



The Economic Successes and Sources of Discontent in East Central Europe¹

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Abstract

By some measures, the European Union's Eastern enlargement, and the attendant securitization of East Central Europe through membership in the North Atlantic Treaty Organization, have brought significant economic and welfare benefits to the former Soviet satellites or republics that have joined these organizations. All of their economies are considerably larger than in 1989. Foreign investment has helped fuel significant growth in the region, and financial linkages between East and West had a stabilizing influence during and after the US financial crisis of 2008-09. But economic success in absolute terms has not prevented a sense of disappointment from settling over the region, nor has it forestalled an illiberal backlash in a number of countries, which has had economic, political, and in some cases ethno-populist dimensions. This article examines some of the main economic trajectories around growth, consumption, investment, and finance. It explains why, despite numerous positive measures, both economic and political liberalism are under intensifying scrutiny. Growing inequality within countries, as well as continuing inequality – including power disparities between East and West Europe – have fueled discontent with the terms on which many East Central European states have integrated into the EU.

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Introduction

East Central Europe (ECE) has historically been the seat of major empires. It has also been the source of cultural, spiritual, and political innovation. But ECE has also been the site of foreign domination and occupation, shifting borders, forced population movements, diaspora settlement and oppression, in addition to the most brutal and comprehensive forms of ethnic cleansing. In the 20th century alone, events in Munich, Yalta, and Katyń were illustrative of the ways in which the then still relatively new nation-states of the region fell victim to foreign political manipulation, ally abandonment, and mass atrocities. Of course, every country in the world faces limits on its sovereignty. But emerging from World War II, such limits in ECE were extreme; in every country except Yugoslavia, Soviet takeovers and Western acquiescence made a mockery of alleged statehood conferred in the aftermath of World War I (Mazower 1998; Rothschild and Wingfield 2000).

The open-door policies of the North Atlantic Treaty Organization (NATO) and the European Union (EU) in the 1990s represented a radical break with the bleak history depicted above. NATO enlargement, beginning in 1999, and EU enlargement, beginning in 2004, gave the relatively small East Central European states an unprecedented opportunity to shape their own political trajectories and international allegiances, and a significant voice within two of the world's most powerful international institutions. Membership in NATO and the EU enhanced these countries' political power through, depending on the organization, voting rights, resources, institutional representation, and security guarantees. Debates about the true motivations and interests at play driving enlargement notwithstanding (Schimmelfennig 2001; Reiter 2001; Moravcsik and Vachudova 2003; Epstein 2008), there is little doubt that the post-1989, post-enlargement phase of Europe's evolution is more democratic, peaceful, representative, and economically open for ECE than any previous transnational political or institutional arrangement.

The focus of this article then is to explain why, despite demonstrably enhanced political efficacy as well as wealth in ECE, there is nevertheless widespread skepticism of the same political and economic liberalism that underpinned ECE's recent dramatic reversal of fortunes. More specifically, the analysis in this article highlights the degree to which income levels between East and West Europe have converged, foreign investment has fueled growth, and financial integration has curbed volatility. In each of these areas, despite a seeming increase in equality, and closer connections between East and West Europe, there are still lingering disparities, both within and between countries. These disparities provide justification for economically nationalist and Euroskeptic narratives. While economic inequality and dependence are not the only issues that have contributed to the rise of some increasingly authoritarian forms of governance in ECE, economic dissatisfaction has been an aggravating factor.

Very often, scholarly work examining developments in ECE focuses on socio-political factors affecting the region (e.g. Trencsényi 2014; Vachudova forthcoming in 2020). Factors include ethno-nationalist mobilization, rhetoric and policies against migrants and asylum-seekers, curbs on checks and balances among democratic institutions, and ongoing corruption under the guise of purported corruption elimination efforts. The argument here, by contrast, is that underlying economic conditions in ECE provide a foundation for illiberal and populist politicians, particularly as those conditions reinforce power disparities between East and West Europe, as well as power and wealth differentials within countries. If at least some populations "evaluate the economy through the prism of identity, relying less on traditional measures like economic growth, social spending, or unemployment and more on perceptions of fairness and concerns about keeping

outsiders away” (Vachudova 2019, 698), politicians can plausibly use some of the underlying economic conditions outlined in this article as evidence of East Central European victimhood.

To be clear, majorities in the EU’s New Member States (NMS) strongly favor EU membership, even as pluralities, if not majorities, have also elevated political parties that are highly critical of EU policies. At the same time, the analysis here argues that ECE’s continuing economic subordination, stemming from a long legacy of relative under-development compared to the West, has contributed to this paradox.

Income Convergence

Measures of income convergence that correct for purchasing power parity show that both the transition that began in 1989, and the EU’s enlargement in 2004, correlate with strong output convergence between Eastern and Western Europe. However, measures of absolute output in ECE lagged significantly behind the ‘old EU-15’. These different measures have affected lived experiences of East Central European populations; accordingly, they impact who can take full advantage of the EU’s single market (or opportunities in the global economy). A country’s share of absolute output is a more accurate measure of power within the EU or larger economy than GDP adjusted for purchasing power. It is by this former measure that ECE countries lag significantly behind many of their Western counterparts.

According to measures that adjust for purchasing power parity across countries, EU enlargement has generated strong income convergence between ECE and the EU 28, as demonstrated in Table 1. Several developments are of note here. First, since 2004, every country except Slovenia has gained ground vis-à-vis the EU as a whole. The US financial crisis and the Eurozone crisis that followed were particularly devastating for Slovenia, which explains its relative stasis compared to many other NMS. Second, Poland, Romania, Slovakia, and the Baltic States stand out for having moved particularly rapidly in the direction of convergence. Third, ECE countries are no longer the poorest as a group in the EU. The US, European and global financial crises moved Greece and Portugal closer to the bottom of the EU 28. In 2019, the Czech Republic surpassed Spain according to the GDP per capita adjusted for purchasing power. One should note that these are the convergence statistics that the European Commission and its attendant statistics bureaus prefer to publicize. They not only show economic progress, but do so in a way that takes into the account the cost of living across countries. In that sense, correcting for purchasing power parity is a good measure of relative welfare. Even if the Polish zloty or the Hungarian forint are volatile or weak compared to other major currencies, including the euro, the table below nevertheless measures how far the currency goes within any given polity or economy, irrespective of that volatility or weakness. From a welfare perspective, the EU can convincingly argue that the EU is in fact a “convergence machine” (World Bank 2012).

Table 1: East Central European GDP per Capita in Purchasing Power Standards (EU 28 = 100)

	2004	2007	2011	2013	2017
Bulgaria	35	41	45	46	49
Croatia	57	61	60	59	62
Czech Republic	79	84	83	83	89
Estonia	55	68	69	75	79
Hungary	62	61	65	67	68
Latvia	47	60	56	62	67
Lithuania	50	61	65	73	78
Poland	49	53	64	67	70
Romania	34	42	51	54	63
Slovak Republic	56	67	73	76	76
Slovenia	86	87	83	81	85

Data Source: Eurostat, available at: <https://ec.europa.eu/eurostat/statistics-explained/index.php/>

GDP per capita, consumption per capita and price level indices. Note that Bulgaria and Romania joined the EU in 2007 and Croatia joined in 2013. All of the other countries depicted here joined in the ‘big bang’ enlargement of 2004.

Income convergence can also be measured in absolute terms, as demonstrated in Table 2. Aside from the fact that Table 2 does not adjust for purchasing power parity, it also compares the NMS to the EU’s older 15 member states, rather than to the EU 28. Both of these differences in measurement provide a more sobering assessment of ECE’s convergence with the West. While Table 1 is a good measure of relative welfare in various EU countries, Table 2 is a better measure of absolute economic output and therefore of relative power in the EU. Absolute output reveals who can readily travel or seek education abroad; it also identifies which countries are more likely to suffer from brain drain, and, on the other side, which countries are likely to be able to afford other countries’ assets and to hire their workers. Whereas Poland went from 49 percent of the EU 28 to 70 percent by 2017 when corrected for purchasing power, in absolute terms the country moved from just over 18 percent of the old EU 15 average to approximately 30 percent. These statistics reveal that Easterners and Westerners can avail themselves of the EU’s common market to significantly varying degrees – whether one is considering business, travel, or educational opportunities. Not surprisingly, brain drain has often been a phenomenon of young, skilled people moving from East to West, while foreign investment has flowed from West to East. While both trends potentially lead to economic and power equalization over time (EBRD 2009), there is no guarantee that they will – particularly if relative deprivation in the East hampers innovation and human capital formation that would otherwise help build the local economy (Bohle and Greskovits 2019).

Table 2: East Central European GDP per Capita as a Percentage of the Old EU-15 Average (not adjusted for purchasing power parity)

	2004	2007	2011	2013	2017
Bulgaria	8.94	11.76	14.99	15.65	17.88
Croatia	24.92	28.14	29.47	28.15	29.08
Czech Republic	30.71	37.37	43.08	41.45	44.26
Estonia	23.55	34.46	35.37	39.73	42.28
Hungary	27.76	28.96	29.4	28.25	30.91
Latvia	16.88	29.12	27.93	31.16	33.89
Lithuania	17.85	25.55	29.12	32.54	36.25
Poland	18.22	23.87	28.18	28.5	30.13
Romania	9.58	16.81	17.6	19.81	23.51
Slovak Republic	28.6	33.34	36.94	37.67	38.26
Slovenia	46.64	50.15	50.54	48.63	51.28

Data Source: World Bank, available at: <https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?end=2017&locations=GR-PT-DE-AT-FR-BE-FI-LU-SE-GB-NL-ES-DK-IE-IT-LT-PL-RO-SK-SI-BG-HR-CZ-EE-HU-LV&start=2017&view=bar>

Even as absolute income in ECE has trailed its West European counterparts, consumption in ECE relative to GDP has rivaled that of the old EU-15 (Deuber 2011). As with measures of income, there are competing interpretations of what increasing consumption means, with both supporters and detractors of increasing consumption in ECE. On the one hand, expanding consumption certainly signals elevated welfare (Farkas 2013). On the other, consumption in the current period does not contribute to growth in later periods unless it generates additional income or reduces current expenses. If current account deficits are financing consumption, as was the case in the run-up to the Eurozone crisis, there is potential for volatility and lost opportunity for productive investment (World Bank 2012; Jacoby 2014). Andrew Janos had long argued that later industrialization and development in ECE compared to the West resulted in increased demand for consumption at the expense of financing underlying productive capacity (Janos 2000; Epstein 2014a). Slow income convergence in absolute terms, in conjunction with relatively high consumption in ECE, has been one source of dissatisfaction with East Central European growth models; this pattern does not necessarily presage full convergence (Galgóczi and Drahekoupil 2017).

Frustration in ECE with income inequality, uneven access to educational and business opportunities in the EU, and perceived economic subordination are directly observable in the policies and rhetoric of many East Central European countries. In Poland, Hungary, Romania, Slovenia, the Czech Republic, and Slovakia, policy-makers have variously tried to domesticate foreign-owned services and industry and have imposed taxes targeted at foreign-controlled sectors.

At the same time, they have cultivated political loyalty among formerly independent institutions such as central banks. They have developed industrial policy apparatuses capable of supporting indigenous innovation in the service of domestic investment and ownership, with the goal of moving domestic production up the value chain. To be sure, rhetoric has at times been more fulsome than policy has been effective. Nevertheless, the re-orientation away from economic liberalism and unbridled openness that has occurred since the 2008-09 US and then the European financial crises has been notable (see, for example, Johnson and Barnes 2015; Appel and Orenstein 2018; Greskovits 2019; Naczyk 2019; Piroška and MÉRŐ 2020).

Foreign Direct Investment

Developments with respect to foreign direct investment (FDI) into ECE have similarly yielded decidedly mixed results, with some unanticipated political consequences. FDI has led to increases in some wages, technical upgrading in select firms, and overall increased economic output in ECE. But because of the absolute output differentials depicted in the previous section, inward investment into ECE has been far larger than outward investment. Economic and power asymmetries are the result. In particular, the West has been able to avail itself of lower production costs in the East (but not vice versa). As such, profit-making, managerial control, innovation, and therefore power have accrued to Western countries more readily than to Eastern ones.

FDI has been large-scale, welfare enhancing, and transformative in terms of technical upgrading. Bohle and Greskovits argue that FDI created a ‘manufacturing miracle’ in much of ECE (2012), while Medve-Bálint has pointed out that in the aughts and after, ECE was receiving more FDI than Brazil, China, India, Russia, or Mexico (2014). Bruszt and Langbein (forthcoming) argue that EU membership in connection with the drive for FDI built unprecedented state capacity in ECE. In all, one can argue that FDI has contributed to more wealth, improved welfare, and increased international linkages for ECE – exactly what had been hoped for by proponents of Eastern Enlargement. But FDI has also generated inequality within countries, cultivated East Central European dependence on Western investors, and failed to create significant innovation capacity in the NMS. While even the most illiberal leaders in ECE have been loath to challenge manufacturing FDI (though there have been more explicit challenges with respect to FDI in finance), economic nationalism and development initiatives in ECE respond in direct ways to the dissatisfaction spawned by FDI’s power asymmetries.

Power asymmetries are manifest in the ‘dependent capitalism’ in ECE that emerged in the wake of state-socialism’s collapse. The origins of this asymmetry rest in part in the huge wealth disparities between East and West Europe by 1989, but also in the industrialization and broad-based education of the communist regimes (Nölke and Vliegthart 2009; Bohle and Greskovits 2012). Low-wage but highly educated (in global comparative terms) workers attracted FDI to ECE across all economic sectors (Medve-Bálint 2014). Key features of the dependent capitalist model included an emphasis on cost competition, not just through low wages, but also through favorable tax treatment for multinational corporations (MNCs) (Appel 2011; Galgóczi and Drahoukoupil 2017; Appel and Orenstein 2018). Research and development, including design and engineering processes, were concentrated in West European countries from which the FDI flowed. FDI financing was also controlled by foreign owners – either through firm financing or through the majority foreign-owned banking sectors in most of ECE (Epstein 2008; Nölke and Vliegthart 2009).

West European FDI, while bringing jobs, capital, and some skills and technology upgrades, also posed risks for ECE. For one, the vertical character of investment, with most high value added and financing functions concentrated in West European headquarters, meant that Eastern populations were working in manufacturing facilities focused on ‘downstream’ assembly and processing, while technological skill transfers were limited (Nölke and Vliegthart 2009). Second, while the direct effects of FDI were strong for firms in ECE on the receiving end, the indirect effects for domestic sectors were much weaker (Hanousek et al 2011, 20-1). Domestically owned firms in ECE were on balance not able to achieve commensurate competitiveness with their foreign-owned counterparts (Farkas 2013, 16-17). The cost competition model predicated on low taxes and low wages also limited the extent to which ECE could spend more on skills, training, and research and development (R&D). That same cost competition model also meant that ECE’s comparative advantage was at constant risk of erosion, since higher rates of economic growth in the periphery were pushing wages up over time (IMF 2013). While “nationally owned businesses would be concerned about these long-term developments” of low levels of spending on training and research, as well as declining comparative advantage, “Western headquarters do not care much about these tendencies, given their potential to relocate production in the long term” (Nölke and Vliegthart 2009, 687).

German automotive FDI into the Visegrád 4 (V4)³ confirms arguments above about the partially disempowering effects of the kinds of FDI that have penetrated ECE on a large scale. By 2012, Germany had 20 percent of the global market in passenger cars. At the same time, approximately 5.5 million cars were produced in Germany (a figure that had remained essentially constant for over a decade), while German firms manufactured over seven million cars elsewhere. Foreign production of German cars registered a three-fold increase between 1992 and 2011. Approximately three million units a year were produced in ECE in 2012 (IMF 2013, 13, Box 1). For car production in ECE, German firms dominated (Pavlínek 2015, 212).

German automotive FDI was organized according to “vertical specialization” or “fragmentation of production” in which lead firms outsourced aspects of production, processing, and assembly to gain efficiencies (IMF 2013; Geröcs and Pinkasz 2019). In practice in ECE, vertical specialization referred to activities “under which Germany exports intermediates that are further processed in downstream facilities in the EU, including the CE4 [referring to the Visegrád 4] and then re-exported directly or indirectly outside the EU to the rest of the world” (IMF 2013, 12, First Background Note). Thus, highly specialized activities, including design, engineering, and non-standardized production took place in Germany, while ECE provided assembly platforms for semi-standardized industrial components. In addition, as German car producers innovated in electric engines in the expectation that combustion would eventually be eclipsed, more of the standardized production of newer versions of older models with combustion engines was re-located to ECE. Higher standardization of production in lower-end models meant decreasing investment per unit produced and increasing pressure on returns in ECE (Geröcs and Pinkasz 2017).

Workers in investing versus receiving countries have experienced FDI’s power asymmetries directly. Whereas in a coordinated market economy like Germany’s, wage and benefits bargaining for workers takes place on a sectoral level in connection with a highly centralized national system of industrial relations (Hall and Soskice 2001), the cost competition model in the V4 depends on firm-level negotiations. This has created competitive and insecure labor markets in ECE, which have moderated wage inflation. Over the same period in which Germany’s foreign auto

³ The Visegrád 4 refers to Poland, Hungary, Slovakia and the Czech Republic.

manufacturing has increased, the proportion of unskilled workers in Germany has declined and unemployment has remained low. Given their broad participation in industrial relations, German labor unions have often willingly agreed to the re-location of lower-end production and assembly to ECE. German jobs lost in highly standardized manufacturing have been replaced with more positions in specialized production, engineering, and design at higher training and compensation levels. Germany's global export power, reflected in successive years of current account and trade surpluses, depends on its own wage restraint (Jacoby 2017), but German wages and purchasing power remain much higher than equivalent measures in ECE.

In its own assessment, the IMF highlighted the extent to which FDI, technology transfer to ECE, and knowledge-intensive manufacturing there had increased East Central European technological sophistication and contributed to income convergence between East and West Europe. However, it was probably premature to conclude, as the IMF's German interlocutors did, that "[p]roduction within a vertically specialized chain is not a 'zero sum game'" (IMF 2013, 14). In a wide-ranging dialogue between IMF researchers and policy-makers and industrialists from the V4 and Germany in June 2013, three points about regional value chains highlighted power disparities. First was the "lively debate" among participants about whether "export growth in knowledge-intensive sectors – especially automobile production – really represented technology transfer and human capital development, or simply entailed low-skilled assembly jobs within a high-tech industry" (IMF 2013, 14). Since the IMF researchers themselves pointed to the precarious position of ECE in those value chains under conditions of income convergence, and the need for East Central European firms to develop their own supply chains to sell intermediate goods downstream "following the Chinese example", even defenders of the FDI model saw a need for more innovative capacity in ECE (IMF 2013, 15).

A second indication that relative gains mattered, and that Germany had the upper hand, was the German attitude toward labor mobilization in ECE. As already noted, Germany and its lower-cost production chain partners had starkly different industrial relations. German labor unions exercised joint authority (with management) over major business decisions, whereas East Central European workers only bargained with their foreign owners at the firm level. The V4 were warned, therefore, that the "potential gains in employment as a result of production spillovers [from German investment] should be kept in mind when considering labor market reforms or during negotiations between industry and labor unions" (IMF 2013, 14).

Third and finally, it was not just labor quiescence that German investors found desirable. Even as the IMF was recommending more investment in human capital, skills, and innovation in ECE, German participants were emphasizing that nothing along those lines was needed at that juncture because "there was no imminent threat to the position" of the V4 in the value chain, "despite narrowing cost differentials" (IMF 2013, 14-15). This was akin to the World Bank arguing a year earlier that because the European Union was a "convergence machine," the NMS did not need a developmental strategy, or to be "ferocious" like their Asian counterparts. They needed only to be "disciplined" to attract foreign investment so that economic development and technology transfer could be secured in ECE through "osmosis" (World Bank 2012, 25). Analyses from the IMF and the World Bank embraced a division of labor between East and West Europe through FDI that had provoked considerable skepticism in ECE by 2010, if not before.

Foreign direct investment also often produces the unintended consequence of increased inequality within countries, which has been the case in ECE (Medve-Bálint 2014). Not surprisingly, measures of income inequality have increased in ECE since the transition began. The Gini coefficient, in

which zero represents an equal distribution of wealth across a population and one represents wealth concentration in one person, is by no means at the high end for much of ECE, with countries such as the Czech Republic, Slovakia, and Slovenia achieving equal or greater equality than Denmark or Sweden. These countries were all below the OECD average of .315 in 2015, and significantly below the US (.415 in 2015).⁴ While East Central European countries such as Poland, Bulgaria, Romania, and the Baltic States were above the OECD average in 2015, what might be more important than the static comparisons are the trends over time, and the ways in which the sense of rising inequality fuels policies that promise to change the status quo. For much of the transition, for example, from 1995 to 2016, income inequality within the new EU-13 (all of the post-communist entrants plus Malta and Cyprus) was on the rise. It was only in 2016 that inequality within these countries begins to abate, driven mostly by inequality declines in Poland and Romania.⁵

Foreign direct investment has had complex effects in ECE that have produced wealth, opportunity, and upgrading alongside subordination and marginalization of groups that have not been direct beneficiaries of foreign capital. The sense of lost opportunity was therefore palpable in some countries – with Prime Minister Viktor Orbán railing against “debt slavery” in Hungary and former Prime Minister Jan Krzysztof Bielecki in Poland pointing out that “capital has a nationality” (see respectively Johnson and Barnes 2015; Naczyk 2019, 17). In response to perceived dependence, these politicians and others have devised economic programs to limit that dependence, engage in more welfare redistribution to combat some of the inequality-inducing effects of FDI, and increase domestic savings, investment, and innovation.

Financial Integration and Foreign Bank Ownership

According to one interpretation, EU enlargement, and ECE’s radical economic openness, has generated major gains for both East and West in financial integration and foreign bank ownership. FDI in East Central European finance brought resources and expertise. Moreover, as documented in a recent study (Epstein 2017), ECE’s bank funding stability was far stronger than in Western Europe, precisely because of high levels of foreign bank ownership in the East as opposed to in the West. Nevertheless, foreign bank presence has been a politically contentious issue in some NMS because of the ways in which domestic bank ownership is perceived to provide greater economic opportunity and autonomy – a privilege that many West European countries maintained for themselves even as Western institutions counseled East European countries to privatize their banks with foreign capital (Epstein 2008; 2014b).

Most countries around the world have long discouraged high levels of foreign bank ownership in their domestic markets, preferring to maintain politically susceptible financial institutions in the service of protecting the domestic deposit base, securing credit to the local government and economy, and insulating themselves against foreign political manipulation (Pauly 1988; Epstein 2017). ECE proved a major exception to this trend beginning in the 1990s when international institutional pressure, banking crises, and a dearth of managerial expertise and capital pushed all

⁴ Gini coefficient statistics are from the World Bank, available at: <https://data.worldbank.org/indicator/SI.POV.GINI> Accessed 10 January 2020.

⁵ Zsolt Darvas, “This is the state of inequality in Europe,” Bruegel and the World Economic Forum, 4 May 2018. Available at: <https://www.weforum.org/agenda/2018/05/european-income-inequality-begins-to-fall-once-again>, accessed 10 January 2020.

the post-communist aspirants to the EU except Slovenia to privatize the bulk of their banking assets with foreign capital (Epstein 2008). ECE became the most highly penetrated banking market in the world, with foreign ownership levels in most cases well over half and in some instances approaching 100 percent (see Table 3). The biggest investors were from Austria, Italy, Belgium, and France, but banks from Portugal, the Netherlands, Ireland, Germany, Sweden, Norway, Denmark, and Greece also had a significant presence in the region.

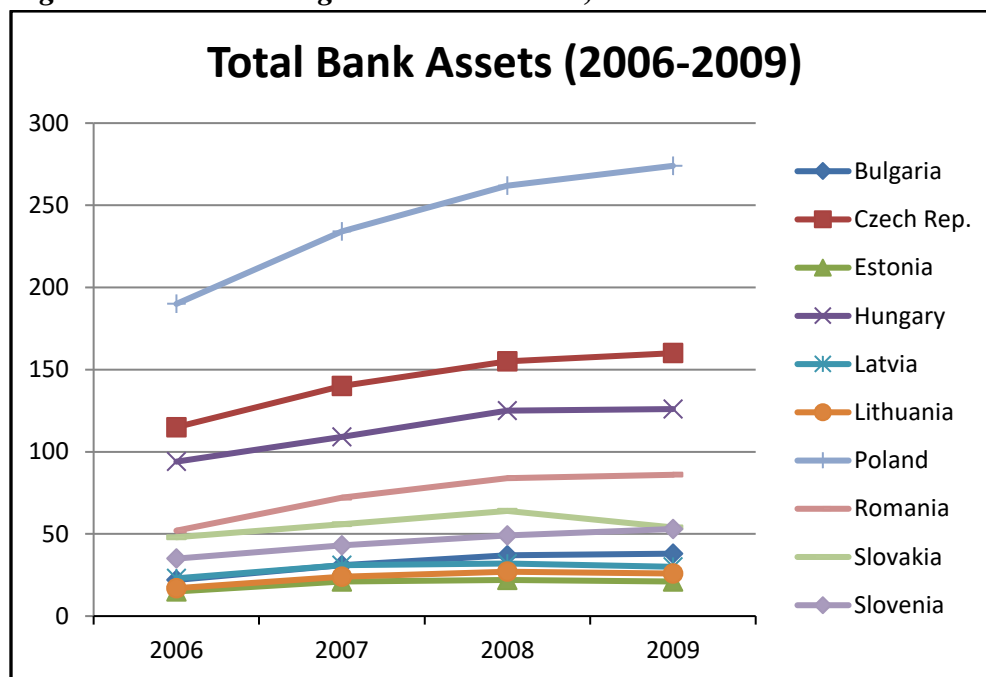
Table 3: East Central Europe, New Member States of the EU

Country	Percentage of Foreign-Owned Banks, Assets: 2008 and 2013	
Bulgaria	84	70
Croatia (joined the EU in 2013)	91	90
Czech Republic*	84	85
Estonia	98	97
Hungary	84	84
Latvia	66	65
Lithuania	92	93
Poland	77	68
Romania	88	89
Slovakia	99	85
Slovenia	31	34

Data Source: EBRD 2009 and EBRD Banking Survey for 2013. *Source for Czech Republic is Claessens and Van Horen 2015 because the country exited EBRD programs before this data was collected.

While there is debate about the developmental consequences of high levels of foreign bank ownership for ECE (EBRD 2009; Bonin et al 2014), scholars agree that foreign bank ownership was a stabilizing force for the region during and following the US financial crisis. Parent banks in Western Europe maintained their exposures to ECE through the crisis, re-capitalizing their subsidiaries on an ongoing basis. There were no major failures or closures of foreign-owned banks during the crisis, though a number of locally owned or managed banks in ECE faced insolvency, requiring emergency nationalization, government bailouts, or closure.⁶ High levels of foreign bank ownership in ECE markets stabilized capital flows and limited fiscal fragility for ECE governments (Bonin and Louie 2016).

⁶ Examples of ECE domestic banks that required substantial government assistance or closure included Parex Bank in Latvia, a number of the state-owned banks in Slovenia and by 2014, FiBank in Bulgaria.

Figure 1: Total Banking Assets in the NMS, 2006-2009

Data Source: Schoenmaker and Peek 2014, 6

Stabilization due to foreign bank ownership in ECE through and after the US financial crisis is surprising in that it contravened analyst expectations and historical experience. Reflecting back on the Asian Financial Crisis of the late 1990s, economist Robert Wade remarked in 2007 that, “No country should let its banking system be taken over by foreign banks.” His reasoning was that “at times of crisis banks rely heavily on their home state and are likely to sacrifice operations in developing countries in order to protect their home base” (Wade 2007, 84). Wade was not alone in his skepticism of foreign bank behavior in crises. By 2008-9, countless news articles, blog posts, and reports on ECE focused on the seemingly dangerous combination of foreign bank ownership, home regulatory pressure, foreign exchange exposure, supervisory prerogatives and escalating uncertainty. Paul Krugman, a Princeton University economist and *New York Times* columnist, published a blog post in October, 2008, equating Southeast Asia in 1997 to East Central Europe in 2008.⁷ Neither Wade nor his counterparts were exactly wrong. West European banks came under precisely the pressure from home governments that Wade specified. The surprise was in the degree to which Europe’s transnationalized banks fought back against a national approach to bank rescue and enlisted the support of international institutions to try to preserve their market position and long investment time horizons in ECE.

The comparison of funding volatility between East and West Europe adds still more weight to the argument that Europe as a whole should seriously consider banking market openness as part of the solution to financial and currency instability. In this respect, Eastern Europe is a model for Western Europe. Volatility in cross-border funding among West European Eurozone states was far more severe than in ECE precisely because foreign bank ownership levels in the West were low. While Western Europe presented a veneer of financial integration before the crisis due to high levels of cross-border debt, a clear lesson of the crisis is that these flows are prone to retreat behind national

⁷ See Krugman’s blog post from October 31, 2008: <https://krugman.blogs.nytimes.com/2008/10/31/eastern-europe-2008-southeast-asia-1997/> accessed 20 July 2019.

borders when risk reigns (Deuber and Epstein 2019). That is exactly what happened. For the Eurozone, a West European home bias in lending upended the European Central Bank's monetary transmission, compounded downturns, accelerated contagion, and exacerbated bank-state doom loops in which government borrowing costs and bank balance sheets both deteriorated at once (Epstein 2017).

In ECE, by contrast, Western banks' business models made it difficult and costly to indulge a home bias in lending. Western bank owners allowed Eastern loan-to-deposit ratios in many countries to climb to well over 100 percent. Letting subsidiaries fail, while legal, would have damaged relations with host authorities and resulted in existentially threatening losses for those Western banks that had spent more than a decade building up mass-market share in the post-communist world. Retreating to small and overbanked markets at home was never an option. This explanation for Western banks' continuing exposures is at odds with the more widely accepted Vienna Initiative explanation – a voluntary bank rollover agreement orchestrated by a range of international organizations (Epstein 2014b; 2017).

Despite widespread skepticism of ECE's approach to opening its banking markets to foreign entrants in the 1990s and 2000s, both from within the region and outside of it, some distinct advantages have flowed to ECE as a consequence. Foreign bank acquisition through subsidiaries proved stabilizing through the crisis and contributed to higher credit ratings in the region, and thereby lower borrowing costs (Grittersová 2017). Foreign owners brought managerial expertise and capital. Transnationalized bank ownership also created an interdependence between East and West that made it difficult for Western firms to relegate the fortunes of Eastern markets to West European economic nationalism. To be sure, foreign banks also brought economic volatility through the funding of credit booms (Deuber and Epstein 2019) – a source of vulnerability that much of ECE has reduced through lower current account deficits. On balance, however, foreign-owned banks supported growth and structural cohesion between East and West. Why, then, have high levels of foreign bank ownership come under increasing scrutiny since the crisis, with Poland and Hungary in particular re-asserting much higher levels of domestic control through ownership? As in the other two empirical cases discussed here, income convergence and FDI, the apparent economic successes mask deeper power disparities. If states have traditionally tried to maintain politically susceptible banking sectors in the interest of credit provision, macroeconomic management, crisis response, and power projection, West European states have behaved much more conventionally than their East European counterparts. Whereas Table 3 shows very high levels of foreign bank ownership in the NMS, Table 4 shows the extent to which West European Eurozone states have restricted foreign entry into their banking markets.

Table 4: Foreign Bank Ownership in the 15 Older EU Members

Country	Percentage of Foreign-Owned Banks, Assets: 2008 and 2013	
Austria	28	26
Belgium	14	47
Denmark (not in the Eurozone)	18	18
Finland	84	84
France	6	5
Germany	12	13
Greece	14	0
Ireland	36	36
Italy	6	6
Luxembourg	95	92
Netherlands	2	4
Portugal	24	23
Spain	2	2
Sweden (not in the Eurozone)	0	0
United Kingdom (not in the Eurozone)	18	11

Data Source: Claessens and van Horen 2015

The four largest Eurozone economies are highlighted because Germany, France, Italy, and Spain have been purposeful about excluding foreign entrants (Bini-Smaghi 2013; Donnelly 2014; Goyer and Valdivielso del Real 2014), as have many other Eurozone countries, with the partial exceptions of Belgium, Finland, and Luxembourg (the last of which is a financial center).

Thus, even if Western banks have brought new technology, funding, and improved credit ratings to ECE, there is nevertheless the sense in some East Central European countries that Western investment has been exploitative and/or has resulted in lost economic opportunity. The earlier reference to former Polish Prime Minister Jan Krzysztof Bielecki's observation that capital always has a nationality is a case in point. Naczyk argues that domestic managers at foreign-owned multinational corporations, and particularly at banks, were greatly frustrated by the fact that out-of-country headquarters always had final decision-making authority. During the crisis of 2008-9, even if foreign parent bank recapitalization of local subsidiaries continued, local managerial authority was nevertheless curtailed and managerial development was stymied (Naczyk 2019). These findings are consistent with earlier research showing both a concern among foreign investors that they limit Research and Development (R&D) capacity in host countries by keeping innovation capacity at home (Nölke and Vliegenthart 2009) and the continuing national embeddedness of capital, particularly among many (but not all) banks (Epstein 2017, chapter 4).

Foreign bank ownership, then, has had nationalist policy effects. Viktor Orbán's mortgage restructuring schemes that thrust high costs on foreign-owned lenders and Poland's economic development plan under the Law and Justice party both point to the extent to which politicians can leverage high levels of foreign ownership in banking (and other industries) to mobilize political support for more economically nationalist policies (Bohle 2014; Piroska and Mérő 2020).⁸ Poland,

⁸ For a summary of Morawiecki Plan ("Responsible Development Plan") of PiS (Law and Justice) in Poland, see: http://cecgr.com/wp-content/uploads/2017/07/CEC_In_Depth_The_Morawiecki_Plan.pdf.

Hungary, Slovakia, and Romania all implemented bank taxes. In Romania's case, the bank tax (eventually scaled back from the original proposal) was in part to deal with "banking greed."⁹ This was another recent example of banking's high political salience – and with good reason. Despite relatively propitious outcomes for ECE in the most recent period, foreign bank ownership or lending under conditions different from those specified here have often wreaked havoc on host markets. Moreover, none of the NMS that are not in the Eurozone have opted to join European Banking Union – another sign of the continuing preference in ECE for a national approach to bank oversight in the aftermaths of the US and Eurozone economic crises.

From a liberal economic perspective, the NMS have on balance both followed liberal prescriptions and reaped the benefits from doing so. Yet robust electoral support for those same liberal principles has not always followed. We would do well to remember Robert Gilpin's admonishment that the problem with liberals is that they take it for granted that all reasonable people agree on the unalloyed benefits of enhanced riches, to the exclusion of concerns about power and control (Gilpin 1975). The populations of East Central Europe are no less reasonable than anyone else. Their economic subordination, its wealth-inducing effects notwithstanding, has led to varying degrees of Euro-skepticism, illiberalism, and nationalism, in keeping with a number of other advanced industrialized countries.

Conclusion

Together, EU and NATO membership created a new geopolitical and economic context in which the countries of East Central Europe have enhanced autonomy, voice in international organizations, access to large and wealthy markets, and significant subsidies in some cases (see also Vachudova 2005). To be sure, EU membership encouraged economic openness, but economic reformers in ECE at times liberalized even more than was required by international organizations (Appel and Orenstein 2018). Liberalization in the form of privatization, freer trade, and foreign direct investment have generated income gains, higher consumption, increased credit provision, enhanced productivity, and technological upgrades. And yet the political response has been far from euphoric. While majorities prefer to remain in the EU in all of the NMS, Euro-skepticism and illiberalism also have enormous appeal. The analysis presented here suggests that ongoing power differentials between new and old EU members, particularly as they manifest in absolute income and the one-way character of foreign direct investment, account for some of the disillusionment. Unequal economic positions provide a basis on which populist politicians can plausibly argue that East Central European populations are victims who are not reaping the full and just rewards of EU membership.

There are at least two critiques of the claims made here. The first is that dependent capitalism is not an accurate way to characterize the relationship between (mostly) Western investors and Eastern host markets (Bruszt and Langbein 2020). This approach suggests that there may be illiberalism, corruption, and other dysfunction in ECE, but it is not because of economic developments or the EU's liberalizing agenda. On the contrary, while the EU had championed liberalization in certain areas, it also has a politically and developmentally based program of

⁹ See Boris Groendahl, "Romania's 'Greed Tax' Reminds Banks of Eastern Europe's Risks," *Bloomberg*, 19 December 2019. Available at: <https://www.bloomberg.com/news/articles/2018-12-19/romania-s-greed-tax-reminds-banks-of-eastern-europe-s-risks> accessed 21 July 2019.

redistribution through its structural funds program. Even more important, the EU has both actively and passively contributed to state capacity building in ECE. Thus the ‘dependent capitalism’ literature tends to understate East Central European agency. According to Bruszt and Langbein, illiberalism cannot stem from relative deprivation and disempowerment because those are not, in fact, features of the current context in ECE.

A second plausible objection that complements the first is that East Central European skepticism of democracy, economic liberalism, and the EU is firmly rooted in domestic politics and history (Trencsényi 2014). The communist-era prohibition against thoroughgoing investigations into past atrocities, including local populations’ culpability, allowed politicians to take liberties in constructing historical narratives. In particular, where political party turnover in the transition facilitated the regeneration of formerly communist parties into competitive socialists (including in Poland and Hungary), nationalists claimed a viral incursion had poisoned the transition from the beginning – and that the virus itself was inextricably linked to liberalism. In addition to Trencsényi’s argument about local political discourses concerning communism, transition, and culpability, one could also argue that democracy is still comparatively new in ECE and that relatively untested democratic institutions are therefore more susceptible to political and partisan pressure.

However, neither of these alternative explanations for illiberalism in ECE necessarily invalidates the argument presented here about the salience of perceived economic subordination and relative deprivation. The EU can build state capacity and at the same time lack control over purchasing power differentials that result in high volumes of net inward investment, brain drain from ECE, and high current account deficits in the run-up to the US and European financial crises. Moreover, the economic context could spawn more than one kind of narrative about the possibilities and perils of economic liberalism. Not just in ECE but in many countries across the globe, critics of economic integration and interdependence have made, and won, the argument against liberalism in its many forms, at least in the most recent period. The global nature of illiberalism’s rise suggests that developments in ECE may not be entirely historically specific. Rather, East Central Europe provides the lens through which we might view and come to understand larger global trends, as has so often been the case of this part of the world.

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