet, the existence of an IMF standby program was not a convincing argument for structural reforms. It offered an interested government a tool for reform, if it so desired, while disinterested governments could just exploit it as a source of financing. Latvia carried out substantial reforms under an IMF program, while Hungary and Romania did much less. The explanation is that the IMF is favorable to structural reforms, but it does not necessarily demand them, whereas its conditions on fiscal and monetary policies are strict. By and large, the same is true of the European Commission, although it is both more political and focused on structural reforms than the IMF.

9. *Equity* was important. In particular Latvia designed its adjustment program so that the burden fell disproportionately on the well-to-do, while securing social safety. The government prohibited double incomes for senior civil servants who served on public boards and cut salaries of top officials more than of junior public employees, while it reinforced unemployment benefits and cut pensions far less than wages. Whereas high marginal income taxes were not considered collectible or desirable since they would reduce the incentive to earn more, other taxes focused on the wealthy, namely property taxes, capital gains taxes, and excise taxes on luxury goods, were introduced or raised.

10. A *social compact* was useful. The Latvian government focused on social dialogue in the spring of 2009. It created a reform management group, together with representatives of employers' organizations, trade unions, and local governments, while preparing proposals for the 2009 budget amendments and the 2010 budget. These painful budget cuts were actually agreed among all these parties that signed a social accord. That key social partners supported the government at the critical time helped maintain social stability. Some parties later regretted this agreement, but their signatures remained.

11. The Baltic governments *implemented their anticrisis programs early and decisively.* The reform government needed to kickstart the reforms to make clear to the population that the paradigm had really changed and to gain credibility. The measures were as front-loaded as possible. Early and decisive action made these economies hit the bottom early on and bred confidence in and credibility of the new economic policy. It is better to be fast and slightly wrong than perfect and late. Radical, early, and comprehensive adjustment turned out to be beneficial.

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3. Lawrence H. Summers, "Five Grim and Essential Lessons for World Leaders," *Financial Times,* November 3, 2011.

At present, a purportedly Keynesian argument is that governments have to stimulate the economy when output is declining, but this general statement makes little sense. Little restoration of growth is likely until the public's confidence in economic fundamentals has been established. The steady but more moderate decline of the Greek economy for at least five years is a case in point. In the early 1990s, Sweden and Finland realized that their huge double-digit budget deficits undermined business confidence. Consequently, they cut their fiscal deficits, and growth returned. In early 2009, the IMF advised the Spanish government to increase its budget deficit, which it did, thus aggravating its current crisis. The conclusion is that fiscal stimulus is only effective—and permissible—when a country really can afford it. Otherwise any country had better put its fiscal house in order as fast as possible. Without fiscal credibility, no growth is likely. The IMF should have known that.

Leszek Balcerowicz (1994) called this short political honeymoon a period of "extraordinary politics," when the public accepts exceptionally radical reforms. Former Estonian Prime Minister Mart Laar stated pertinently: "To wait is to fail." To quote Lawrence Summers: "Where policy has succeeded…it has been based on clear actions exceeding the minimum necessary to stabilize the situation."[4] Institutional economists claim that everything has to be built slowly and organically, but that is the opposite of crisis resolution. It is like telling the fire brigade to drive slowly to a fire. The father of the German economic miracle, Ludwig Erhard (1957), carried out currency reform and deregulation in one big package in 1948, which explains its success, regardless of massive resistance.

12. *Domestic ownership was important.* The Baltic countries and Bulgaria all opposed the IMF orthodoxy that they had to devalue. Thereby they seized ownership of their stabilization programs. This was particularly true of Estonia, Lithuania, and Bulgaria, which carried out major adjustments without any particular support from the IMF or the European Union, but also of Latvia, which forced the IMF to accept its key policies. All these four countries took great pride in choosing their own policies.

13. Finally, *salesmanship and transparency* were key. Latvia's Prime Minister Valdis Dombrovskis made clear to the population how bad the situation was and that there were two alternatives. One was bad, and the other was worse, and Dombrovskis stated that he preferred the bad one. This downbeat determination helped. Crises breed rumors and suspicion. Therefore, the government program must be public, clear, and readable. The new program should be published in a regular newspaper and new reform ministers need to go out to the public and the media and explain the program over and over again.

Ultimately, policy reform is about restoring confidence in the state, which derives from fast, firm, and consistent action. The three Baltic countries managed to do this. Since most reform action was undertaken in the first half year of crisis resolution, no resistance surged because after half a year most crisis indicators had already fallen off their peaks. The demands of political economy coincide with the arguments for early, radical, and comprehensive reform.

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4. Ibid.

CONCLUSIONS FROM CENTRAL AND EASTERN EUROPE FOR EURO AREA COUNTRIES

The crisis resolution in Central and Eastern Europe during the global financial crisis was successful; while not exceptional, it harbors interesting insights for euro area countries.

First, the rules for good political economy are common and apply to most countries, including Italy, which seems about to comply with them. The sense of crisis is severe. A clear idea reigns that Italy needs both public expenditure cuts and structural reforms to promote growth. Italy got new political leaders in November 2011, and outside technocrats have come to the fore. A comprehensive reform program has been presented, and it has gained parliamentary support. Its implementation is under way. Italy should be able to manage without special financial support from the IMF and the European Union. Yet little has been done with regard to equity and social compact.

Second, devaluation has been neither necessary nor beneficial for regaining competitiveness. On the contrary, fixed exchange rates prompted the greatest fiscal and structural adjustments in CEE. The crisis resolution in the Baltic countries and Bulgaria has proven that internal devaluation is a viable option and perhaps even advantageous. This applies also to the members of the Economic and Monetary Union. Indeed, the role of exchange rate regime seems to be overemphasized. Maurice Obstfeld and Kenneth Rogoff (2001, 373) pointed out "the exceedingly weak relationship between the exchange rate and virtually any macroeconomic aggregates." Other policies are simply more important. Therefore, the need even for major cost adjustment is not a reason to leave the euro area.

Third, the Baltic countries showed that radical spending cuts and structural reforms are perfectly possible in well-functioning democracies. They carried out fiscal adjustment of 9 to 10 percent of GDP in 2009 alone. Their experience has brought out the universal advantages of carrying out as much of the belt-tightening as possible early on with radical and comprehensive adjustment. As a consequence of strong and early fiscal measures, most performance indexes bottomed out in the first half of 2009, for example industrial production, consumer confidence, market interest rates, and the stock market. Thus, the government could restore confidence early on.

The front-loaded Baltic anticrisis programs encountered minimal social resistance. Latvia and Lithuania each had only one day of demonstrations in January 2009 before the crisis resolution really started. By contrast, the slow, delayed, and insufficient Greek measures unleashed massive protests because the government did not convince the people through early and firm actions. The nature of the trade unions matters, but the credibility of the policies is probably more important. For Italy, since its initial budget deficit is so limited, much less belt-tightening would be necessary, and most of it should be easier to do early on.

Fourth, Central and East Europeans have by and large accepted the idea that it is better to cut expenditures than to raise taxes. Three-quarters of the early fiscal adjustment in the Baltics came through public expenditure cuts rather than tax hikes. Large selective cuts facilitate beneficial structural reforms. They not only reduce the capacity of public services but also often improve the quality of public services through reforms of administration, health care, and education. Alberto Alesina and Silvia Ardagna (2009) offered statistical evidence for the thesis that "fiscal adjustments…based upon spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those based upon tax increases." Eminent examples of countries that carried out radical fiscal adjustment and moved to a higher growth trajectory are Sweden and Finland in the early 1990s.

The IMF (2010, 113) tried to contradict this evidence, but it did so by focusing on the very short term. Yet, it had to acknowledge that "an expansion in net exports usually occurs and this limits the impact on GDP" and "[c]entral banks usually offset some of the contractionary pressure by reducing policy rates." Moreover, the IMF found "that spending-based deficit cuts…have smaller contractionary effects than tax-based adjustments." That is exactly what I have discussed here, and the time horizon is longer, leaving the IMF arguments in doubt.

Fifth, the crisis forced all CEE countries to trim their public sectors and improve their already well-functioning economic systems, rendering them even more competitive. The Baltics stand out for several wise choices. They acted fast with large, early adjustments. They chose to cut their elevated expenditures rather than raise taxes. They used the austerity to introduce structural reforms on a broad scale, which are likely to promote economic growth. None of them suffered more than two years of output contraction. In 2011, the three Baltic countries are the fastest expanding economies in Europe with a growth of 5.5 to 8 percent, which was driven by exports. Admittedly, growth will be constrained by less credit expansion because of deleveraging and slow economic growth in Western Europe, but free market policies are not in danger, nor are democracy or social peace.

The big structural problems for Italy that are apparent from the brief statistical overview here are too much state bureaucracy, too much corruption, too regulated markets, and too high taxes and public expenditures. All these problems are perfectly possible to sort out. Many other European countries have done so.

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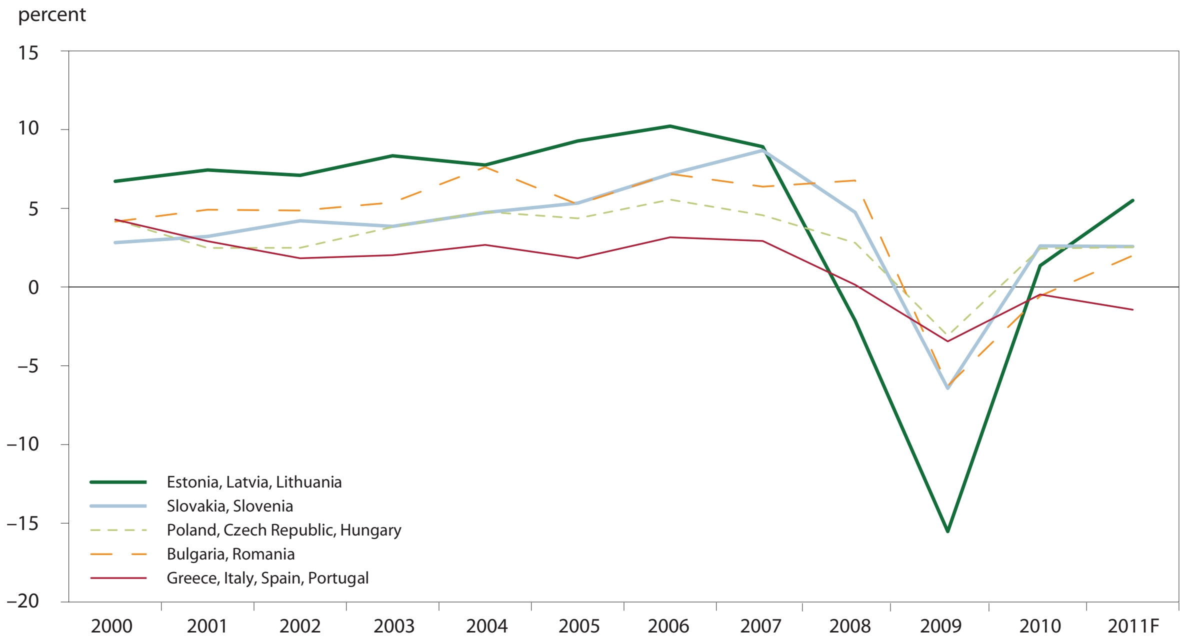
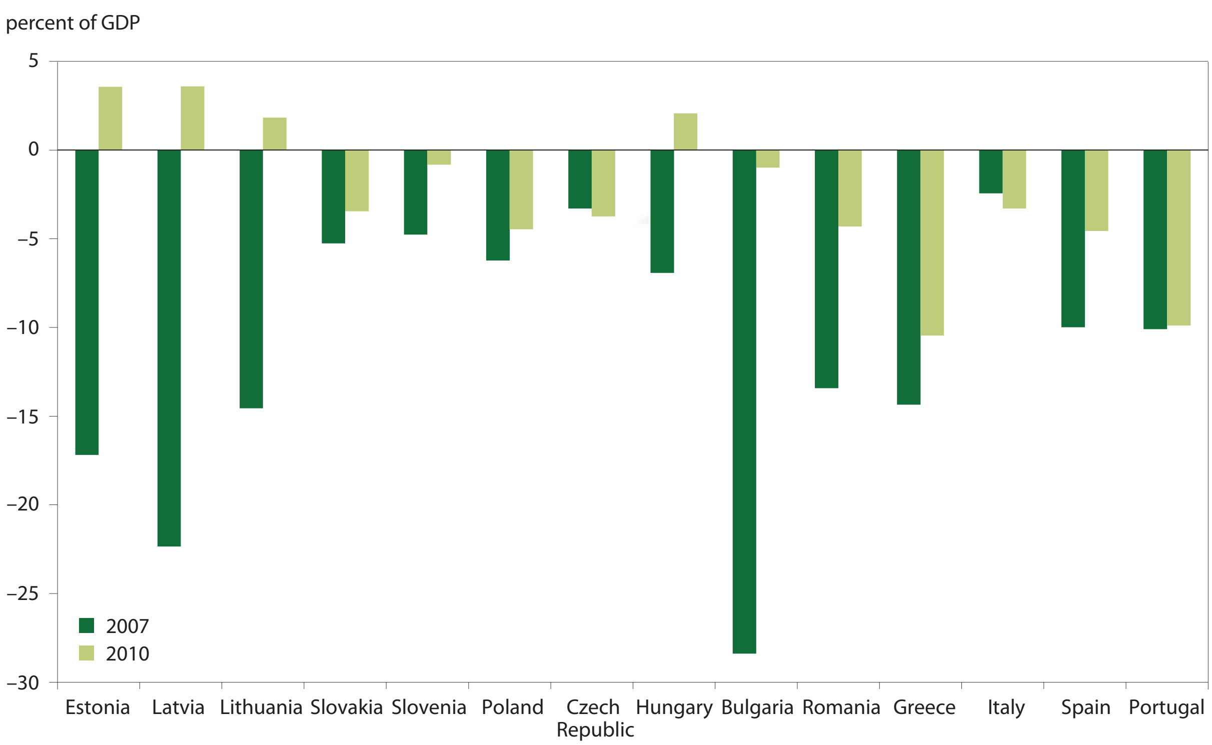
Figure 1 GDP growth, 2000–11



F = forecast

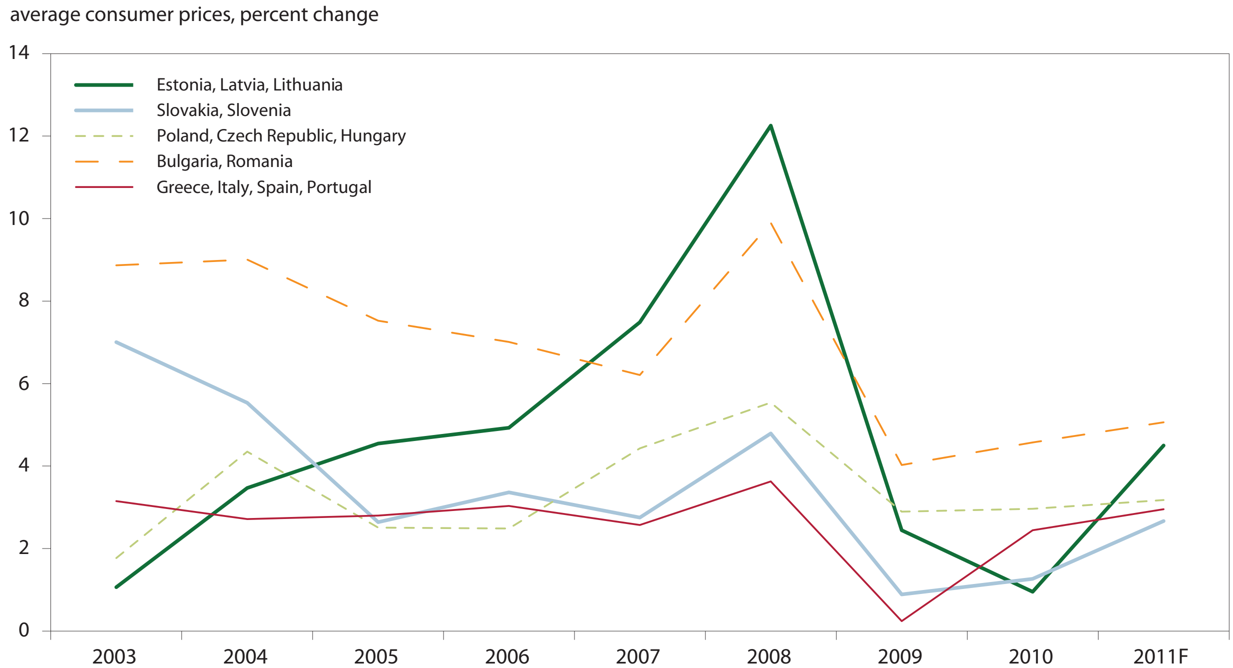
Source: International Monetary Fund, *World Economic Outlook* Database, September 2011 (accessed on October 31, 2011).

Figure 2 Current account balance, 2007 and 2010



Source: International Monetary Fund, *World Economic Outlook* Database, September 2011 (accessed on October 31, 2011).

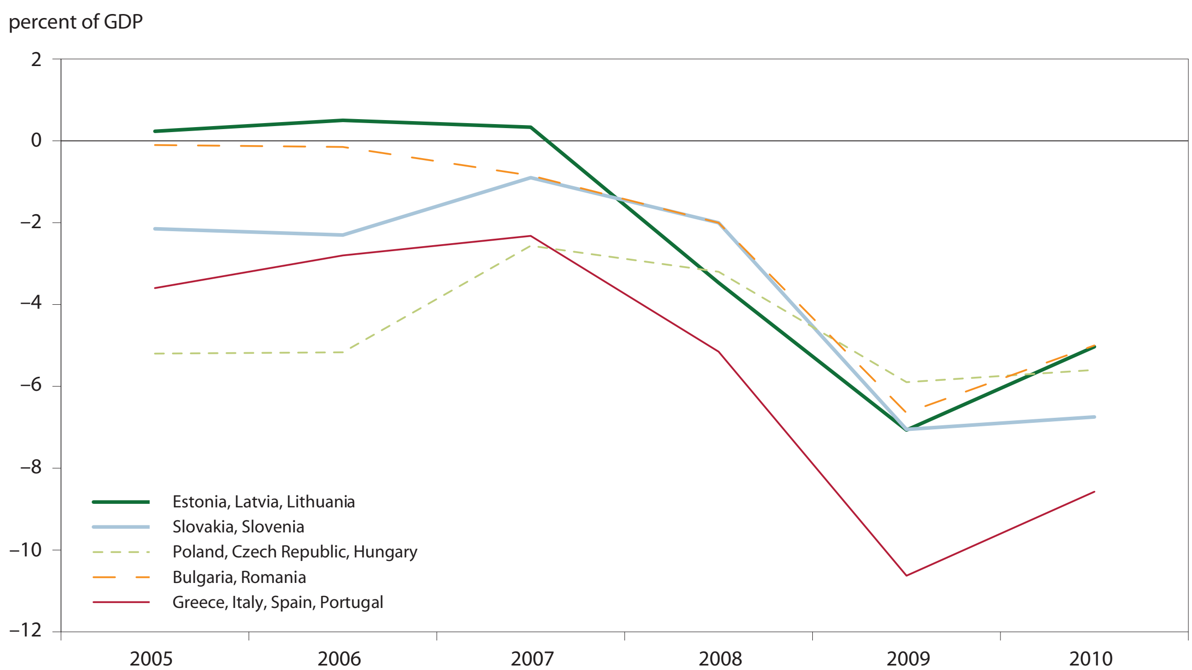
Figure 3 Inflation, 2003–11



F = forecast

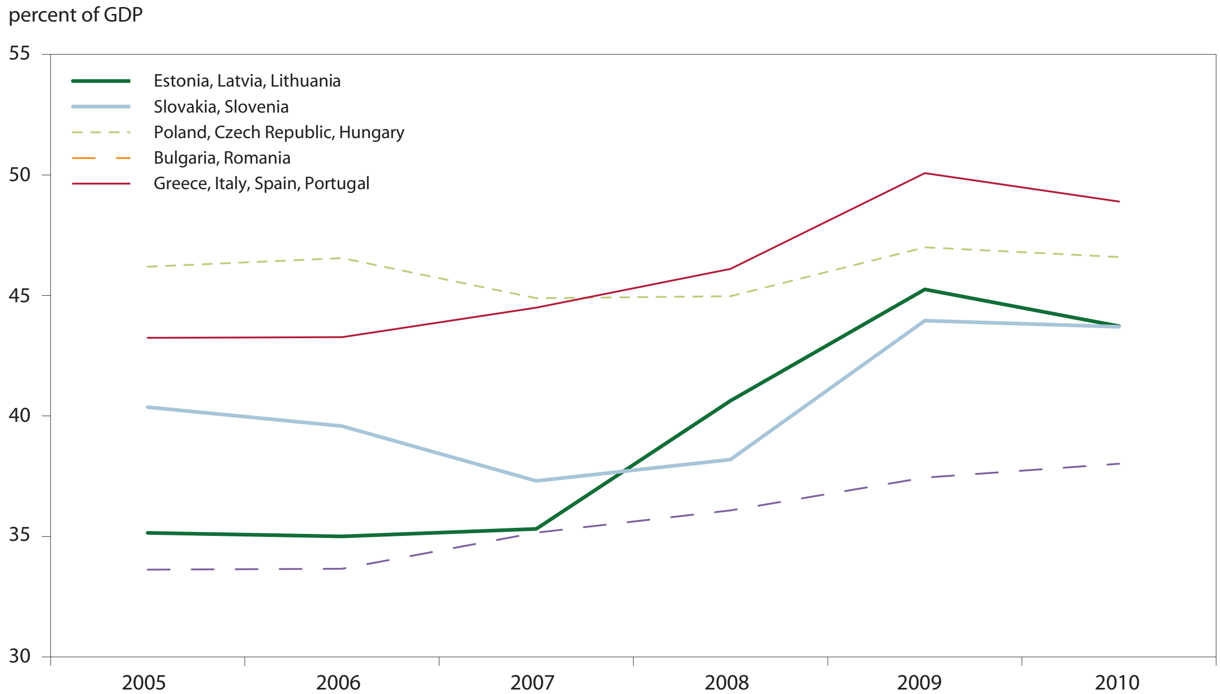
Source: International Monetary Fund, *World Economic Outlook* Database, September 2011 (accessed on October 31, 2011).

Figure 4 Budget deficit, 2005–10



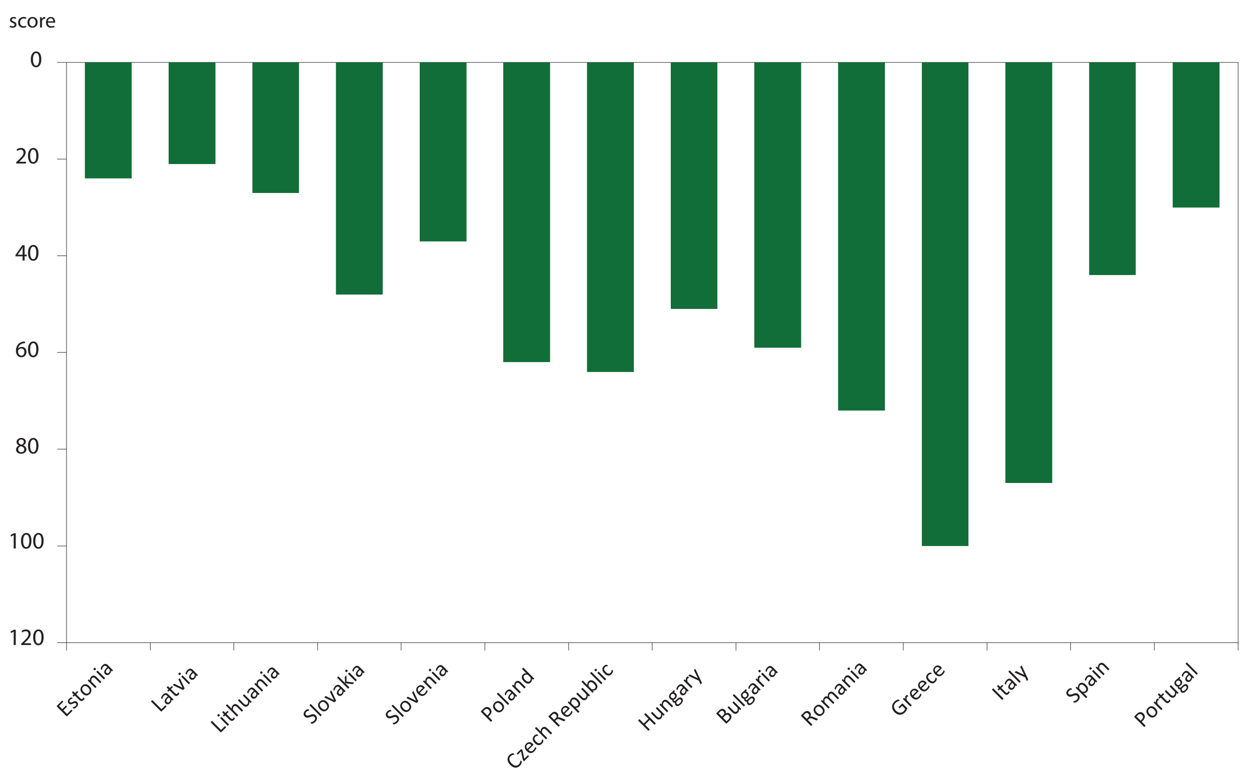
Source: European Commission, Eurostat Statistical Database (accessed on October 31, 2011).

Figure 5 Public expenditure as a share of GDP, 2005–10



Source: International Monetary Fund, *World Economic Outlook* Database, September 2011 (accessed on October 31, 2011).

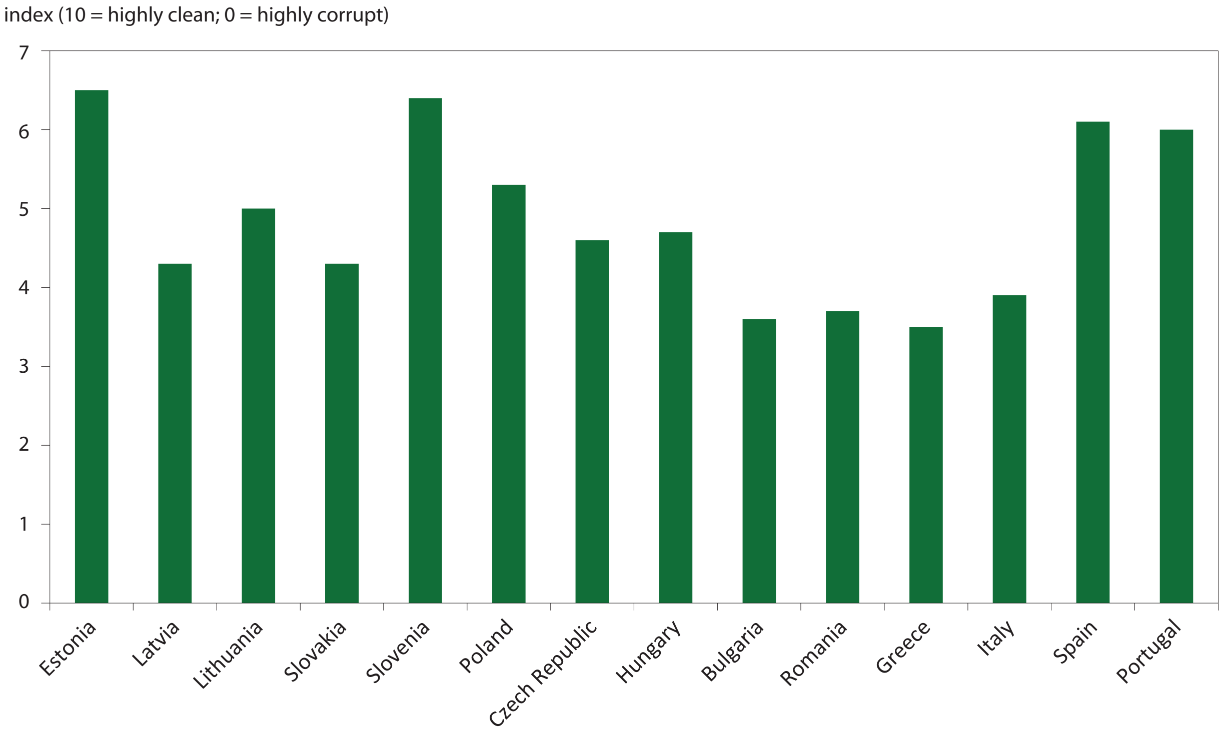
Figure 6 Ease of doing business ranking, 2012



Note: Lower score indicates greater ease of doing business.

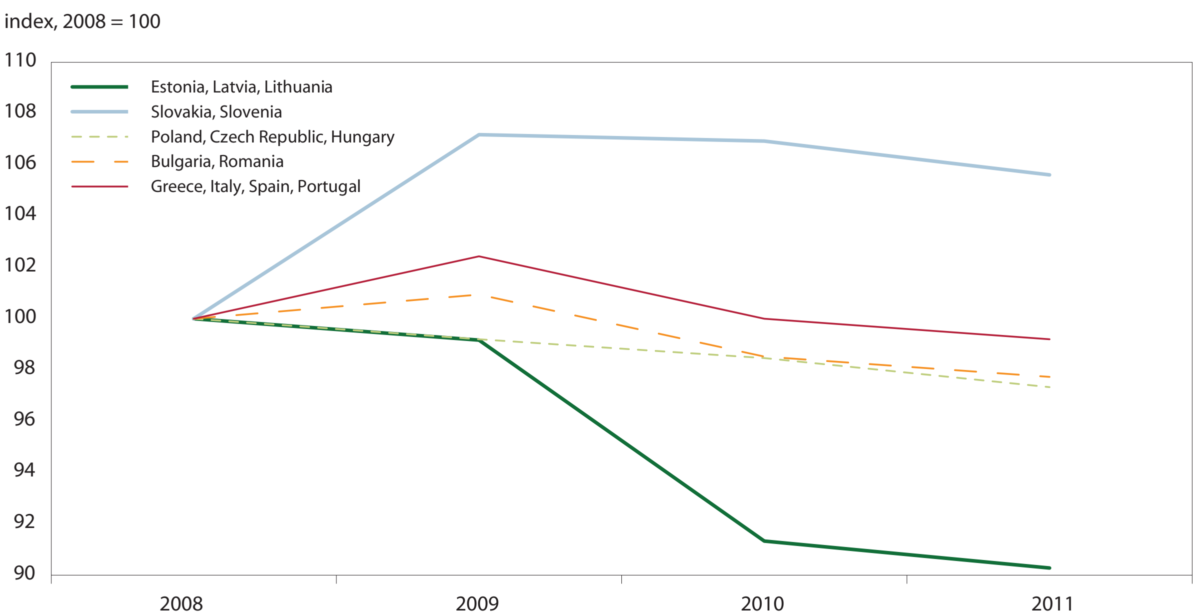
Source: World Bank and International Finance Corporation, *Doing Business 2012* (accessed on October 31, 2011).

Figure 7 Corruption Perceptions Index, 2010



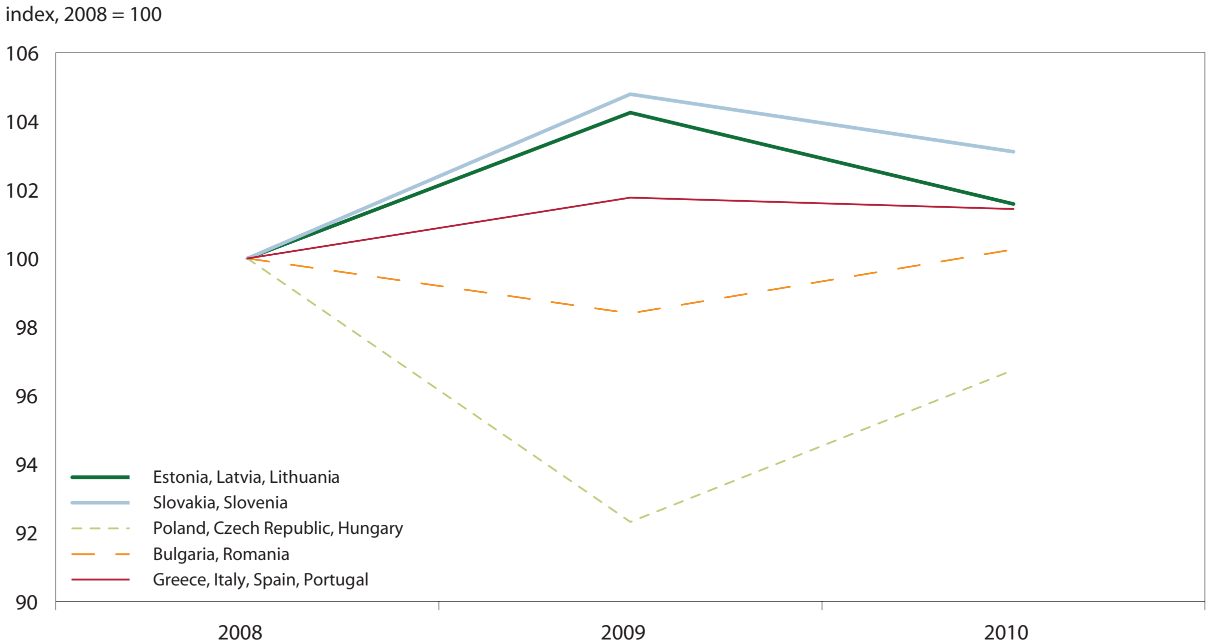
Source: Transparency International, Corruption Perceptions Index 2010 (accessed on October 31, 2011).

Figure 8 Real unit labor cost, 2008–11



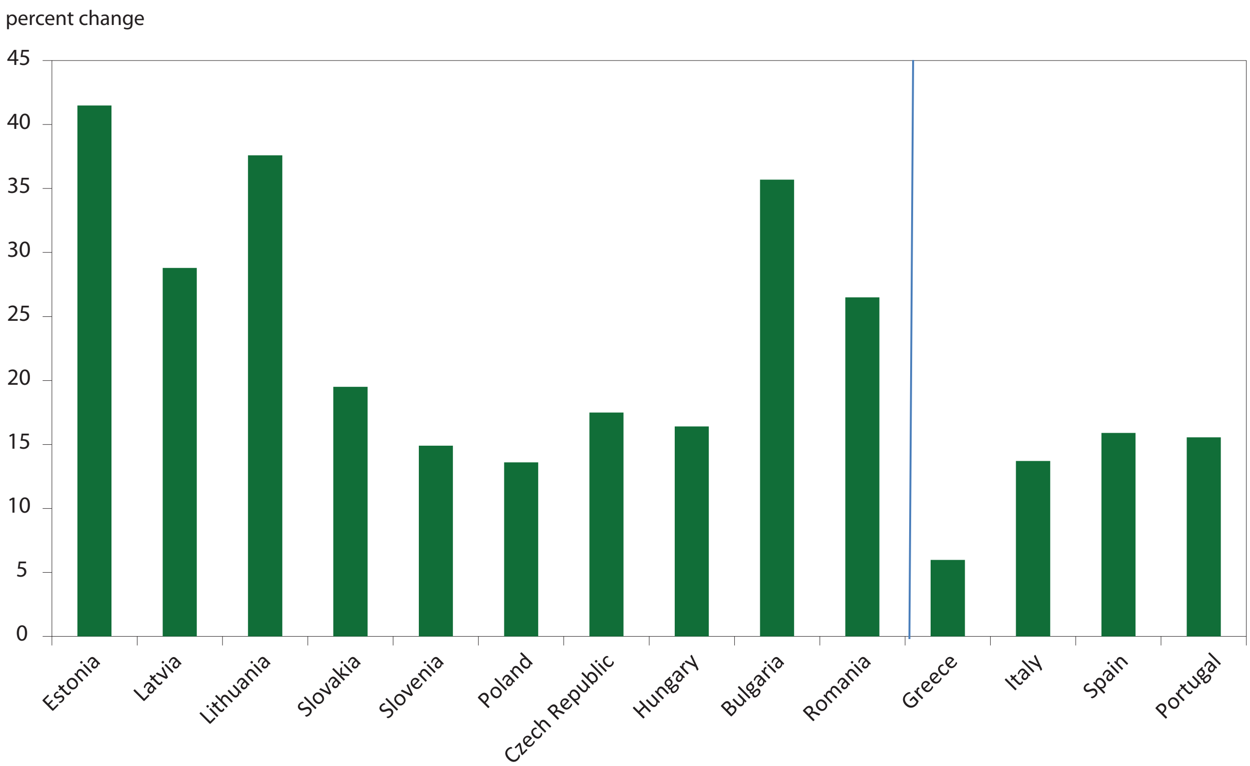
Source: European Commission, Eurostat Statistical Database (accessed on October 31, 2011).

Figure 9 Real effective exchange rate, 2008–10



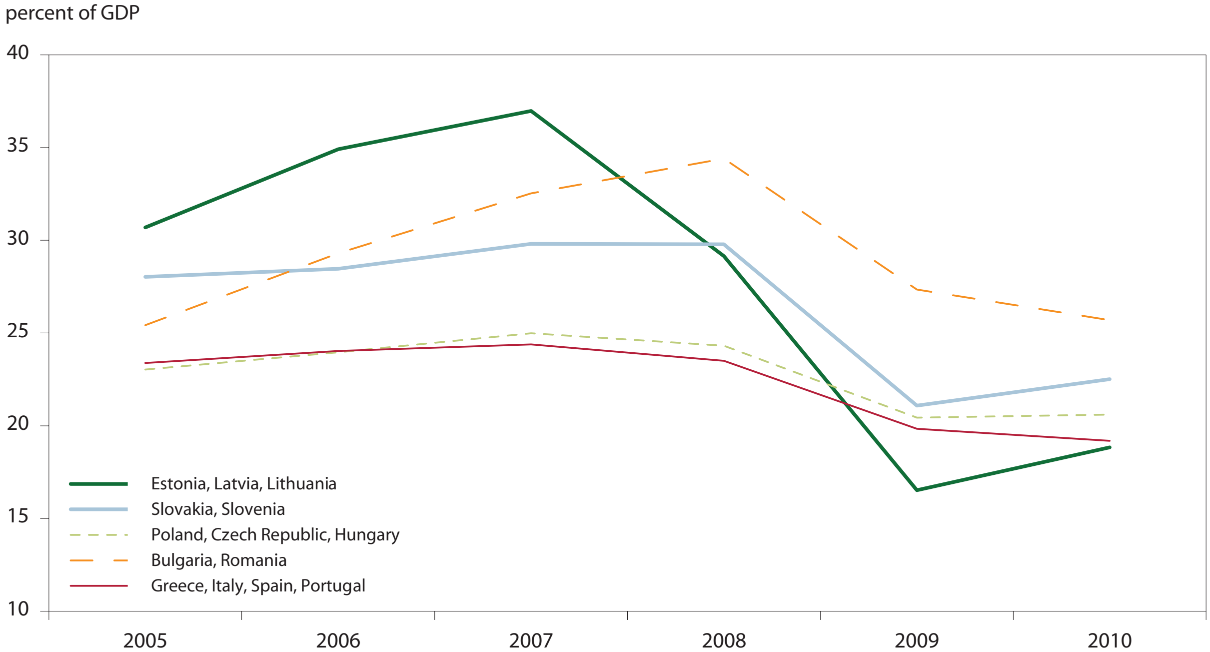
Source: European Commission, Eurostat Statistical Database (accessed on October 31, 2011).

Figure 10 Total exports, percent increase, 2010–11 (first half of year, year over year)



Source: European Commission, Eurostat Statistical Database (accessed on October 31, 2011).

Figure 11 Investment as a share of GDP, 2005–10



Source: International Monetary Fund, *World Economic Outlook* Database, September 2011 (accessed on October 31, 2011).