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The Central European Predicament

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The Central European Predicament

Tamas Novak[*]

Introduction

Central and Eastern Europe (CEE) has experienced a very deep economic and political transformation since the beginning of the nineties. The early years of transition were characterized by big hopes for a quick and successful development. The international community, including the EU and the USA showed interest in the transformation of the region for a number of reasons. From a geopolitical perspective, the transformation was of tremendous importance as it confirmed the end of the cold war and the bipolar global system was replaced first by a unipolar superpower system and later gave way to a multipolar or a new bipolar system. This also signaled the weakness of the Soviet Union (and later Russia), as it was not able to prevent this transformation and was soon mired in a serious and long lasting economic and political crisis that undermined its international position. After the dissolution of the Soviet Union during the nineties Russia remained very weak, both economically and politically. The power vacuum and the transformation in Central Europe made the establishment of a new international economic and security structure possible. The new economic and political pattern that started to develop within the region was based on the liberal market economy model, with the objective of opening up markets and integrating the region into the world economy and the North Atlantic security structure.

The economic transformation strategies of the Central European countries that were considered to be the flagships of transition took greatly divergent paths in many respects in the past two decades. In the beginning of the transformation, Poland attempted to create the starting conditions required for market economic development with fast and drastic measures. In the Czech Republic they thought that the foundations of the economy did not really need to be adjusted and the country would be suitable to build a market economy on without much restructuring, while in Hungary the rapid transformation of certain sectors was set as a priority objective, without drastic measures in many other areas. The economic position of Poland, Hungary, and the Czech Republic remained, nevertheless, very similar. Owing to the structural reforms launched towards the end of the nineties, Slovakia soon joined the most developed group of regional countries. On the whole, however, these countries went through the very same stages during their economic transformation. Although there may have been differences between the specific countries in what they considered to be the focal point and centre of gravity in terms of joining the NATO and EU-accession talks, the general tendencies converged on the whole.

The first years of EU membership saw diverging economic performances within the region. Some countries achieved exceptionally dynamic economic growth (sometimes above ten percent), increasing

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external imbalances (double digit current account deficits in the Baltic States) or continuously high budget deficits (in Hungary). Catching up prospects became very different. After the economic crisis struck in 2008-2009, small countries in Central Europe were seriously hit, leading to very deep recessions and sovereign debt crises calling for IMF-EU programs in several countries.[1] When the crisis in Greece and other Eurozone countries started to threaten the existence of the Eurozone itself, previously unimaginable and very costly rescue programs soon became unavoidable solutions for saving some countries from bankruptcy. In particular the so-called Visegrad four countries (Czech Republic, Hungary, Poland and Slovakia), but also the larger CEE region was overshadowed by these issues as well. Increasing negligence towards the region and the sometimes very rigid approach of EU policymakers to handling regional peculiarities[2] gave rise to growing dissatisfaction with the EU itself.

Changing Perceptions and Future Challenges

Perceptions of the success of transformation have changed substantially over the last two decades in Central Europe. After a period of quick catching up, the last few years have brought slow economic growth and declining or slightly rising living standards with sharpening income differences. These trends and their extrapolation into the future[3] create an environment where Western values and their future attractiveness can be questioned along different lines of reasoning in the wider Central European region. The following points highlight some of them: (1) Small countries like the Central Europeans that would like to increase living standards should establish strong economic ties with fast growing regions. The EU certainly does not belong to this group; (2) International corporations that have invested in Central Europe only pump out their "extra" profits and disregard the true interest of the countries in which they have invested; (3) The European Union uses double standards when applying economic and political rules and regulations – "new" and weak members have to exhibit better performance than large countries; for example, far less public debt is tolerated[4]; (4) The whole transformation has been based on ideologies and principles that were not in the interest of the Central European countries, but only in the interest of the West (e.g. the basic principles of the Washington consensus, supported by renowned western, mostly

[1] Hungary, Latvia and Romania in 2008-2009.

[2] One of the examples is the handling of the issue of private pension funds (created in late nineties in Central Europe on the urging of the OECD) "The European Union said a request by nine member states to account for the cost of pension overhaul in debt and deficit calculations is "not possible" to accommodate, which may spur countries to reverse changes. European Union Economy and Monetary Affairs Commissioner Olli Rehn in a letter to the countries said that while the request is "justified," it's "not possible" to accept it under the current accounting system." Accessed at: http://www.bloomberg.com/news/2010-10-22/eu-says-pension-accounting-change-sought-by-poland-hungary-not-possible.html. This approach did not improve the image of the EU. Ironically, later the EU made changes in accounting possible. But by that time it was late: several countries introduced measures that affected or even destroyed the three pillar pensions systems. This was a clear example of misunderstanding what unexpected reactions can be expected from governments under pressure in Central Europe.

[3] See: OECD. 2012. *Looking to 2060: Long-term growth prospects*, Paris: OECD.

[4] For example, Hungarian public debt is less than the EU average (and the highest among "new members") but a very strict macroeconomic policy was expected from it. Nor was it permitted to smooth or slow deficit reduction. At the same time, the average of public debt in the Eurozone is on the rise, and many countries run public debts larger than their annual GDP.

American advisors); (5) International organizations also apply double standards when preparing their reports and analyses.

The other important trend observed in the region relates to the perception of democracy and the liberal market economy. It has been a common belief among decision-makers and scholars that one of the biggest advantages of EU accession was the guarantee it provided against basic economic and political backsliding in the region through integration into a democratic, pluralist international order. It was also expected that North Atlantic integration would strengthen democracy and the liberal market economy and, by doing so, the Central European region would serve as a stable border region of the European Union delivering the message of the stability of democratic institutions and economic prosperity to the neighboring, less developed countries. However, the economic crisis that hit the European Union has seriously placed its future in question. And doubts were also raised about the ability of the EU to control its own internal economic and political processes. Skepticism is coupled with the devastating impact of the strict conditions of financial stabilization in several member countries. Economic hardship can very easily lead to the reemergence of populism and nationalism; problems that, under the surface, continue to be characteristic of many CEE countries and as historical experience has taught, can be very extreme in the region. All of these changes have weakened support for democracy and liberal capitalism in a number of countries.

In the Central European region, the differentiation between South and North that characterizes the older EU member states as well seems to be developing, and this relates either to macroeconomic indicators such as GDP growth or to the microsphere, such as the problems (that can have different origins in the individual countries) in the banking sector. Countries like Hungary, Croatia, Romania, Slovenia and Bulgaria seem to be going in a different direction compared to the Northern countries, most importantly Poland and Slovakia (in Slovakia also there are warning signs).[5] With its favorable economic performance Poland is more and more dominating in the region, not just because of its strategic role in the EU, but regarding microeconomic issues as well.[6] The Czech Republic is somewhere in between but its structural features make it more like the Northern countries.[7] Slovenia`s case is a clear sign of a failed economic transformation strategy based on domestic resources and avoiding larger penetration of foreign capital or foreign interests.[8] The Baltic States have been very forthright in implementing adjustments at the expense of political popularity and the public has accepted the hardships associated with the chosen

[5] The changing strategies and policies are well reflected, for example, in changes in EBRD transition indicators. EBRD Transition Report. 2013. *Struck in Transition?* London: EBRD.

[6] See: Deloitte TOP500 Central Europe 2013. Accessed at: http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Central%20Europe/CE%20Top%20500/CETop500_2013_web.PDF. Polish firms are becoming the most powerful in Central Europe. Thus they play an increasing role in intraregional investments as well.

[7] The risk, however, is increasing in the Czech Republic regarding the future economic directions, due to the policy of the new government formed after the elections held in the fall of 2013.

[8] The responsibility of politicians regarding the long-term development prospects of the regions' countries is huge. It also has to be noted that the negative role of politicians has been stronger or weaker in each Visegrad countries over the past twenty years. It is sufficient to recall the case of Slovakia in the nineties or Poland under the Kaczyński government not long ago. This also means that country positions regarding the method of economic and social development have changed rapidly within each country and across the region over the last two decades. The depth and impact of bad policies may differ significantly however depending on the external political, economic and institutional developments.

method of crisis management. Even despite government changes, politicians have been adamant in executing the stabilization with the final aim of introducing the euro as a guarantee against external financial shocks.[9]

Framework for a New (?) Development Model

For two decades, Central Europe's pre-crisis economic model was based on export orientation led by transnational firms. This was the case for each of them, sometimes leading to strong competition for foreign direct investments (FDI), not least because of the expectation of associated economic benefits in terms of employment, growth and competitiveness.[10] The financing of investment is probably the most significant bottleneck, as domestic savings are too small in international comparison, making foreign-sourced financing essential. The lack of financing for growth and the possible decline or very low level of investment that is already the case in some of the countries may result in long-term slow economic growth. Without todays' (mostly corporate) investments, a high level of sustained future economic growth cannot be achieved. State investments may substitute corporate investment for a while, but in the long run, only corporate investment can lead to sustainable growth.[11] An additional aspect beyond investment in production or business services is investment in education, which is an increasingly important precondition of future growth due to its role in fast technology development. Regarding this issue, worsening trends can be observed in several member states in the Central European region due to budget consolidation needs. Budget cuts have curtailed spending on education and innovation. Low investment levels and uncertainty would definitely negatively affect potential growth rates and can cause a slowing down or cessation of the catching up process.[12] If these issues are not addressed properly, the current short-term growth problems could easily be converted into long-term development problems, stopping the catching up process for longer periods. Any future oriented strategy in the region must seriously consider these observations.

In the pre accession years, the EU served as an external anchor that significantly helped the economic and political transformation of the CEE countries. External pressure indirectly helped the convergence of economic policies between the Visegrad countries, independently of economic or strategic coordination during the EU accession process. Each country aimed to enter the EU as soon as possible, contributing significantly to the fast and successful adjustment to the new conditions the democratization and marketization of the economy required. External pressure in complying with EU

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[9] For more details on that see: Anders Åslund. 2011. *The Last Shall Be the First: The East European Financial Crisis.* Washington, DC.: The Peterson Institute for International Economics, 2010, pp.111-114.

[10] The most dynamic phase of FDI inflow took place *before* the accession. Alana A. Bevan & Saul Estrin. 2004. "The determinants of foreign direct investment into European transition economies," *Journal of Comparative Economics 32*, pp.775-787.

[11] Charles Roxburgh & Eric Labaye & Fraser Thompson & Tilman Tacke & Duncan Kauffman. 2012. *Investing in growth: Europe's next challenge.* McKinsey Global Institute.

[12] Over the past ten years, gross capital formation as a share of GDP went down in the Czech Republic from about 27% to 22%, in Hungary from 23% to 17%, and in Slovenia from 25% to 17%. A more favorable but very volatile trend has been observed in the Baltic States that have been able to increase investment rates after a sharp decline during the worst period of the crisis. Slovakia, on the other hand, has been able to stabilize after the crisis and Poland has successfully avoided drops compared to ten years ago.

rules and regulations was a very important factor in the convergence of policy measures that contributed to the fast and similar transformation path within the region and the creation and strengthening of democratic institutions. The expectation for the post accession period was that the need to comply with the Maastricht criteria pushes the Central European countries to implement economic policies in order to increase competitiveness that automatically leads to faster development and catching up in terms of per capita GDP and living standards, including wages.[13] The indirect harmonization of economic policies in order to become successful in the single market and eventually adopt the euro was supposed to be a tool for supporting convergences between their economies. This expectation has not been fulfilled. The will to introduce the euro weakened in several countries and was questioned in many others as a consequence of the Eurozone crisis.

Instead of similar strategies for responding to the same challenges the countries in the region faced, the divergence was already observed well before the economic crisis hit. Diverse strategies today are largely due to the differences inherent in the economic models pursued by the individual states—which had already seemed to begin to cement a few years ago—the different intensity of the impact of the economic crisis and the different levels of success that accompanied EU accession. The deepness of the crisis and its duration depended very much on the countries` openness and structural preparedness for rapid changes in the international environment. The economic model differences were mostly related to public finance, government debt and the level of integration into the production network of large multinational firms. As a result, divergence in economic philosophies must also be identified. Poland, the Czech Republic and Slovakia continue to apply a market oriented model where the state aims to create the conditions for long term economic growth by providing incentives through the provision of a business friendly environment. This also entails that state intervention in the economy is limited to business friendly regulation. At the same time, in Hungary, state control is thought to be superior to market solutions in many areas, not an unknown phenomenon in other countries as an after crisis approach. This explains why the state is attempting to extend public ownership in many sectors and influencing macroeconomic processes with non-market interventions (price control of many products) that temporarily can decrease inflation and moderate costs for the population. But in the long run, the related negative impacts cannot be calculated. Widespread state intervention is a clear sign of departing from mainstream European economic policy approaches and recalls the state capitalist models pursued in countries like Russia or China. This belief has been partly justified by the economic performance of many emerging countries over the past decade. But it must be realized that this can only work temporarily in less developed countries, and especially in those where the tremendous resources available through saving or natural resources make possible non-market solutions carrying potential financial losses as well. In recent years the diverging economic philosophy in Hungary seems to run so deep that it differentiates this country's path from the development model in the rest of the Visegrad region.

The crisis created an environment previously unknown to many of the EU countries. As a result of the changing international environment and the crisis, the effects of national economic choices are

[13] Ivan T. Berend. 2007. "The European Union's policy of Eastward Enlargement and its Role in Transformation," *Development and Finance*, No.2. Accesses at: http://ffdf.hu/en/2007-2/the-european-union-s-policy-of-eastward-enlargement-and-its-role-in-transformation

gaining increasing importance. The problem here lies in political traditions, culture and political interests. The above-framed developments can provide room for politically motivated actions that could not have emerged in times of stable, well-functioning EU markets, delivering an increasing standard of living. Given the weakening attractiveness of the EU and its political culture, as well as the negative experiences with economic transformation and crisis management, populist approaches can easily be strengthened. While the external financing constraint forced the countries to focus on improving public finances and stabilization, at the same time governments started to introduce measures that had been unimaginable only a few years before. Just to mention some examples: the solution offered by Iceland to the banking crisis; partial or full nationalization of private pension funds in several countries; different forms of quantitative easing, such as in the USA; Europe also started to change its monetary instruments; massive bailouts in different sectors, most importantly in the banking industry, or sectoral taxes introduced by many countries (although at very different rates); expensive bailouts in the Eurozone to save countries from sovereign default. These interventions are creating precedents to which any country can refer later as instruments to be used in exceptional circumstances. And there is an increasing risk that all these measures may have an impact on political stability and the quality of democracy, especially in countries where the democratic tradition is weak and the temptation to create authoritarian regimes is greater. Besides several countries in the territory of the former Soviet Union, the most endangered group of countries in this respect seems to be in the Southern part of the Central European region. But the risk is endemic to the entire region.

One of the crucial questions is related to the role of development centers in the world, including most importantly the role that European integration can play in the shaping of the economic and political strategies pursued by the Central and East European countries. Today's world cannot be described in the simple terms of the bipolar world's traditional center-periphery relations when political support of large powers helped the economic growth of less developed states in order to gain more international influence. The picture is further complicated by the transnationalisation of business activities as a result of increasing global competition between large firms and by the surge of regional integration initiatives that sometimes overlap each other in scope or geography. Peripheral countries in that way are no longer the background territories of only one economic or political center, but are influenced by several at the same time, although the level of political and economic influence varies from one center to the other. For example, in countries like Ukraine the parallel impact of the EU and Russia is obvious.[14] Even if a peripheral country is integrated into the EU, this does not necessarily mean the elimination of the influence of other centers. The same is true for neighboring non-member countries that started close to the EU but, under changing international conditions, have been subjected to the rising importance of other countries and regions, like some of the Western Balkan countries and Turkey. On the other hand, it also has to be noted that today different centers represent very different rules and values, as reflected for example in different civilization patterns (EU, China, Russia, etc.). This multi-polarity makes the situation

[14] The difficult situation of Ukraine in negotiating the conditions of a possible associate status with the EU is a telling example. See: Tamas Novak. 2013. *Changes in Ukraine and the future of Central and Eastern Europe,* Center for Transatlantic Relations. Accessed at: http://transatlantic.sais-jhu.edu/publications/NovakT-Changes%20in%20the%20Ukraine.pdf

of peripheral regions very difficult, as it is not possible to utilize each center's advantages–which otherwise would be desirable. This would only be possible if each center operated according to the same rules. Since they do not—and clearly this is the case now—the only viable option is to choose the center that has the biggest potential development impact.

The weakening anchor (the European Union) creates the risk for increasing uncertainty in the region depending on the intentions of domestic political forces. The former socialist countries that are implementing different models of capitalism may today still be under Western influence, but the future is much more unpredictable than anyone would have thought during the period of EU enlargement in 2004 and 2007. At that time it seemed that most of the region was firmly committed to the Western European development model in terms of economics, politics and the institutional system. In countries suffering from the adverse effects of the economic crisis, the weakening of the EU and the increasing influence of populism may result in unpredictable political and economic changes in the future. All in all, international and domestic economic development, the current state of international political relations and the uncertain development of the European Union have created an environment where previous relations and decisions can be questioned, or previously developed relations changed, strategic directions modified, but without clear identification of future objectives.[15]

Conclusion

Is there a real chance for a completely new strategy to be introduced in Central Europe regarding economic instruments or the approach to development centers, democracy, openness or relations with the EU? The answer is clearly "yes". If economic problems are numerous domestically and the credibility and attractiveness of the European Union has considerably weakened due to disputes over future development directions or economic and/or political crisis, this would reduce the interest to adjust to their norms, even if, in the long-term, the advantages are still obvious. Given this situation, those countries that are less strongly integrated with the center may prefer to challenge the situation for political reasons. This is probably the worst-case scenario for the region or a part of it. Economic integration can be considered "too deep" because the original objective of economic and political transformation has not been achieved and, instead of catching up with the living standards of more developed countries, a more complicated balance has been experienced. From here, questioning the basic development model, the principles of free market competition and the efficiency of democratic institutions in crisis times is not a big step. This approach has already pushed some countries in the region to pursue strategies similar those pursued by some of the CIS countries regarding either indirect or even open limitations on democratic procedure. The situation could easily worsen. Tempted by the almost unlimited power of leaders in some post-Soviet countries, democratic systems could morph into something "new", into very destructive, obsolete structures in which country identity is defined in opposition to the European development model. This would represent a complete change compared to the pre-accession period, when it was commonly accepted that the EU, with its conditionality principle, could promote the democratization of new

[15] Probably this explains the unknown or very vague EU strategies, for example, in Hungary and the Czech Republic.

members, enforce economic and political discipline, and thereby consolidate the democratic transformation. This also suggests that while the EU presumably played a strong disciplinary role prior to accession, it no longer has the tools to enforce these principles.

Commitments and obligations within the EU were further weakened by the perception that the EU has not been able to manage the impact of the crisis in quite the same way that some large and not so democratic emerging countries have been able to. Moreover, most of the more developed countries were unable to respect the Maastricht criteria immediately after the crisis broke out. In other words, rules are meaningless when large countries face hardships. In this regard, only the example of successful countries (such as China, Russia and many others) has provided the pattern for some countries to follow, raising incentives to strengthen economic relations with them, because these connections are thought to be different (better) than those with the euro-Atlantic institutional systems. While the latter generally demand democratic and business-friendly economic conditions in exchange for economic support, the former do not make the same demands (though of course they want something else). If large, liberal, democratic, international actors do not consider Central Europe important, the region's fate will ultimately be more and more strongly defined by Russia and/or local inward-looking nationalistic or populist politicians. Especially with the emergence of new waves of economic hardship, such options cannot be foreclosed.