Introduction

The year 1989 has become known as the *annus mirabilis*, or miraculous year. And, indeed, what happened that year was neither predicted nor believable. It surprised the world. State socialism, which had established its isolated bridgehead in Russia after the Bolshevik Revolution of 1917, spread and conquered Central and Eastern Europe after World War II. Besides the Soviet bloc in the eastern half of Europe, it gradually incorporated nearly one-third of the world by the 1980s. The Soviet Union emerged as a superpower with an enormous army and nuclear arsenal. In times of crisis that threatened the system in other countries, such as the 1953 Berlin revolt, the 1956 Hungarian Revolution, the Prague Spring in 1968, or the Afghan crisis in 1979, the Soviet military machine did not hesitate to intervene and "save" socialism. The international military balance of power during the Cold War decades kept the postwar world order intact and, as everybody believed, unchangeable. Moreover, in 1975, the Helsinki Agreement reaffirmed international acceptance and guarantee of the *status quo*.

By the late 1980s, however, historical changes had rendered impossible a brutal military solution to such crises. Not even hardliners risked open confrontation and the use of force. In situations where force seemed the *ultima ratio*, they refrained from using it and capitulated. And, in 1989, state socialism peacefully collapsed in Poland and Hungary over the course of a few months, and then throughout Central and Eastern Europe within six weeks. This process concluded with the collapse of the Soviet Union itself in 1991. The miracle of peaceful revolution destroyed state socialism because nobody was ready to defend the regime. The elite prepared to save its position by giving up power, or at least part of it, through major reforms and compromises.

The year 1989 thus became a historical landmark of twentieth-century Europe. In retrospect, the situation offered no alternatives, and the transformation from the late 1980s, as Timothy Garton Ash noted, "proceeds at break-neck speed with a quiet democratic revolution" or, in his coinage from the words *revolution* and *reform*, "refolution" (Garton Ash, 1989).

What happened in Central and Eastern Europe in 1989 was, however, not only a break with the postwar socialist past. The countries of the region followed a different historical path from that of the advanced West in most parts of the twentieth century: economic nationalism, self-sufficiency from the 1920s, authoritarian dirigisme during the 1930s and early 1940s, and later a Soviet-type non-market system with central planning. From the early 1930s and then during the entire period of the 1950s to the 1980s, the countries of Central and Eastern Europe belonged to isolationist regional alliance systems led first by Nazi Germany and then by the Soviet Union.

The unsolvable crisis of the 1970s and 1980s dramatically strengthened opposition to the state socialist regime and contributed to its collapse. Moreover, 1989 marked the end of a long revolt, from both the Right and the Left, against the West. Instead the trend turned to adjustment and "Joining Europe!" This slogan of 1989 targeted the replacement of the failed system that was unable to cope with the challenge of globalization. The countries of the region longed to follow the successful West and introduce its integrationist open market system. They wanted to be part of the European Union.

At the same time, the European Union itself experienced slowdown and crisis beginning in the late 1960s and early 1970s. It sought to regain its vitality, to reestablish its competitiveness, and to cope with the challenge of globalization. Western Europe was the only major player in the rapidly globalizing world system without an economic "backyard." Latin America and large parts of Asia became part of the production networks of the United States and Japan, respectively, and assisted their economic performance.

After 1989, the European Union was immediately ready to integrate and incorporate Central and Eastern Europe in order to stabilize peace on the continent and to build its own nearby production network. To achieve that, the Union was ready to direct and assist the transformation of Central and Eastern Europe, and to accept ten ill-prepared, former communist countries as EU members in the near future. The enlargement of the Union and the preparation for further enlargement in the Western Balkans were important for the economic interests of the old member countries of the European Union. The enlargement strengthened the EU's production network and stabilized the continent. The metamorphosis of Central and Eastern Europe is, therefore, also a chapter of the history of the European Union. Both East and West became winners through integration.

Central and Eastern Europe's transformation was thus determined by the dual characteristics of the turn of the millennium in Europe: globalization and the European Union's response to its challenge.

The first chapter of the region's transformation was essentially complete by the time ten of its countries were accepted to the EU in the new *anni mirabiles* of 2004 and 2007. The countries adjusted to the requirements of the West, abolished their dictatorial regimes and their state-owned, non-market systems, and rushed to introduce parliamentary democracy and free market economies. They abandoned gradualism, took risks, and made serious mistakes on an uncharted road, but in a decade and a half successfully changed their situation. The social cost was dear, and social pain, increased poverty, and income disparity affected wide layers of their societies. Even demographic trends worsened. The social shock, caused partly by the change of systems, but even more by radically changed values and culture, is not yet over and characterizes both winners and losers alike in these societies. It renders the political situation fragile, and it opens the door to the sort of populist-nationalist fundamentalism which spread through the region in the early 1990s, especially in the Balkans, and then reemerged again in Poland, Slovakia, and Hungary as late as 2006 and 2007.

A significant contribution to the rapid transformation of the region was the European Union's insistence on compliance with its legal and institutional requirements (*acquis communautaire*), combined with more financial assistance than was received under the postwar Marshall Plan, and an even higher amount of direct investments. The EU offered its markets and modernized the telecommunications and banking systems of the transforming countries. Central and Eastern Europe adjusted to the requirements of the free market and became an important part of the production network of old EU countries. An old dream came true, although the countries of Central and East European region are not yet equal partners in the formerly exclusive European club, and the new members often consider themselves second-class citizens in Europe.

The Central and East European income level, as a consequence of its different historical past, is much lower – from one-half to one-quarter of that of the established members of the European Union – and the region's economy is highly dependent on the West and Western investments. The social patterns of the new and prospective Union member countries also carry the heavy burden of an unfortunate past. The region consequently has a subordinate position in globalization. Will they break through and in time become prosperous equals? Will they achieve European Union levels in terms of such basics as income level, labor productivity, infrastructure, consumption, and modern social-occupational structures and attitudes?

Successful transformation does not mean merely full adjustment to the market system and the requirements of the European Union. In a broader sense it also requires adjustment to modern Western values and behavioral patterns, and achievement of advanced income levels similar to those in the West. Catching up with the EU-15 in this broader sense is a long historical march that requires a competitive economy based on domestic innovation, appropriate social and educational institutions, advanced domestic banking and the availability of venture capital, and a wide array of small- and medium-sized companies. Only the very first steps have been taken to establish all of that, and only in a handful of countries.

The process, however, has already begun. If it succeeds, Central and Eastern Europe will organically incorporate into a larger entity: Europe. The caravan of Central and Eastern Europe is on the move. The possibility of catching up with the West, which has motivated these countries from the early nineteenth century, has become a realistic goal for the first time in history, though it will be neither a quick nor an easy one to achieve. A positive outcome will require generations and is not a given or even evident at this stage of development. The door is wide open. Some of the countries will enter. Others will not, or will cross the threshold only much later.

This book covers the area of Central and Eastern Europe. At this point, I need to clarify what I mean by that.[1] The eastern half of the European continent, often called Eastern Europe, Central Europe, or Central and Eastern Europe, has a huge variety of definitions. Without summarizing a century-long debate and the various interpretations of the region from Leopold von Ranke ([1824] 1909) to Jenő Szűcs (1983), I am going to discuss the region that in earlier centuries was located between the German, Russian, and Ottoman empires, and which interwar German authors called *Zwischen Europa*, or "in-between Europe." History in this zone began half a millennium later than in the Western Carolingian Empire; Christendom conquered most of it in the ninth and tenth centuries, but this zone remained the frontier of Christian-feudal Europe for centuries, open to "barbaric" attacks from the East (N. Berend, 2001;

[1] I use the terms Southern Europe and Mediterranean Europe interchangeably to mean Greece, Italy, Portugal, and Spain, while Western Europe means Austria, Belgium, Britain, Denmark, Finland, France, Germany, Ireland, Liechtenstein, Luxembourg, the Netherlands, Norway, Sweden, and Switzerland.

2007). Unlike the western half of the continent, the region remained agrarian until World War II. Nation building remained unfinished, and borders and state formations have changed right up to the present, as multiethnic states divide and split apart. Most of the countries of the region belonged to huge multiethnic empires for up to five centuries, and they remained ethnically mixed, politically authoritarian, and oppressive against minorities.

In many ways, however, and in spite of important similarities, this region is different from the "East *par excellence*," as Szűcs (1983) called Russia. It is difficult to generalize about the various countries because they belonged to three empires in the middle of the nineteenth century, formed ten states in the interwar decades, and comprise seventeen countries today. One can differentiate between two distinct subregions, Central Europe and the Balkans, which exhibit significant differences. They, nevertheless, were and are characterized by basic similarities. All of them lost independence between the late fourteenth and eighteenth centuries and became incorporated into huge neighboring empires and, after regaining independence, they all formed part of the Nazi German *Lebensraum* and then the Soviet bloc in the twentieth century. Nowadays, they are all equally countries "in transformation." The historical trajectories of Central and Eastern Europe thus differ significantly from the West and, in many senses, from neighboring Russia and Turkey, as well (I. Berend, 2005).

This is a region which has existed as a historical unit for a millennium, but it might begin to disappear as a distinguishable entity if the transformation successfully continues, and if the countries of the area prove able to rise to the level of the West in the space of one or two generations.

CHAPTER 1

The economic factors in the collapse of state socialism and the new international environment, 1973–1989

The collapse of a regime always has more than one cause. In my interpretation, however, among the various international and domestic factors that led to the collapse of state socialism in Central and Eastern Europe, basic economic facts were primary. Accordingly, we must first unravel, out of the numberless threads that make up the fabric of history, the dramatic changes in economic processes brought about by the shock to the world economy caused by the oil crisis of 1973.

The economic base of state socialism was visibly undermined from the 1970s on, accelerating its collapse. For a full understanding of this process, it is important to give a relatively detailed explanation of the international economic situation, the Western reaction to a changing economic world, and the Eastern inability to adjust to it. These developments are not only the main factors in the collapse of socialism, but also explain the requirements and trends of postcommunist transformation. This is, therefore, the proper point of departure for analyzing the two crucially important decades around the turn of the century.

The year 1973 was indeed the beginning of a new chapter of greater European economic history, which, in the case of Central and Eastern Europe, led to the collapse of their state socialist regimes. It should be noted, however, that this chronological division is also somewhat artificial. As I explain below, the slowdown in economic growth and productivity in the region and around the world had been unfolding gradually over a longer period of time. Moreover, major political and economic crises had hit the Soviet bloc countries quite a few times already before. Nevertheless, I still begin with the politically motivated oil crisis of 1973, which made dramatically manifest this development's gradually accumulating limitations and emerging predicament.

CAMBRIDGE

Cambridge University Press
978-0-521-72950-5 - From the Soviet Bloc to the European Union: The Economic and Social Transformation of Central and Eastern Europe since 1973
Ivan T. Berend
Excerpt
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Economic crisis, slowdown, and technological transformation in the West and lack of adjustment and decline in the East after 1973

The West

In the fall of 1973, the seemingly "endless" postwar prosperity in Europe came to an abrupt halt. As many contemporaries speculated, the sudden change might have been accidental, generated by a political drama – namely, the October 1973 Yom Kippur War in the Near East – followed by the boycott decision of the Organization of Petroleum Exporting Countries (OPEC). Crude oil prices soared from $2.70 per barrel in 1973 to $9.76 by 1974. Another political drama, the Iranian Revolution of 1979, generated a second "oil crisis" in 1979–80, and, taken as a whole, oil prices increased tenfold. This new development eroded the hope and prospect of adjustment.

From that time, nothing worked as usual. Economic growth stopped, prices and unemployment sharply increased, and Keynesian demand-side economics – according to which additional demand, and strengthening the purchasing power of the population through job creation and state investments, could enable governments to cope with economic crisis – became unable to cure the stagnation and decline any longer. In fact, it generated even higher inflation. The Philips curve, the classic "law" describing the inverse relationship between inflation and unemployment, i.e., increasing inflation decreases unemployment and vice versa, also stopped working as inflation and unemployment rose together. What followed was a sudden slowing down and decline accompanied by high inflation and unemployment. This odd pairing of stagnation *and* inflation led to the introduction of a new economic term: *stagflation.*

Why did Keynesian economics, which worked for roughly forty years, fail? Why did all the usual economic trends suddenly change? Was it the mysterious long-term Kondratiev cycle that has its 20- to 25-year upturn and then 20- to 25-year downturn, one following the other since the late eighteenth century? Was it the cycle's downturn which had arrived like a German train, right on schedule, following the postwar quarter-century of high prosperity? We have several more exact explanations, including a role for an overheated, exceptional boom, which gradually compromised itself. As Andrea Boltho stated:

> The year 1973 represented a watershed . . . a very sudden break with the past, but the trend towards a deteriorating performance had already set in earlier. In a way, the success of the 1950s and 1960s had laid the preconditions for at least some of the failures of the 1970s. (Boltho, 1982: 28)

Herman Van der Wee also underlines the close connection between the high prosperity and its end by noting that the gross capital stock per employee in France, Germany, the Netherlands, and Britain went from $78,440 to $208,211 between 1950 and 1973 (in 1990 values):

> [T]remendous over-investment [took place] in the traditional industrial sectors of the modern consumption economy during the 1960s, causing massive overcapacity. This over-investment and overcapacity in the West was accentuated by the industrialization process in the Eastern bloc and the Third World, a process which was often concentrated in identical sectors . . . the enormous investment in the secondary and tertiary sectors held out the prospect of a shortage of foodstuff, raw materials and energy. The turning of the terms of trade in favour of primary producers from the beginning of the 1970s came as a result of this growing imbalance. (Van der Wee, 1986: 90)

The price of energy and raw materials increased significantly before the oil crisis, and by as much as 63% in 1972–73, while the rate of inflation in Germany reached 7% in that year. The economy became overheated and industrial output in the advanced West increased by 10% that year.

A quarter-century of excessive growth and skyrocketing consumption led to the saturation of consumer goods markets. As part of this trend, exports also became more difficult, and their growth slowed. Mass production, a key factor of prosperity, became less and less sustainable. Robert Brenner commented: "The advanced capitalist world entered into a crisis well before the end of 1973, experiencing falling profitability, especially in manufacturing and increased rate of inflation" (1998: 138). For example, between 1965 and 1973 the aggregate manufacturing profitability of the seven wealthiest countries of the world declined by 25 percent.

In reality, the change in 1973 was not abrupt, and it was assisted by non-economic factors, among them mistaken policy interventions, which confused the usual trends. Clouds began gathering during the boom years. From the late 1960s, labor markets changed and, especially around 1968, led to the end of corporative cooperation between employers and employees, a major stabilizing factor in the postwar period. In Michael Piore and Charles Sabel's explanation, both the workers' environment and their attitudes changed. Virtually full employment, the need for a reserve which can enter and leave the market, and a shortage of labor that initiated immigration strengthened the position of employees. The transformation of the labor environment went hand in hand with a generation change: "a new generation matured in the postwar prosperity, without memories of the Great Depression . . . the freedom from such constraints encouraged protest." Collective self-restraint, the authors continue, disappeared. In France, wages were indexed to cost of living. The Italian Statuto dei

Lavoratori and the German Arbeitsförderungsgesetz gradually made wage levels and purchasing power independent of the labor market (Piore and Sabel, 1984: 167). Social unrest and rising political turmoil in overheated economies led to wage explosions in Germany, France, Italy, and several other countries.

This was accompanied, however, by employer responses and price increases to compensate for wage increases; as a consequence, a wage–price spiral pushed prices up. Domestic political upheavals, a mini-revolution in France in 1968, social disturbances in Germany, and the "hot autumn" in Italy in 1969 led to rapid increases in wages and social expenditures. The 1969 Italian contract stipulated a 19 percent wage increase for industrial workers, and public spending grew from 30 to 50 percent of GDP. In France, wages rose more quickly than GDP every year between 1968 and 1973. Prices also soared and rigorous fiscal measures were introduced in June 1972 (OECD, 1987: 129). In Germany, the rate of wage increases doubled in 1969–70. In France, a gradual inflationary spiral had emerged during the period of high prosperity and full employment, and became strongly visible between 1968 and 1970:

> As early as the mid-1960s, it was evident that a slowdown of growth did not bring about any appreciable slowdown in price rises . . . The rise in oil prices at the end of 1973 only hastened a phenomenon that was already emerging more and more clearly. (Caron, 1979: 322)

The international monetary system, as a consequence of mistaken policy intervention, was also shaken. The immediate cause of the change was the deterioration of the United States' competitive position in international markets, which generated a significant increase in its balance-of-payments deficit. The Johnson administration avoided increasing taxes to finance the Vietnam War. Inflation had jumped to 6 percent in 1970. The dollar was devalued, and then the Nixon administration practically ended dollar convertibility in August 1971. The Bretton Woods agreement at the end of World War II, which had created stable exchange rates for a quarter-century, collapsed. Since the dollar was the international reserve currency, Europe was strongly challenged, and the floating exchange rate "made the price of goods in international trade hostage to forces only distantly connected to national economic performance – and almost impossible to forecast and control" (Piore and Sabel, 1984: 173–74). The collapse of Bretton Woods had widespread negative consequences. Stability, on which mass production was based, dramatically weakened:

> not just inflation but the business cycle grew increasingly volatile . . . With the commitment to par values removed, agents had no reason to regard an

acceleration of inflation as temporary. When governments stimulated demand in the effort to offset a recession, this provoked compensating wage increases; aggregate demand policies therefore elicited inflation rather than stabilizing output. (Eichengreen, [1994] 1996: 61)

Finally, in the instable international economic situation another mistaken policy intervention made the crisis complete. Under inflationary pressure, the American Federal Reserve Board decided to increase interest rates: Federal Reserve discount rates increased from 5.5% in 1977 to 13.4% by 1981. Banks' prime rates jumped from 6.8% to 18.9%. The advanced industrial countries declined into a deep recession. Less developed, indebted countries, which had tried balancing their economies with foreign credits in the 1970s, had to refinance at steeply increased rates because of their repayment difficulties. Repayment often became impossible. The International Monetary Fund (IMF), because it lacked sufficient funding from the rich countries, was unable to maintain the liquidity of the international banking system. Severe austerity measures became unavoidable and the circle was closed: "the economic disorder began as a crisis of supply then turned into a crisis of demand" (Piore and Sabel, 1984: 183).

The entire 1970s and even the early 1980s became a period of high, often double-digit, inflation in the world economy. A quarter-century of exceptional boom, full employment, and stability was followed by a decade of instability, slower growth, and occasional setbacks. Between 1950–73 and 1973–83, consumer price increases in the leading Western economies more than doubled (from an annual average of 4.2% to 9.4%). In the Mediterranean region they more than quadrupled (from 4.0% to 18.4%). World price levels had also more than doubled, reaching 233% of 1973 levels by 1982. Unemployment, averaging 2% to 4% in Western and Mediterranean Europe between 1950 and 1973, jumped to 12% by 1984–93, and reached more than 7 million people in Europe (Maddison, 1995a: 84).

Based on ninety-four countries with 98 percent of the world's population, the average annual rate of growth, i.e., the increase of produced goods and services, dropped from 3.4% between 1950 and 1973 to –0.1% between 1973 and 1987. Economic growth in the sixteen most advanced countries of the world economy slowed significantly: after complete stagnation in the first three years after 1973, average GDP in these countries increased by only 20% in the first decade after 1973. The volume of imports had dropped by 7% by 1975, and then increased by 18% in the first decade after the oil shock. In the same period, the terms of trade, i.e., the relation between import and export prices, declined by 20% in the advanced countries (Maddison, 1985: 13).