

Chapter

THE WARSAW CONSENSUS: THE NEW EUROPEAN GROWTH MODEL

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1. INTRODUCTION

Until the beginning of transition in 1989, most countries of Central Europe¹ (they will be hereafter interchangeably referred to as EU-10 or New Europe) were Europe's "Third World", a perennial economic periphery of the continent stretching back in time to early Renaissance.² Throughout centuries, "Eastern" Europe has become a byword for economic backwardness, low-productivity agriculture, inefficient and corrupt public administration, overpopulation, thorny class relations, technological retardation, and political instability.³ Economic weakness was one of the root causes and at the same time a result of the region's loss of independence and occupation by more powerful neighbors, Prussia, Russia, Austria-Hungary and the Ottoman Empire. The takeover of Central Europe by the Soviet Union after 1945 and imposition of a planned economic system completed the economic degradation of the region. In 1992, at the bottom of the post-socialist recession, Central Europe's level of income collapsed to less than one third of that in Western Europe (on a PPP basis, even lower based on the then current exchange rates), the lowest relative income level in the region's history (Maddison, 2010).

Then a miracle happened.

In less than two decades the EU-10 countries were some of the fastest growing economies in the world, converging with Western Europe at a historically unprecedented rate.

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¹ Often wrongly called Eastern Europe, in ignorance of geography. This group includes Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

² With a potential exception of today's Czech Republic, which has done quite well as part of the Habsburg empire during XIX century and then during its interwar independence 1918–1938.

³ See, for instance, Aldcroft (2006), Berend (1996, 2005, 2006), Berend and Ranki (1974) and Piatkowski (2009). Aldcroft (2006) entitled his book about Central Europe in the most direct way *Europe's Third World: The European Periphery in the Interwar Years*.

In 2013, EU-10 countries reached one of the highest levels of income and quality of life relative to Western Europe in its history and were close to making up for 500 years of economic decline⁴. New Europeans probably never had it so good before.

However, the global crisis that started in 2008, hit the region hard and has weakened the pace of the region's convergence with the West, especially relative to the pre-crisis rates. It is not clear now at what pace New Europe can continue converging with the West and whether it can ever fully catch up. It is also not clear whether the current growth model needs to be sustained or re-adjusted.

In this context, the paper argues the following. First, despite the projected deceleration in economic growth, the EU-10 will continue to converge with Western Europe, although at a slightly slower rate than before the crisis. Second, the region will also grow slower than other high-achieving emerging markets, at least in the medium term. Third, given that the global crisis has undermined the credibility of the current growth model, going forward the EU-10 will need to adjust its growth strategy to accelerate post-crisis growth rates and better insulate the region from outside shocks. The new growth model proposed in the paper called the "Warsaw Consensus", in recognition of Poland's special role in the region and its economic success, should be based on ten policy pillars. Fourth, given that the science of economics cannot always precisely pinpoint drivers of economic growth, the new growth model should be guided by a new policy approach based on a policy triad of experimentation, evaluation and pragmatism, and be embedded in the social, political and cultural context of the region. Finally, the paper argues that any proposed policies under the Warsaw Consensus should be assessed against its impact not only on economic growth, but also on the well-being and happiness (called here the Golden Growth Triangle).

The paper is structured as follows. Following the introduction, the second section of this paper discusses the historical growth performance of the EU-11 and the short-term growth prospects. The third section analyzes the long-term growth prospects for the EU-10 relative to Western Europe. The following section analyses the need for adjusting the region's growth model and presents the outline of the new growth model. The final section concludes.

2. IMPACT OF THE GLOBAL CRISIS ON ECONOMIC GROWTH IN THE REGION

New Europe was steadily catching up with the EU-15 countries until the onset of the global financial and economic crisis in 2008. GDP growth in the EU-10 countries averaged nearly six percent during 2000–08. By 2008, GDP per capita in the EU-10 region had reached its highest level since the beginning of the transition in 1989 and income levels relative to EU-15 were at their highest since 1500 (Piatkowski 2011). GDP per capita in Slovenia and the Czech Republic exceeded that of Portugal.

Fast growth in New Europe was largely driven by improvements in total factor productivity (TFP), reflecting growing openness to trade, rising quality of education and an ongoing absorption of technology from abroad, particularly through FDI. The contribution of capital was also high, mainly owing to enhanced macroeconomic stability, booming demand

⁴ At its peak in 1500, the region's level of income per capita amounted to some 62 percent of the Western European level (Maddison, 2010); in 2013, it is projected to reach the same level as in year 1500 (Eurostat data).

for new production, and high public investment funded by EU structural funds. The contribution of employment was weaker, though it increased during 2005–08 on the back of improved labor market conditions and structural reforms enhancing labor supply (Figure 1).

However, the speedy catch-up was interrupted by the global crisis, which hit the region very hard. In 2009, against expectations that the EU-10 region could largely decouple from the global crisis, New Europe's GDP fell by 3.6 percent, slightly less than the EU-15, but much more than the rest of the world's economy (Piatkowski, 2011). The strong impact of the crisis on the region was attributed to the unprecedented current account imbalances in a number of EU-10 countries before the crisis, rapid expansion in credit, asset bubbles in non-tradable sectors, fast real exchange rate appreciation, strong reliance on external inflows of capital and often loose fiscal policy (Piatkowski, 2010).

Nonetheless, despite the severity of the crisis, the convergence process continued, as GDP in Western Europe fell more than in New Europe (Figure 2). But the pace of convergence was much slower than before the crisis and is also projected to remain subdued in 2013 and 2014, falling to 1 and 0.6 percent, respectively, below the 1.5 percentage point annual speed suggested by the conditional convergence literature.⁵

However, there was a significant divergence in economic performance in the region: Poland converged at an unprecedented rate, having grown its economy by almost twenty percent since 2007, while the Baltic States struggled (Figure 3).

EU-10 has also done worse during the crisis than its emerging market peers outside Europe and the world economy as a whole (Figure 4). Prospects for 2013 and 2014 are also less opportune, largely due to the lingering effects of the euro zone crisis, which undermine the region's exports as well as consumer and business confidence.

Nonetheless, despite the impact of the global crisis on the EU-10, the region has still done amazingly well since the beginning of transition. GDP per capita across the region has closed a significant gap relative to the EU-15 (Figure 5).

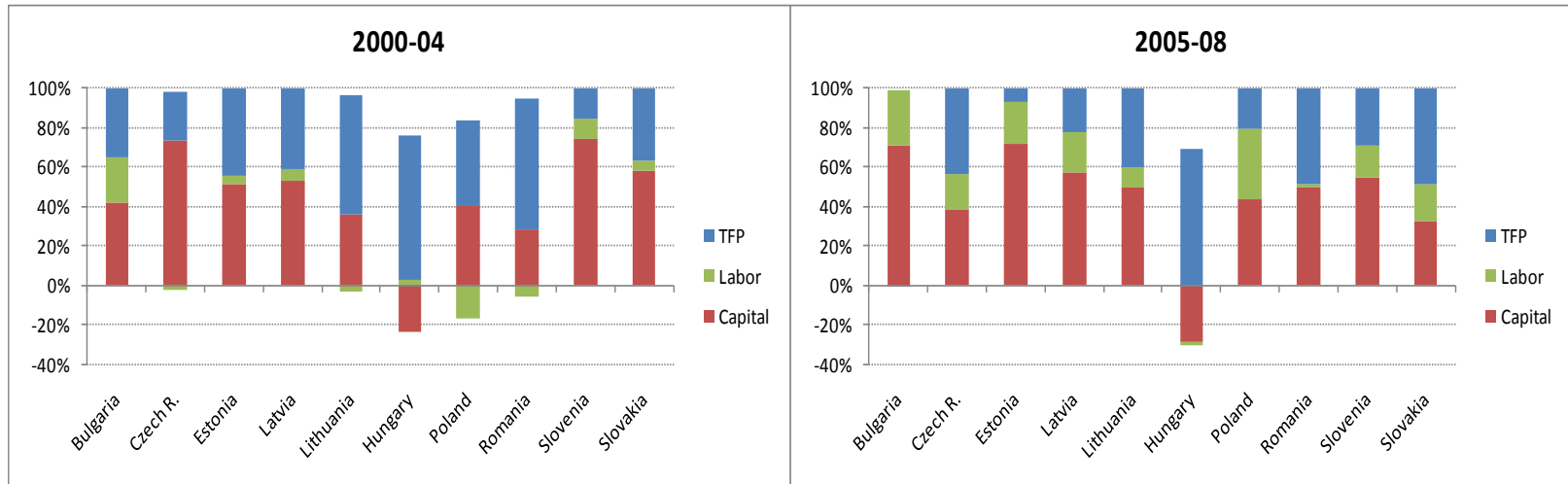
In addition, New Europe has grown faster than most countries at a similar level of development, even taking into account the negative impact of the global crisis (Figure 6). This performance stands in large contrast to the opinions promoted by global investment banks and the global media, which tend to underappreciate the remarkable success of New Europe in the last 20 years relative to all comparable emerging markets.

3. THE LONG-TERM GROWTH PROSPECTS

Baseline scenarios for long-term growth of the EU-10 region are not overly optimistic. Owing to the projected rapid de-population and aging, the pace of economic growth in the EU-10 is projected to decline, particularly after 2020, when the demographic situation is forecast to deteriorate ever more quickly⁶. The European Commission's (2012) "2012 Ageing Report" projects that while the EU-10 will grow much faster than the EU-15 until 2020, the pace of convergence will decline during 2021–2040 and then even slide below that of the EU-15 during 2041–2060 (Figure 7).

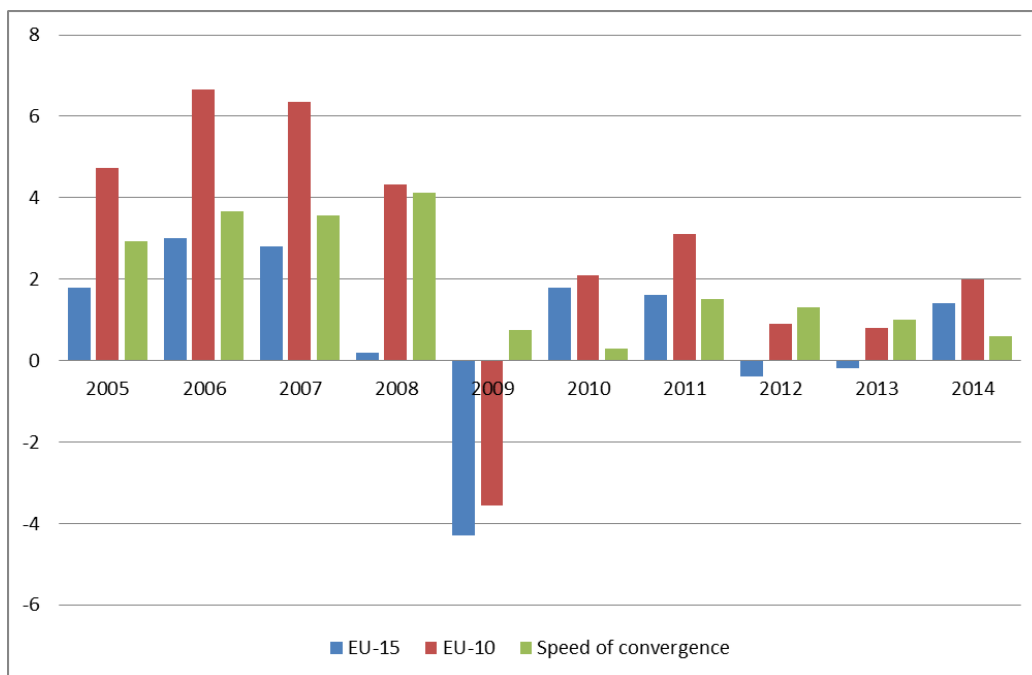
⁵ See Barro and Sala-i-Martin (2003).

⁶ For instance, according to the European Commission, Poland's population is projected to decline from 38 million now to 32 million in 2060 and age significantly at the same time.



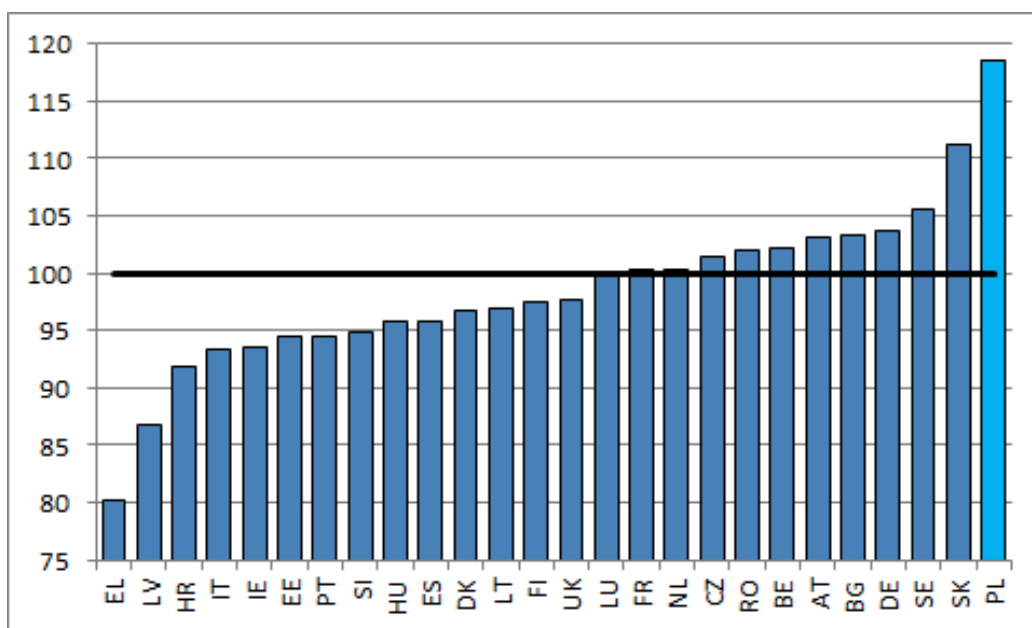
Source: World Bank (2011b).

Figure 1. Contribution of TFP, Labor, and Capital to GDP Growth in EU-10 Countries, in percent.



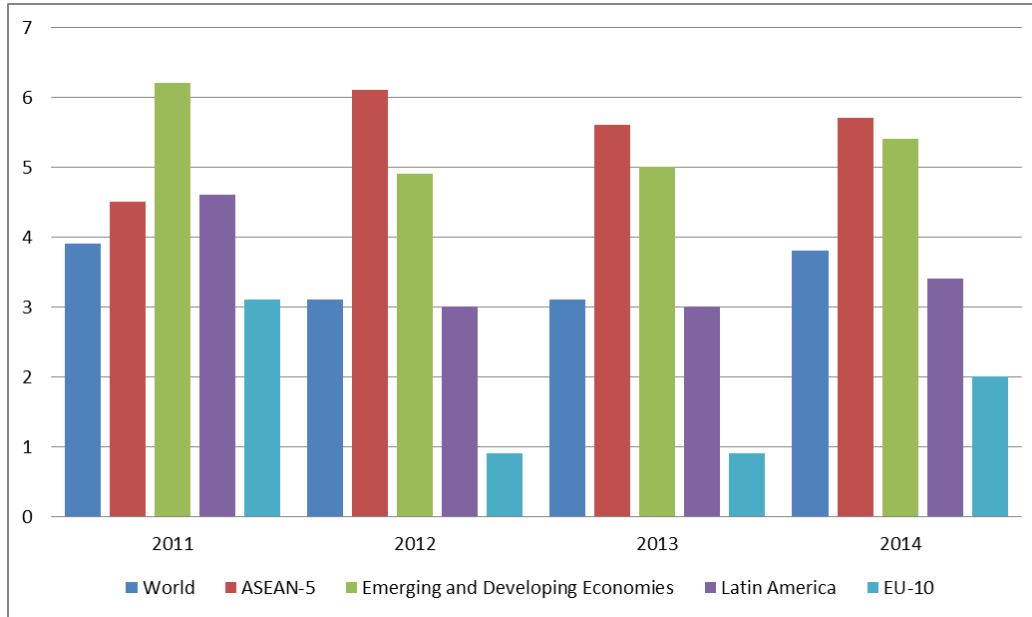
Sources: Author’s calculations based on Eurostat and the World Bank’s EU11 Regular Economic Reports.

Figure 2. GDP growth rates in EU-10, EU-15 and the speed of convergence, 2005–2014, in percent.



Source: Korczyk et al. (2013) based on Eurostat.

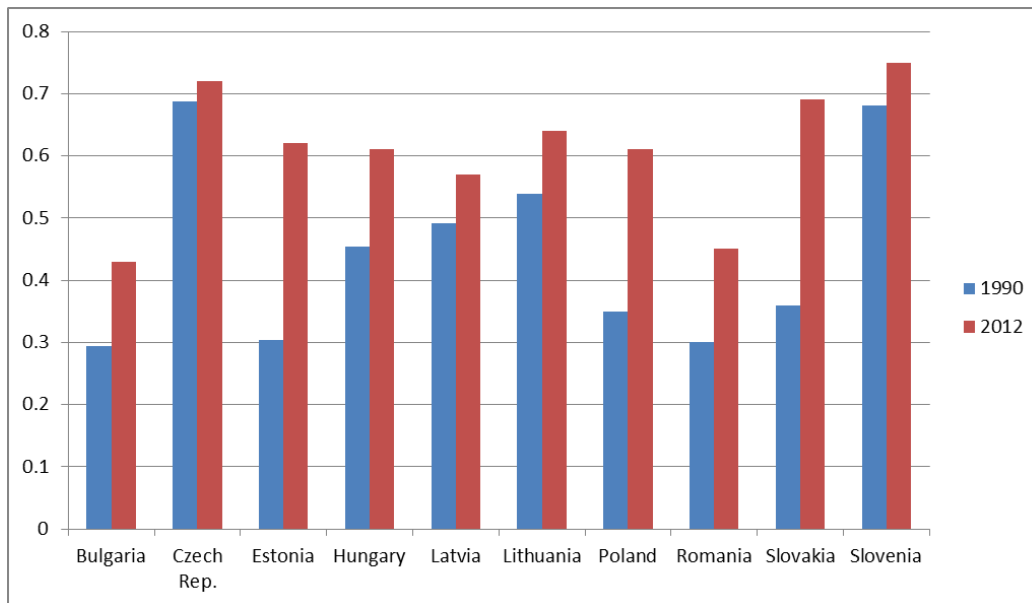
Figure 3. EU27 output level in 2012, 2007=100.



Note: Definitions as in the IMF's World Economic Outlook.

Source: own calculations based on the IMF World Economic Outlook database, April 2013; projections for 2013 and 2014.

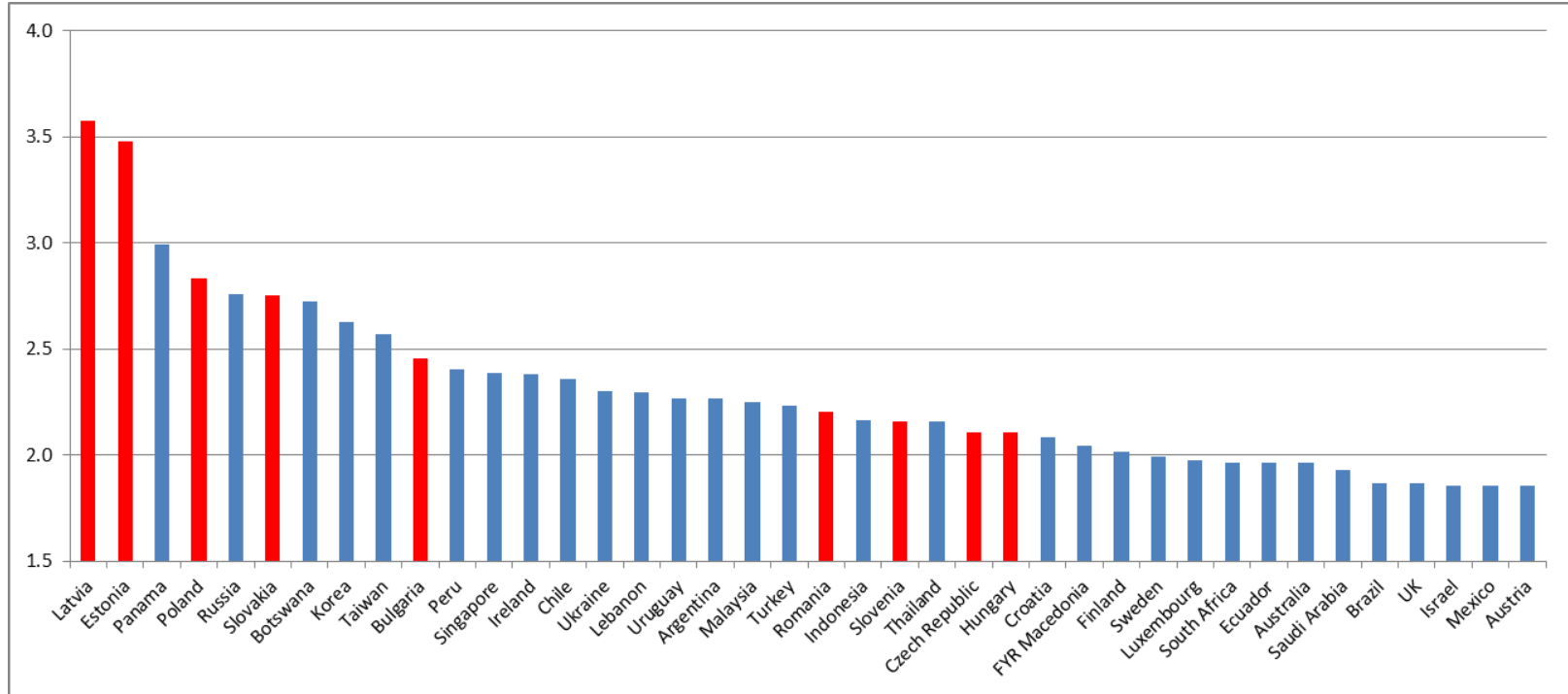
Figure 4. GDP growth in EU-10 and other emerging markets, 2011-2014.



Note: Bulgaria, Estonia, Hungary and Slovakia, based on the earliest available data from 1990-1993.

Source: Author's own calculations based on Eurostat.

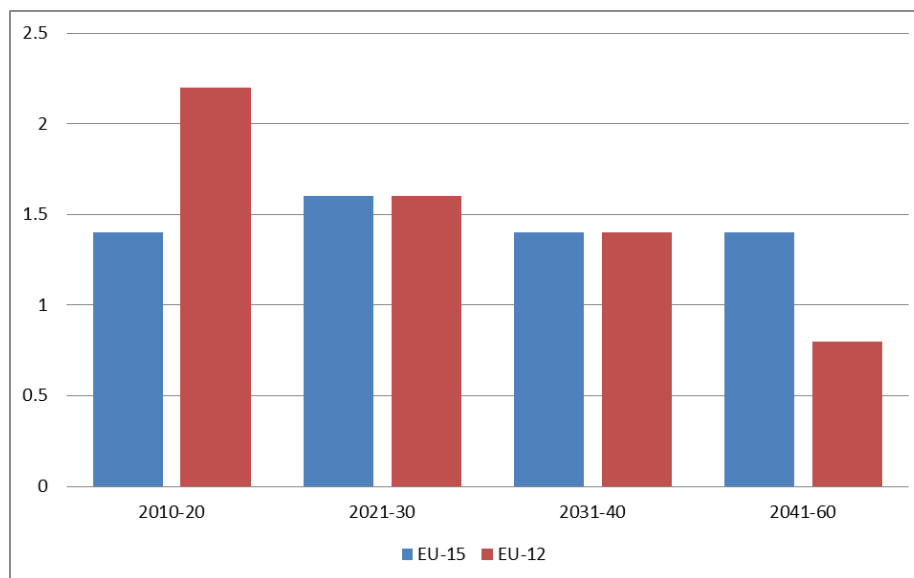
Figure 5. GDP Per Capita in New Europe 1990-2012, PPS (EU-15 = 1).



Note: Includes forty countries classified as middle, upper-middle and high income. In current international dollars. Excludes Belarus (unreliable data) and Lithuania (missing data).

Source: own calculations based on the IMF World Economic Outlook database, April 2013.

Figure 6. Change in GDP per capita PPP between 1995 and 2012, 1995=100.



Source: European Commission (2012).

Figure 7. Projected GDP growth rates for EU-10 and EU-15, 2010–2060, in percent.

Table 1. Projected growth in GDP per capita in the new EU member states, the euro zone and the EU-27, 2010-2060

Country	2010-60	2020	2030	2040	2050	2060
BG	1.9	2,0	2,2	1,8	1,4	1,7
PL	1.8	2,0	1,9	1,6	1,0	1,3
EE	1,8	2,1	2,4	1,8	1,1	1,6
SK	1,8	2,8	1,8	1,1	0,9	1,5
LV	1,8	2,5	2,5	1,8	1,0	1,4
LT	1,7	1,9	2,1	2,1	1,2	1,4
CZ	1,6	1,6	1,8	1,5	1,2	1,5
RO	1,5	1,6	1,7	1,5	1,1	1,2
HU	1,4	1,5	2,1	1,4	1,2	1,3
EU27	1,4	1,5	1,4	1,4	1,4	1,6
EA17	1,3	1,4	1,2	1,2	1,4	1,6

Average EU10.

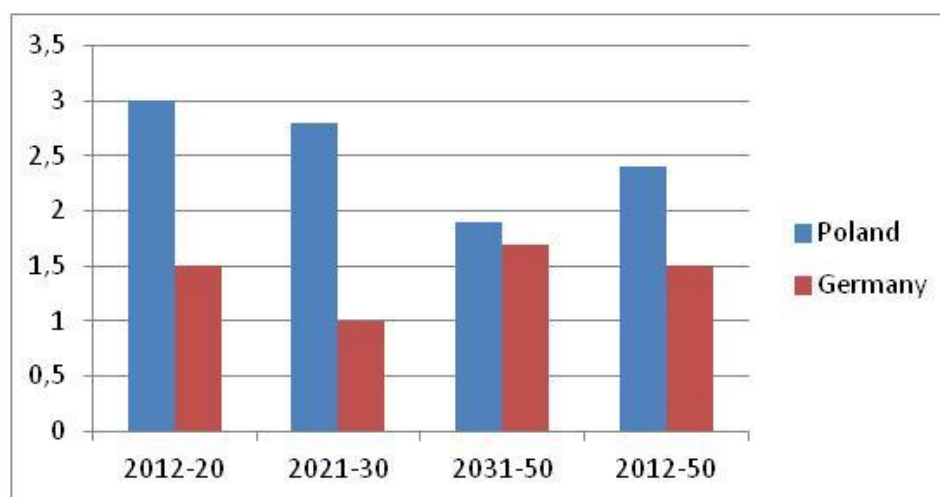
The EC's projections imply that the EU-10 would continue to converge with the EU-15 until 2020, but then stop converging after that, stopping at around 70 percent of the EU-15 level of income (PPP).

However, other projections are more optimistic: OECD (2012) predicts that GDP per capita among the five OECD members – Czech Republic, Hungary, Poland, Slovakia and Slovenia – will grow at an average rate of 2.5 percent a year during 2011–2030, faster than the OECD average of 1.7 percent and the EC's projections, and then decline to 1.8 percent per year during 2030-60, around the OECD average.

PWC, a consulting firm, is even more optimistic, at least as regards the economic prospects of Poland, the largest economy in the EU-10 region (with about 40 percent of the region's GDP). According to its growth model, Poland is projected to grow at an average rate of 2.5 percent per year until 2050, a much faster rate than Germany, a benchmark economy for Western Europe (Figure 8), especially until 2030 (PWC 2013). As a result, Poland's level of income would reach 83 percent of the German level by 2030 and then slowly grow to 87 percent by 2050.

On the whole, all long-term projections suggest that New Europe will continue converging with Western Europe for another decade or so, achieving at least 70 percent of the EU-15 level of income, the highest in the region's history (Piatkowski 2011). Indicators of well-being and happiness, which are already at the highest absolute and relative levels on record, are forecast to also continue to catch up.⁷ This would herald the arrival of New Europe's new Golden Age.

That said, the strongly negative impact of the crisis, the slow pace of economic recovery, especially relative to emerging markets⁸, slowing speed of convergence, the prospects of the end of convergence with Western Europe sometime after 2030 and even a possible de-convergence afterwards all suggest that the current growth model seems to have reached its limits.⁹ A new growth model is thus needed to better insulate the region from future crises, strengthen its economic foundations and accelerate the post-crisis growth to ensure that the convergence with Western Europe continues at a fast pace and that the region—contrary to the current projections—full catches up with the EU-15 within a life of one or maximum two generations.



Source: PWC (2013).

Figure 8. Projected real GDP growth rates for Poland and Germany, 2012-2050.

⁷ For a discussion of the importance of well-being relative to GDP growth, see Stiglitz, Sen and Fitoussi (2008) and Kolodko (2011).

⁸ This paper does not consider EU-10 countries as emerging markets, given that GDP per capita PPP in the majority of countries in the region exceeds \$20,000 and that the OECD and the World Bank considers a large part of them to be “high income”.

⁹ Others seem to agree. See, for instance, Gil and Raiser (2012), Bruegel (2010), Darvas (2010), Atoyán (2010), Piatkowski (2011).

The new growth model will be called “The Warsaw Consensus” in recognition of the large economic role Poland in the region, with almost a 40 percent share in the EU-10 income, its successful post-1989 political and economic transition and the way it managed the global crisis.¹⁰

4. THE NEW GROWTH MODEL – “THE WARSAW CONSENSUS”

This section starts with a definition of a growth model. It then argues that the science of economics on the whole knows surprisingly little about the drivers of growth, especially in more developed countries such as the EU-10, which have already built the basic economic foundations. Economists seem to know more about what not to do rather than what to do. Hence, given the lack of clear growth prescriptions, the paper argues for a growth model based on the minimization of risks (the negative approach) and removal of the most binding constraints to growth (the positive approach). It postulates a new approach to growth policy to be based on experimenting, evaluating and pragmaticizing (being pragmatic). Finally, it asserts that all policies produced under the new, Warsaw Consensus growth model, should be assessed *ex ante* and *ex post* not only on the impact of GDP growth, but also on the impact of well-being and happiness at the same time.

Let us start with a definition of a growth model. Economic theory on the whole finds it rather difficult to agree what is meant by a “growth model”. This is because there are at least two meanings of the “growth model”: one meaning of a growth model is that of a theoretical economic model, which explains—as best as possible—the sources, variables and drivers of economic growth and which seeks to clarify “why some societies growth so much faster than others” (Kaldor 1957, p. 591). There has been a multitude of growth models developed in the past, starting from the Harrod-Domar, Rostow, Lewis and—the most famous of all—the Solow growth model, which emphasized the importance for growth of savings, population growth and technological progress. These models were more later complemented by Lucas’ (1988) endogenous growth model, which sought to explain the sources of technological progress, something which was assumed as residual in the Solow model.

The second meaning of the “growth model” has a less theoretical and more policy-oriented meaning, as it tries to differentiate among various ways of how countries combine capital, labor and technological progress to promote growth. There are thus various growth models, such as a Scandinavian growth model, which is characterized by a large role of the state and a significant size of the welfare state, the so-called Anglo-Saxon model, based on the American and UK more *laissez faire* approach to managing the economy, or the Asian model, which relies of high exports and high domestic savings.

This paper concerns itself only with the second meaning of the “growth model” to design a policy-oriented growth model for Central Europe, embedded in the political, social and economic context of the region.

¹⁰ Poland has also had a disproportionate contribution to the theory of economics of transition, see, for instance, Kolodko (2000), Kolodko and Tomkiewicz (2011) and Estrin, Kolodko, Uvalic (2008).

Economists Do Not Know What Drives Economic Growth

Or at least not precisely, especially going beyond the basic economic foundations.

In general, economists are believed to know and be able to predict much more than what can be reasonably expected from them, and especially as regards predicting the future. It is partly because people often mistake prominence for relevance, that is they are misled by the prominence of economists, especially in the media, driven by the insatiable appetite of the ever growing financial markets for “talking heads” to “explain” what is happening in the global economy, to believe that economists know much more than they really do and that their predictions are much better than that of the others.

The reality is that while economists know a lot about conditions, which most often are necessary for economic growth—macroeconomic stability, protection of property rights, education, health, political stability, openness to trade, good infrastructure, the right incentives and so on—these conditions are not always sufficient for growth to occur, especially in the short and medium-term. Moreover, even if there is some consensus on the drivers of growth, the necessary policies to support these growth drivers are much more controversial. Moreover, the track record of economists in terms of their ability to project the future and to recommend the right policies for growth is far from stellar.

As to the ability to project the future, it would be sufficient to mention that almost a million economists, analysts, and all kinds of economic experts worldwide, including such respectable institutions such as the International Monetary Fund, which employs almost two thousand well-paid and well-educated economic PhDs, have failed to predict the 2008 global crisis.¹¹ So it was also for all Nobel Prize Winners in Economics: none of them predicted the crisis. Some of them even argued that a global crisis was no longer possible.¹² On the whole, there were only a handful of economists, who saw it coming.¹³

Moreover, the implications for the crisis even in the short term are also hard to be guessed: for example, financial markets ignored the risks of Greece going bankrupt (something that ex post looked so obvious) until the speech of the new prime minister of Greece in late 2008, announcing that the previous government coalition fudged the deficit and debt numbers. Until then, the well paid economic “talent” in Wall Street and in London’s City was happy to finance Greece at only slightly higher price than that of Germany.

Finally, it is not clear whether economists’ projections are any better than that of lay men or those based on random choice. Tetlock (2006) showed, based on the analysis of the predictive power of thousands of political scientists and economists during the previous 20 years, that the value of their projections is not much different than the average for the whole population (and even lower in the case of TV economic personalities). In other words, despite their large knowledge and experience, economic pundits were no much better in predicting the future than anyone else.¹⁴

¹¹ Even in October 2008, already after the collapse of Lehman Brothers, the IMF forecast that in 2009 the US would grow 0.1%, the euro zone by 0.2% and the world economy by 2.6%. In reality, GDP declined by 3.5%, 4.2% and 2.6% respectively.

¹² In 2003, Robert Lucas, a Nobel Laureate in Economics, argued in his lecture to the American Economic Association that “macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades.”

¹³ Such as Nouriel Roubini.

¹⁴ See also an interesting book by Friedman (2010) on why experts are often wrong.

As regards the economists' ability to pinpoint drivers of economic growth, the truth is that we do not fully know which specific conditions affect growth, especially once we go beyond the basic fundamentals mentioned above. Let us list of couple of arguments.

First, the World Bank's Growth Commission, headed by Michael Spence, Nobel laureate in economics, and mandated to come up with the best policies for supporting economic growth, concluded that "no generic formula" exists for policies to support growth as "each country has specific characteristics and historical experiences that must be reflected in its growth strategy" (World Bank 2008, p. 2). Moreover, it also asserted that "it is hard to know how the economy will respond to a policy, and the right answer in the present moment may not apply in the future" (ibid. p. 29). In a similar vein, a statement issued under the Barcelona Development Agenda (2004) by such eminent economists such as Olivier Blanchard, Joseph Stiglitz or Paul Krugman concluded that "there is no single set of policies that can be guaranteed to ignite sustained growth" and that "effective institutional innovations are highly dependent on a country's history, culture and other specific circumstances."

Furthermore, Cohen and Easterly (2009) somewhat sarcastically point to 145 variables that economists have so far identified in their econometric regressions as "the" supposed drivers of growth.¹⁵ Robert Solow, the father of the growth theory, famously said that "in real life it is very hard to move the permanent growth rate; and when it happens the source can be a bit mysterious even after the fact." (Solow 2007, p. 5). Another growth theorist, Arnold C. Harberger (2003, p. 215) concluded that "there aren't too many policies that we can say with certainty deeply and positively affect growth". Paul Ormerod, (1994, p. 34), an Oxford economist, argued that "the ability of orthodox economics to understand the workings of the economy at the overall level is manifestly weak (some would say it was entirely non-existent)". Joseph Stiglitz, another Nobel prize winner, quipped that it would be much easier for economists to explain the failure of China because of its unorthodox economic policies, which did not have much to do with the prescriptions of standard economic textbooks and the then reigning Washington Consensus, than China's unprecedented economic success (Stiglitz 2003). Easterly (2008, p. 129) concludes that there is no "universal factor X that works everywhere to reliably raise growth".¹⁶

Second, in economic literature it has so far proven impossible to conclusively explain the variation in growth rates in specific countries (Hausmann, Pritchett, Rodrik, 2005) suggesting that we do not know what was responsible for their different economic behavior. In addition, Cohen and Easterly (2009) show that there is practically no correlation between countries' economic growth rates decade after decade, undermining the belief in the existence of permanent growth drivers. World Bank (2005) similarly argues that it is difficult for economists to explain why countries that have implemented far reaching economic reforms in the 1980s and 1990s have most often developed slower than countries that implemented only partial reforms.

¹⁵ The authors note that such results were often achieved thanks to creative econometrics, dictated by political economy constraints of international institutions or the need to increase chances of being published in peer refereed journals. When the author of this paper worked at the IMF, there seemed to be an unwritten assumption that "one needs to torture the data until they will confess".

¹⁶ In this context, it should not be surprising to a lot of readers that the conclusions of so many economic publications, including those authored by economic Nobel laureates, often end on a somewhat trivial note such as "there is a need to find a golden mean in policy", "it is important to have a good diagnosis of the situation" or that "it is important to ensure proper implementation".

Kahneman (2011) would most likely explain such behavior by the simple statistical reversion to mean, with countries at some point in time growing faster or slower depending on a specific confluence of external and internal factors, positive or negative fortune. Luck, however, has no place in economists' debates: economists are hard wired, like the rest of humans, to find „reasons” for divergent performance of specific countries, even if it is often random or transitory. The need to justify the economists' employment and produce “advice” for political leaders, the media and the public does not help either.

Third, the ability to recommend the right policies for growth is also largely constrained by Talebian „black swans”, unexpected external and internal growth shocks (Taleb 2008, 2012). The ongoing global crisis shows this well: textbook monetary and fiscal policies were widely discarded when confronted with a new crisis. As argued by Piatkowski (2009) and Balcerowicz and Rzońca (2011), shocks are in the long-term the most important factor explaining the countries' performance.¹⁷

Finally, economists, like most other human beings, are subject to many cognitive biases (Kahneman, 2011). They are subject to a confirmation bias, looking for data that confirm their pre-existing views and – consciously or unconsciously – rejecting other sources of data. They are exposed to “framing”, where the way certain ideas are presented affects their interpretation (when taxes, for instance, are called “social security contributions”). Like other humans, they build narratives and stories around economic processes, often simplifying the reality and building overconfidence (Sedlacek, 2011). They are liable to “herd behavior”, following intellectual ideas, which are in vogue. They are subject to pressures to publish (for academics) and to find supporting evidence for certain ideas (in government or in international financial institutions). Psychologically wired in the same way as all other people, which was crucial to human survival fifty thousand years ago and is perhaps less valid today, economists also often find patterns in randomness, which really do not exist. Everything, also for economists, has to have an “explanation”, a “reason” even if there is none.¹⁸

They are also subject to a “halo” effect, selection bias (we choose to focus on the performance of the winners and never bother to ask about those who have had the same policies, but have failed to be successful) and survivors' bias. Despite ever improving research methodologies, economists also often find spurious causality when there is only correlation. Using statistical methods, we assume away the shape of the probability distribution (most often, normal distribution) and—as argued by Taleb (2012)—ignore the most interesting and informative segments of the distribution in areas beyond the usual 0.9 and 0.95 confidence levels, the “fat tails”. When models go badly wrong, like when the credit rating agencies were assigning AAA credit scores to subprime mortgages *en masse*, they tend to blame the reality rather than the model assumptions or plead ignorance (credit rating agencies defended themselves by saying that their credit ratings were “only opinions”).

Moreover, economists also often have “no skin in the game”, where proffering advice or offering projections without having anything at stake or facing asymmetric incentives (when a

¹⁷ One of such recent “black swans” is the discovery of shale gas in the US. Only a couple of years ago, there was virtually no one, who predicted that shale gas could so dramatically change the American and the global energy market, drastically reducing the cost of natural gas and fundamentally changing the competitiveness of many industries and economies.

¹⁸ Haidt (2012) explains the evolutionary benefits for humans to be hard wired to see patterns in otherwise random events.

projection comes true, one becomes an economic guru, when it however turns awry, there are always good reasons while it did so).

Finally, economists are not always above conflicts of interests, as when they, for instance, publish academic papers and provide consulting services at the same time.¹⁹ They are often myopic, focusing on the economic explanations of social phenomena only, without seeking succor in other scientific disciplines. They also tend to ignore economic history, believing that “this time is different”. Or simply make calculation errors, as in the recent instance of Reinhart and Rogoff’s Excel-based calculations on the impact of growing public debt on growth (which contributed to the euro zone’s ill-fated drive for fiscal austerity).

As a result, economic theories seemingly set in stone can crumble with an astonishing speed. The ongoing global crisis has upended many heretofore widely cherished beliefs on capital controls, foreign exchange interventions, state ownership, money printing (euphemistically called “quantitative easing” to ease bad consciences), fiscal multipliers or even a minimum wage.

The bottom line is that we know much less than we think we know and are often blind to our blindness, especially since it keeps us employed.

Implications for New Europe’s Growth Model

So, what to do then if we know much less than we think about drivers of growth?

In short, the best recommendation for growth-oriented policies is to proceed cautiously and humbly.

In terms of specific policy ideas, we first must eliminate policies that we know are not working: unfettered financial markets, lax banking supervision, loose monetary policy, large and permanent fiscal deficits, closed markets or hindered competition.

Second, we need to minimize risks to growth and vulnerability to external shocks by controlling public and private debts (in most of the region and for most of the time public debts, for instance, should not exceed 40% of GDP), strictly supervising the banking sector, which has a tendency to explode every some time and take countries down with it (*vide* the situation in a couple of euro zone crisis, starting from Ireland). Conservative, utility banking should be the default option everywhere in the region.

Third, we should focus on the main binding constraints to growth through a policy based on experimentation, evaluation and pragmatism.²⁰ Since we do not *ex ante* know which policies will deliver results in the current circumstances, policy makers should experiment with policies, properly evaluate them, using the most rigorous methodologies available such as randomization methods based on treatment and control groups (which economics borrowed from medicine), and then be pragmatic in expanding policies that work and closing down those policies that don’t.

¹⁹ See, for instance, the Oscar-winning movie “The Inside Job”.

²⁰ See, for instance, Easterly (2009), Rodrik (2008) and Kolodko and Tomkiewicz (2012) for a discussion on a flexible, experimental approach to economic policy.

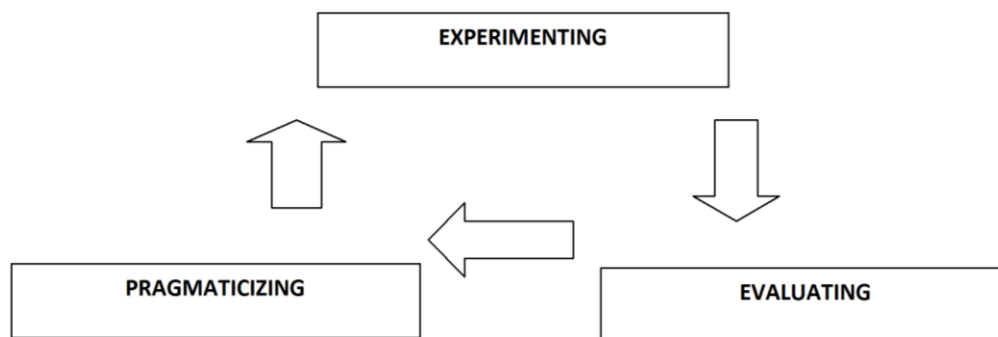


Figure 9. The “Warsaw Consensus”.

The “Warsaw Consensus”

Against this background, we can now start designing the new growth model for the region, the Warsaw Consensus.²¹

The new model should combine the best features of the current EU-10 growth model – openness to trade, relatively strong institutions, labor mobility, a common EU institutional framework, attention to social values, well-being and quality of the natural environment – and the best characteristics of the Asian development model – high savings, diversified exports, mixed ownership and controlled real exchange rate appreciation (Piatkowski, 2011).

By nature, the Warsaw Consensus has to be different from growth models for other parts of the global economy. This is largely because of the unique characteristics of the region: its common post-socialist background, medium-to-high level of economic development and — above all—its membership in the EU.

Building on the prescriptions of the classical and the endogenous growth theory²², diagnosis of the most important binding constraints to growth and lessons from the ongoing global crisis, the new growth model would be focused on the following ten pillars:²³

1. High domestic savings and investment
2. High employment rate
3. High labor productivity growth driven by innovation, skills, and friendly business climate
4. Controlled real exchange rate appreciation
5. Openness to immigration
6. Low income inequality
7. Diversified exports
8. Strong supervision over the financial sector
9. Full integration of the EU market and further EU enlargement
10. Focus on well-being and happiness going beyond GDP

²¹ Tanzi (2006) was first to use the term the “Warsaw Consensus, but it was used it in a different context focused mostly on the role of public finance and taxation in growth.

²² See Barro and Sala-i-Martin (2003) for a useful review of theoretical foundations of economic growth models.

²³ This part of the paper is based on Piatkowski (2011).

Let us focus on the selected policy pillars in more detail.

High domestic savings

The issue: EU-10 countries do not save enough to support high investment rates and help insulate them from future crises by lessening reliance on imports of volatile foreign capital.

The solution: Raise private and public saving through: pension reforms, higher effective retirement ages, stricter fiscal rules, including introduction of constitutional debt limits, to increase public saving (decrease dissaving); pan-European tax harmonization, starting from corporate income tax base and a minimum CIT tax rate among the EU-10 countries; and increased transparency of tax payments by multinationals. In addition, all EU-10 countries should eventually adopt the Euro around 2020 or so, at a competitive exchange rate, to make transfers of savings from Western Europe safer (while adopting prudential regulations to prevent boom-bust patterns). The target should be for the domestic savings rate to amount to at least 25 percent of GDP, up from around 20 percent currently. Together with imported savings of up to five percent of GDP, mostly in the form of FDI, this should allow domestic investment to amount to least 30 percent of GDP, in line with the high investment ratios experienced in the past by successful catch-up countries, such as Japan, Korea, Singapore and Taiwan (World Bank 2008).

High employment rate

The issue: Despite substantial improvements in the last two years, the average employment rate among 20-64 year olds in the EU-10 region amounted to around 66 percent in 2011, below the 75 percent target of the EU 2020 Strategy.

The solution: Raise effective retirement ages, rationalize access to disability pensions, enhance skills through educational reforms and lifelong learning, especially for older generations, and help finance people's re-skilling and job search. The target should be to raise the employment rate to the 75 percent target by 2020, boosting economic growth and helping to stabilize public finances.²⁴

High labor productivity growth

The issue: Slowing growth in total factor productivity (TFP) driven by low spending on R&D and innovation and exhaustion of simple post-transition growth reserves.

The solution: Increase TFP growth to at least two percent per year by fully opening domestic and EU markets to competition, particularly in the utilities and services sectors; promoting labor immigration, especially among high-skilled workers; improving business climate; promoting export-sector FDI; enhancing human capital and labor skills, increasing the efficiency of public administration, including through a full introduction of e-government, and increasing the value and efficiency of public spending on technology absorption and innovation.²⁵ On business climate, the target for all EU-10 countries should be to be ranked in the top thirty in the World Bank Doing Business ranking.

²⁴ World Bank (2011) estimates that if Poland's employment rate among the elderly matched that of Germany, Poland's GDP would increase by 6 percent, translating into almost 0.8 percentage points of additional growth a year by 2020.

²⁵ World Bank (2012) found that the efficiency of EU financed spending on enterprise innovation in Poland is far from optimal.

Controlled real exchange rate appreciation

The issue: Uncompetitive exchange rates before the crisis led to unsustainable asset booms and reallocation of resources from export-oriented sectors toward non-tradable sectors, mainly real estate, which undermined growth and the stability of the balance of payments.

The solution: Following in the footsteps of all previously successful catch-up countries, including Japan, Korea, Taiwan and now China, EU-10 countries should ensure that wage growth never exceeds growth in labor productivity. This should be done through maintaining labor market flexibility, opening labor markets to migration, controlling increases in public wages and implementing active fiscal policies. EU-10 countries with floating exchange rates should not be afraid to pragmatically manage the nominal exchange rate, whenever possible.

Openness to immigration

The issue: Impending demographic decline and population aging, which could undermine economic growth and the stability of public finances.

The solution: Given that pro-natalist policies, while important, would be insufficient to raise fertility ratios to replacement levels, the EU-10 should fully open its labor market to immigration, re-attract EU-10 citizens working abroad, and actively promote migration inflows, especially among high-skilled workers from Eastern Europe (Ukraine, Belarus and Moldova). The region should aim to attract foreign labor force to represent up to 5 percent of total population.

Strong financial sector supervision

The issue: Insufficient control over excessive credit growth, leading to asset booms, financial instability and sovereign debt crises.

The solution: Strengthen supervisory control over foreign banks operating in the region - which hold the dominant share in the region's banking sector assets - through domestic and EU-wide anti-cyclical macro prudential policy; limits on foreign currency borrowing; close cooperation with financial supervisory authorities in home countries; emphasis on conservative, utility-like business models; introduction of bank crisis resolution frameworks; and diversified ownership of the banking sector. The experience of the global crisis showed that domestic banks may be crucial to sustaining credit growth and cushioning the economy during external crises, when foreign-owned banks tend to cut lending regardless of the local economic fundamentals.²⁶ The flexible target could be for the locally-owned banks to represent up to one third of total banking sector's assets.

Low income inequality

The issue: Rising or already high levels of income inequality, slowing down growth and undermining well-being and happiness.

The solution: The EU-10 countries need to ensure relative social equality, as it is a crucial ingredient of both short-term (by supporting effective demand) and long-term term economic growth (World Bank 2006) as well as overall well-being (Pickett and Wilkinson 2011). The

²⁶ Piatkowski (2012) emphasizes the importance of PKO BP, the state-controlled bank in Poland, in supporting lending during the crucial years of 2008-2010, while foreign-owned banks retreated en masse from the credit market. Given that in most other EU-10 countries, whose markets are dominated by foreign-owned banks, bank lending remains subdued, it could be useful to consider the Polish experience and promote ownership diversification.

solution should be to introduce measures—more progressive taxation system, smarter social assistance, improved system of vocational training—to ensure that the incomes of the bottom 10% and 40% are rising faster than incomes of others and that the Gini coefficient declines to below 0.30 across the region.

Further EU integration and enlargement

The issue: Incomplete integration of the EU product, service and labor markets; pause in the enlargement process.

The solution: Promote all EU-wide initiatives such as the “blue button” project to consolidate and harmonize the EU online markets that aim to achieve a real integration of the EU market and thus increase the EU’s competitiveness, full opening of the service markets; support for further EU enlargement, including first through expanding free trade agreements to countries like Ukraine or Turkey.

Diversified exports

The issue: Too narrow focus on the EU export markets, which weakens growth potential and increases the risk of economic instability.

The solution: Rebuild economic ties with emerging markets, including the BRICs, through strategic diplomatic focus, increased financial support and the introduction of partnership agreements promoting FDI inflows into the region from non-EU countries, in exchange for access to their domestic markets. The long-term target should be for the share of non-EU oriented exports to represent at least one-third of the total, up from less than one-fifth currently.

Focus on well-being and quality of life beyond GDP

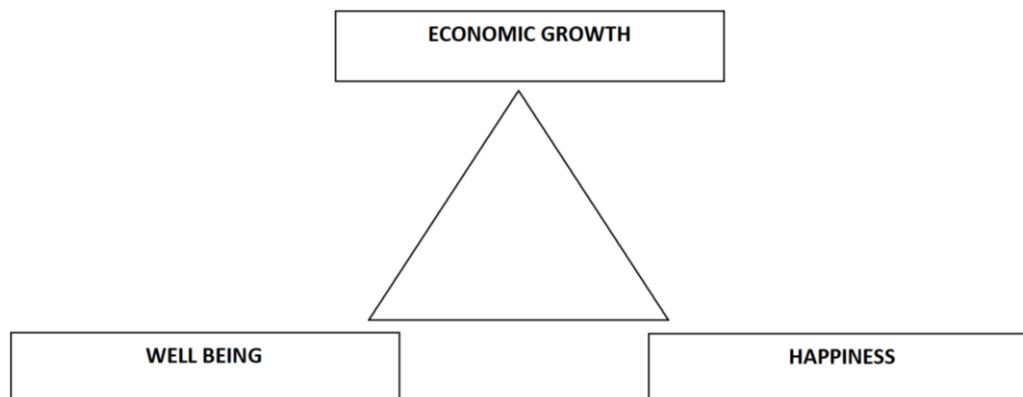
The issue: Excessive focus on GDP as a measure of social and human development.

The solution: Focus strategic economic policies not only on expanding GDP, but also on promoting well-being, including life expectancy, educational attainment, quality of governance, quality of natural environment, level of personal freedom, safety and security, availability of leisure time, public trust and strength of social networks. Develop corresponding indicators.

Focus on GDP Growth, but Also on Well-Being and Happiness

The last pillar of the Warsaw Consensus is especially important: given the weakness of GDP as a measure of social development, myopic nature of economics as a science and large margins of errors in economic policy making, policies proposed under the new growth model should be assessed not only based on its impact on GDP growth, but also at the same time on its impact on social well-being and society’s happiness.²⁷ The three targets when put out together would construct what could be called a Golden Growth Triangle.

²⁷ Well-being in this paper is defined in a narrow sense of living standards to contrast it with wider definitions of well-being, which include subjective assessments and emotional reactions. Such definitions make well-being almost indistinguishable from a definition of happiness. Well-being will thus reflect such broadly objective social indicators such as the quality of education, level of inequality, life expectancy, health outcomes, the quality of natural environment, level of crime, level of social trust etc. The well-being as defined in this paper



Source: author's own elaboration.

Figure 10. Golden Growth Triangle.

This is because not every policy that may increase economic growth will increase or at least maintain social well-being and the society's happiness. To give a trivial example, cutting down a natural forest and selling the resulting wood will raise GDP, but lower well-being and undermine happiness at the same time. In a less obvious example, increasing labor market flexibility (i.e. making it easier to fire people) above a certain cultural threshold specific for each nation to raise economic growth may undermine well-being and happiness more than the purported benefits of faster growth owing to lower job security and increased uncertainty about the future. Increased job insecurity might also lower the fertility rate, slow demographic growth and thus turn against economic growth itself. Similarly, weaker trade unions may help spur economic growth by lowering wage growth below that of productivity growth, but this may undermine well-being and happiness by increasing income inequality (as higher corporate profits will accrue mostly to the richest citizens).

The default assumption should be that only policies that improve all three measures (or at least do not undermine any of the three parts of the Golden Growth Triangle) should be accepted.

5. CONCLUSION

The objective of the paper was to analyze the post-crisis growth prospects of the EU-10 countries and discuss whether the region needs a new growth model.

The paper concludes that economic growth in New Europe in the near term will be lower than it was before the crisis, but the region will nonetheless continue to converge with Western Europe. As a result, by 2020, the EU-10 is likely to achieve the highest level of income per capita relative to Western Europe since 1500. The overall level of well-being and quality of life will be even closer to Western Europe than what the income level alone would suggest. This would herald the arrival of the region's new Golden Age.

would be best reflected in the OECD's Better Life Index. Happiness in turn is defined in a broad sense of all indicators tracking people's happiness and life satisfaction.

However, long-term growth projections suggest that New Europe's convergence with Western Europe can come to a halt around and after 2030. This suggests, along with the strongly negative impact of the global crisis, the slow pace of economic recovery, especially relative to emerging markets, and a slowing speed of convergence suggests that the current growth model has reached its limits. A new growth model is needed to better insulate the region from future crises, strengthen its economic foundations and accelerate the post-crisis growth to ensure that the convergence with Western Europe continues at a fast pace.

The new growth model, called the Warsaw Consensus, should be based on ten growth pillars, which represent the most binding growth constraints for the region. These include the need to increase domestic savings and employment, open labor markets to immigration and others, but also to focus on well-being and standard of living beyond GDP.

Given that we economists have difficulty with pinpointing drivers of growth, policies under the new growth model should be guided by a new policy approach based on experimenting, evaluating and pragmaticizing (being pragmatic); the impact of these policies should in turn be assessed ex ante and ex post against its impact on economic growth, well-being and happiness (what is called here the Golden Growth Triangle).

Full implementation of the Warsaw Consensus should allow New Europe to accelerate post-crisis growth rates and to better insulate the region from future global and regional economic shocks to fully catch up with the EU-15 within a life of one or two generations, for the first time in the region's history.

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