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East European capitalism – What went wrong?

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Introduction

Not all that long ago, the East European newcomers to the European Union (EU) were considered economic miracles which successfully weathered the storms of transformation from socialism, and were ready to settle on stable democratic capitalist development paths. It was even assumed that these countries, toughened by the experience of repeated crises in the 1990s and backed by EU-entry requirements, had developed regulations and institutions that would prove resistant to the current global crisis. Things have turned out otherwise. Almost all new EU member states have accumulated major economic imbalances, and are boarding on steep recessions. Two countries – Hungary and Latvia – had already to turn to the International Monetary Fund (IMF) in order to defend their currencies and keep their economies afloat. Other countries of the region are prone to follow. The crisis in

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Eastern Europe is not only economic. Surging protests and the increasing appeal of political illiberalism in the region attest to an end of the »political economy of patience« (Offe 1991) which characterized the first years of post-socialist transformation.

What has made the region's democratic capitalist project so vulnerable? This essay seeks for answers by taking as its starting point the worry expressed by many students of the region in the early 1990s that the double transformation to capitalism and democracy constitutes a challenging agenda. The introduction of capitalism was a political project, and it could only succeed if based on strong democratic legitimacy. At the same time, it was however considered highly unlikely that the population would patiently bear the high social costs of transformation without making use of their newly acquired democratic voice to obstruct market reforms. The crucial question, therefore, was whether East European societies could mobilize resources to increase tolerance for the economic costs of transformation (Offe 1991, Greskovits 1998).

Comparing the Hungarian and Latvian experiences, I argue that both countries relied on a number of methods to make the pains of economic transformation tolerable. While Hungary mitigated the costs through social policies, Latvia – a newly independent state – used identity politics to instill tolerance for social hardship in its society. These domestic resources were however insufficient to create solid support for capitalism, and showed already signs of exhaustion during the 1990s. Increasingly, international actors and markets came to the rescue of the fragile capitalist democracies. The EU's decision to start entry negotiations offered an external anchor for reforms, and made the countries also much more attractive for international capital flows, which were abundant in the 2000s. The tolerance of international markets and institutions for great economic imbalances allowed governments in both countries to grant their population a broader share of the new system's wealth. The global financial crisis has however pulled the rug out from under such solutions.

Mitigating the social costs of transformation: Welfare states and identity politics¹

Hungary's transformation strategy has been characterized by major policy swings from introducing (market) shocks which led to major structural changes, and state-paternalistic compensation packages for industries and major segments of the population. The first conservative democratic government attempted a radical shift away from the »goulash communist« past by cutting subsidies and simultaneously raising the charges on fuel. Confronted with fierce resistance, it had to backpedal, and henceforth committed itself to pacifying the society by means of relatively generous welfare provisions (Vanhuyse 2006). Similarly, after introducing tough bankruptcy laws which caused the breakdown of thousands of firms and prompted a banking crisis, the government launched a bank consolidation program amounting to ten per cent of the Hungarian GDP and almost 20 per cent of its 1994 budget (Stark/Bruszt 1998: 151). The compensation packages resulted in major macroeconomic imbalances,

1 This section builds on Bohle/Greskovits 2007.

which in turn led the second government formed by a left-liberal coalition to launch a major austerity program, the so-called ›Bokros package‹. While improving Hungary's external balance through facilitating a shift towards export-oriented re-industrialization, the

»shock administered by the Bokros package of 1995 proved to be a lasting nightmare for the Hungarians, produced loss of trust in the Socialists' and Liberals' sensitivity on issues of social welfare, and reinforced the welfarist opportunity structure of political life« (Greskovits 2006: 282).

Latvia's transformation strategy differed in important aspects from that of Hungary. As a newly independent state, it relied on identity politics rather than welfare spending in order to generate support among its citizens. A crucial policy choice in terms of identity politics was the (re)introduction of its own currency, the lats, shortly after independence. As Gilbert and Helleiner (1999) argued, national currencies are a major device to bind state and nation, and have an important role in building national identities. Latvia opted for a strong currency. It pegged it against an external anchor, and the Central Bank's policy has mimicked successfully the currency board arrangements of its two Baltic neighbors (Knöbl et al. 2002: 20).² As a corollary of the choice of the currency regime, Latvia accorded great importance to macroeconomic stability. Its policy of controlling public expenditure limited its room for compensatory policies. Although the social costs of transformation were much higher than in Hungary, social benefits stayed very low. Latvia was also the first country in the region to embark on radical welfare state reforms.

In the first years, Latvian policy-makers overwhelmingly relied on a shared national identity among its citizens to generate support for the new system. At the same time, Latvia did not start its transformation as a full-fledged democracy. Latvian politicians excluded their large Russian-speaking minority – around 35 per cent of the resident population – from citizenship. Naturalization of Russian speakers only started very gradually in 1995 (Smith-Sivertsen 2004: 102). The exclusion of Russian speakers from democratic politics also limited the spectrum of political competition, as no major left-wing party could emerge. The patience of the Latvian citizens with the hardships of transformation however started to wear off fast. In domestic politics, socio-economic issues have gained more importance since the mid-1990s, thus gradually displacing questions of nation building (Smith-Sivertsen 2004).

Thus, despite different policy choices since the second half of the 1990s, governments in Hungary and Latvia faced increasing dissatisfaction with democracy and market reforms alike. Moreover, neither country's external position seemed to allow for substantial social improvement which would help to mitigate popular dissatisfaction (see Table 1).

2 The lats was first pegged against the Special Drawing Rights, and from 2004 against the euro.

Table 1: Social, political and economic variables, 1997 – 1999

	Social indicators (1999)			Satisfaction with democratic capitalism (1997)		External vulnerabilities (1999)	
	Real wages (1989 = 100)	Unemployment (% of labor force)	Social protection spending (% of GDP)	Satisfaction with market economy (% of respondents)	Satisfaction with democracy (% of respondents)	External debt (% of exports)	Current account (% of GDP)
Hungary	81.0	6.9	20.7	6	30	101.5	-7.8
Latvia	66.2	14.0	17.2	0	24	131.1	-9.0

Sources: Column 1: Transmonet database 2004, Column 2: AMECO Database, Column 3: Eurostat, Column 4 and 5 Central and Eastern Eurobarometer 1997, Questions: (Annex 71) Do you personally feel that the creation of a market economy is right or wrong for your country's future? (Annex 72) On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy is developing/working in your country?, Column 5 and 6: EBRD Transition Report 2007.

The extension of the grace period

At this point in time, however, international actors and markets came to the rescue of the fragile capitalist democracies. Most importantly, the EU's decision to start entry negotiations with Hungary in 1997 and Latvia in 1999 offered an external anchor for reforms and the perspective of additional funds that would ease the tasks ahead. The perspective of EU membership also made the countries very attractive for international capital flows, which were getting abundant in the 2000s. Foreign investment in strategic sectors, most importantly the financial sector, was actively encouraged by the EU. It was assumed that selling off the banks to outsiders is the

»best way to create a solid financial system, allowing countries to borrow freely and grow fast, without risking the kind of crisis suffered by emerging markets in past decades« (The Economist 2008).

Foreign ownership of strategic sectors thus created a short-cut on the road to capitalism, made possible by the EU's seal of approval impressed upon the accession countries.³

3 A similar short-cut was the formulation of strict accession criteria, which kept major reforms out of the reach of domestic politics, while allowing the EU to supervise the progress of the accession countries.

Governments in Hungary and Latvia used the grace period offered by a more permissive international environment to accommodate the social pressures that had built up. In Hungary, political competition led to an acceleration of public spending on housing, welfare programs and public sector wages targeted specifically to the middle classes. Under the conservative Orban government (1998 – 2002), minimum wages were raised twice, by altogether 80 per cent, public construction programs launched, and home builders were granted generously subsidized loans. After 2002, the victorious left-liberal coalition continued the welfare effort by additionally focusing on public sector employees and pensioners (Greskovits 2006).

In addition to the state-financed welfare programs, Hungarian governments also turned a blind eye to the rapid increase of foreign currency denominated credits to private households. Foreign currency borrowing in Hungary was introduced by its foreign banks, dominantly of Austrian origin, who transplanted a fashion created earlier in their home country, namely to issue credits denominated in Swiss franc. In Hungary, Swiss franc-denominated lending took off in 2003, after the Swiss National Bank dropped interest rates dramatically. By the end of 2007 roughly half of the contracted mortgage and personal loans were in Swiss franc, and between 2006 – 2007 alone 80 per cent of all new home loans and half of small business credits and personal loans were taken out in Swiss franc (Hugh 2008a).

The effects of the informal ›swissfrancization‹ of the Hungarian economy can be dubbed ›house-price Keynesianism‹. I borrow this term from Hay et al. (2008: 197), who analyze the Irish mortgage boom after EMU entry under this heading. The origin of the Irish housing boom lies in the difference between the interest rates set within the euro area and those that would have been needed in Ireland to combat its higher inflation. The lower euro interest rates made mortgage loans and their repayment cheaper and led to a rise of housing prices. These developments compensated consumers for the increases in retail prices. Similar forces were at play in Hungary. Since 2002, its Central Bank pursued a policy of high interest rates to fight inflation and the growing deficit. This made borrowing in Hungarian forint almost prohibitive. The much lower interest rates of the Swiss franc-denominated loans and the ensuing house price rises, however, compensated consumers for the restrictive domestic monetary policy and rising retail prices. Nominal housing prices in Hungary increased by twelve per cent annually between 2002 and 2006, and thus at a similar rate as in Ireland (Egert/Mihaljek 2007: 4). High interest rates also led to an appreciation of the forint that made borrowing in foreign currency look even more advantageous. The flip-side of the coin was that the exchange rate risk was privatized to the consumers. Yet, both consumers and financiers seem to have been banking on Hungary's eventual euro entry, which was going to put an end to exchange rate risks.⁴

Latvian governments relied to a much stronger degree on this kind of ›market forces‹ to promote the living standard of their citizens. As in the first decade, during the 2000s governments stayed committed to prudent fiscal policies and were reluctant to stretch fis-

4 For a thorough discussion of the Euroization in Eastern Europe see Becker (2007).

cal limits by increasing social spending, minimum wages, or public sector salaries. The high catching-up growth rates of 8.5 per cent on average between 2000 and 2006 made it easy, however, to reconcile pension and wage growth with fairly balanced budgets. Growth also brought down unemployment. Moreover, in contrast to Hungarians, Latvians made use of the newly acquired right to exit when the country joined the EU. Six to eight per cent of the labor force was working abroad in 2006, mostly in the United Kingdom and Ireland (Hugh 2007). As a consequence, labor markets tightened, leading to exceptional wage growth (see Table 2).

At the same time, Latvians experienced a mortgage and housing boom which by far outpaced that of Hungary. As in Hungary, it was the penetration of foreign banks that lay at the origin of the expansion of foreign-denominated credits to households and domestic enterprises. Overall credits to households grew at a rapid pace, and mortgage loans took up a growing share (see Table 2). By 2006, more than 70 per cent of the loans were issued in foreign currency, mostly euro.

Table 2: Social, political and economic indicators, 2006

	Social indicators				Satisfaction with democratic capitalism		External vulnerabilities	
	Real wages 2006 (2000 =100)	Unemployment (% of labor force)	Social Spending (% of GDP)	Mortgage loans (% of GDP)	Trust in the economic situation (% of respondents)	Satisfaction with democracy (% of respondents)	External debt (% of exports)	Current account (% of GDP)
Hungary	135.6	7.5	22.3	13.9	26	45	121.4	- 8.4
Latvia	159.5	6.8	12.2	28.9	19	41	271.8	-21.1

Sources: Column 1 – 2: AMECO database, deflator: private consumption, Column 3: Eurostat, Column 4: EBRD structural indicators, Column 6 – 7 Eurobarometer 65, 2006, Questions QC1: How would you judge the situation of the national economy? QA34a: On the whole, are you very satisfied, fairly satisfied, not very satisfied or not at all satisfied with the way democracy works in your country? (fieldwork from spring, thus before the Hungarian adjustment package), Column 7 and 8: EBRD Transition Report 2007.

It was Hansabanka, owned by the Swedish banking group Swedbank, one of Latvia's biggest banks and leader in private mortgage lending, that set off the country's unprecedented housing boom. In May 2002, Hansabanka submitted a proposal to promote mortgage lending, which the center-right government under Andris Berzins duly accepted (Swedbank 2002, Leitner 2007). As a consequence, housing construction took off and housing prices soared. The average price of a square meter in a standard type block house in Riga increased on average by 42 per cent annually between December 2001 and December 2006 (Latio Real Estate 2007). According to Egert/Mihaljek (2007: 4) housing prices in the Baltic States have exhibited growth rates »unseen in the industrial world.«⁵

Falling from international grace

The Hungarian and Latvian social contracts of the 2000s were built on shaky international foundations. Export competitiveness declined, external debt and current account deficit soared in both countries (see Table 2). It was Hungary that first felt the increasing heat, although its fundamental macroeconomic and financial imbalances were by no means worse than those of Latvia. But its twin fiscal and current account deficit as well as persistent exchange rate instability brought it on the radar screen of several international actors. Almost immediately after enlargement, the EU started to scrutinize the new member states for their economic convergence on the Maastricht criteria and started excessive deficit procedures against Hungary. In June 2006 Ferenc Gyurcsány, just re-elected as Prime Minister, announced drastic changes in the social and economic policies in order to bring the budget deficit back under control and prepare the country for meeting the Maastricht criteria.

While the EU Commission accepted the new convergence program, international rating agencies judged Gyurcsány's effort as unsatisfactory. All major agencies cut their ratings in late summer 2006 on the ground that

»the very strong focus on the revenue side fails to address persistent expenditure-side pressures that are at the heart of Hungary's budget woes« (Finciczki/Penz 2006, National Bank of Hungary).

The increasingly negative perception of Hungary's economic outlook added to the country's economic difficulties.

While the Gyurcsány package started to redress the domestic and external imbalances, it had negative repercussions on growth, real wages and consumption. The shock of the package was not yet digested when Hungary became one of the hot spots of the global financial crisis. In October 2008, its currency and stock markets started to plunge and credits dried up. In order to boost confidence in the forint and to get access to foreign currency liquidity, the Hungarian government decided to turn to the IMF. While the loan – all in all 20

5 These authors do not provide data for Latvia, but according to all available sources, Latvia is at the high end of the housing boom in the Baltic countries.

billion € granted by the IMF, the EU and the World Bank – is huge by any comparison, the conditions attached to it are bound to be grim for a large part of the Hungarian population. The Hungarian letter of intent stipulates that this time around, the adjustment will focus on the public expenditure side (see Table 3 on the next page).

Latvia's much more disciplined approach to fiscal policies, which is grounded in its effort to defend the currency peg and has remained largely unchallenged as a result of the limited political party competition, has allowed the country to cruise longer below the radar screen of international attention. The first signs of stress occurred when after successfully joining the ERM II in 2005 Latvia's inflation rate was persistently higher than the EMU reference value. At that time, however, it was generally assumed that inflation would be soon brought under control (Feldmann 2006). In 2006 the IMF published one of the first critical analyses of Latvia's growing imbalances. The report drew attention to the rising current account deficit of the country, and its limited capacity to close the gap through exports. The same report also stressed the problems of rapid growth of credits to private households, and duly warned that »[a]s numerous cross-country studies have documented, rapid credit growth is the single best predictor of banking crises.« (IMF 2006: 54)

Despite increasing signs of imbalances, Latvia stayed committed to its currency peg, thus severely limiting the policy options available to attack its problems. In March 2007, the Kalvītis government endorsed an anti-inflation plan, which seemed modest for an economy that had spiraled out of control. Latvia's current account deficit reached more than 25 per cent of GDP in the first quarter of 2007, wage and price inflation accelerated, and the real exchange rate rapidly appreciated (IMF 2009, Hugh 2007). With the outbreak of the global financial crisis, both the banking system and the peg came under increasing pressure. In autumn 2008, the major domestically owned bank, Parex, encountered serious liquidity problems, and official reserves fell by almost 20 per cent due to the Bank of Latvia's attempt to defend the currency. Despite the huge effort, the pressure on the lats stayed strong (IMF 2009). In December 2008, facing bankruptcy, the Godmanis government turned to the IMF for support.

Latvia received a loan of 1.7 billion € from the IMF complemented by additional funds from the EU, the World Bank and several bilateral creditors bringing the total amount to 7.5 billion €. Latvia's adjustment program is severe even by IMF standards. IMF Managing Director Dominique Strauss-Kahn said as much:

»It [the program, D.B.] is centered on the authorities' objective of maintaining the current exchange rate peg, recognizing that this calls *for extraordinarily strong domestic policies*, with the support of a broad political and social consensus« (quoted in Hugh 2008b, see also Table 3 on the next page).

Although the IMF in the end endorsed Latvia's commitment to keep the currency peg, it initially opted for a widening of the lat corridor (IMF 2009: 10).

Table 3: The IMF stand-by agreements

	Hungary	Latvia
Overall loan (billion euro)	20 (of which IMF-loan 12.5)	7.5 (of which IMF-loan: 1.7)
Fiscal policy	<p><i>Short term</i> Budget deficit target: 2.5 % (implies a fiscal adjustment of 2.5 % of GDP) To be achieved through:</p> <ul style="list-style-type: none"> – Keeping nominal wages in public sector constant through 2009 – Eliminating 13th month salary for all public servants – Capping 13th month pension payment – Postponing the indexation of selected social benefits – Trimming operating expenditures across the board <p><i>Medium term</i> Fiscal discipline, reinforced by fiscal responsibility law</p>	<p><i>Short term</i> Budget deficit of 4.9 % (difference to pre-agreement target: 7% of GDP) To be achieved through Tax increases (mostly indirect taxes) (1/3) Cutting expenditures (2/3)</p> <ul style="list-style-type: none"> – Cutting of public sector wages of 25 % – Expenditure cutting across the board of 25 % – Freezing of pension indexation in 2009 <p><i>Medium term</i></p> <ul style="list-style-type: none"> – Structural reforms of civil service, health care, unemployment benefits and pensions – Extend public sector wage reductions to state-owned enterprises and local governments – Install a tripartite committee to promote wage restraint – Fiscal discipline reinforced by fiscal responsibility law
Financial Sector Policies	Government seeks agreement with commercial banks to mitigate balance sheet risk of households from their foreign currency loan Support package for qualified domestic banks (HUF 600 billion)	Partial nationalization and recapitalization of domestic Parex bank, potentially recapitalization of other banks Development of a comprehensive private debt restructuring strategy
Monetary and exchange rate policy	Exchange rate band was removed in early 2008, monetary policy to focus exclusively on inflation target.	Maintenance of exchange rate peg

Source: IMF 2008 and 2009

Conclusion

Twenty years after Eastern Europe embarked on its path towards democratic capitalism, the challenges of the double transformation have once again come to the fore. The remarkably smooth transformation in the region so far has relied on the mobilization of a number of resources to mitigate the social costs. In the case of Latvia, identity politics has lengthened the time horizon of reformers, while Hungary pacified its society through generous welfare policies. These policies were not sustainable: Already in 1995, macroeconomic imbalances and the external constraint forced Hungary into a tough austerity package. In Latvia socio-economic grievances started to displace the national question, while its external imbalances got worse. The fragile new regimes however got a grace period. Their rapprochement to the EU encouraged mostly foreign banks to channel a significant amount of liquidity to the region in a period of easy money, when international financial markets were ready to finance external imbalances of unusual proportions. Under the protective shield of EU accession, Hungary could renew its welfare effort and rely, at the same time, on house-price Keynesianism backed by informal swissfrancization. Latvia relied more on ›market forces‹ – mass emigration resulting in tight labor markets, and a euro-loan financed housing boom unheard of in the industrial world – to improve the living standards of its citizens. The global financial crisis put an end to all of this. Even worse, it reversed the impact of the institutions and devices which have so far contributed to mitigate the costs of transformation. Rather than a resource for democratic capitalism, welfare spending has turned into a liability for Hungary. Latvia's stable lats, once the proud symbol of renewed nationhood, has turned into a straightjacket. Short-cuts to Western capitalism, such as foreign dominated banking systems, have turned into major risk factors, as their huge loan books in the East are not necessarily covered by their home countries' bailout plans. Informal Euroization or Swissfrancization, once backed by the perspective of formal euro entry, has turned into a trap of gigantic proportions for the debtors who bear the exchange rate risk.

Faced with austerity and the perspective of hard landing, Hungarian and Latvian protesters gathered in great numbers in front of their parliaments. Riots have become rituals in the once peaceful Hungary, and have occurred in Latvia for the first time since the early years of independence. In both countries the governments which negotiated the IMF packages had to resign. With popular dissatisfaction growing, and governments at loss of resources to mitigate the pains to come, the future of democratic capitalism in the region is once again uncertain.

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