CENTRAL EUROPE IN THE SECOND DECADE OF THE 2000s

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Transition, Accession, Divergence

Central and Eastern Europe (CEE) has experienced a very deep economic and political transformation since the beginning of the 1990s. The early years of transition were characterized by big hopes for a quick and successful development. The opportunity for democratic transformation and catching-up was opened wide for these countries. The international community, including the EU and the United States, 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; 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 signalled 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 1990s, 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. Not least because of the political and economic changes in this part of the world, thought- provoking theories on the new world order and future global transformation were formulated, including the end of history[1] or the clash of civilizations[2]. By introducing the market economy framework and adopting the principles of democracy, it was believed that countries would automatically enter upon a path leading to a rapid convergence with the richer countries after a relatively short transitionary period.[3]

Systemic changes and sudden liberalization caused the collapse of the domestic economies and a surge of unemployment due to competitiveness problems and market loss. The transformational recession was further burdened by the lack of institutions able to manage the transition. This resulted in massive bankruptcies during the early years of transition as part of the structural change. Several non-viable firms with state aid survived that later prompted costly consolidation programs.[4] Consumers instantaneously wanted to satisfy pent up demand after decades of scarcity, creating very profitable opportunities for foreign firms selling consumer goods. In addition to flooding the market with imported products, good investment opportunities opened up for large firms to take over domestic markets from insolvent local firms through privatization or create export-oriented greenfield investments attracted by cheap labour and cost related incentives also increased from early nineties. This rush of Western business into the

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[1] "From Latin America to Eastern Europe, from the Soviet Union to the Middle East and Asia, strong governments have been failing over the last two decades. And while they have not given way in all cases to stable liberal democracies, liberal democracy remains the only coherent political aspiration that spans different regions and cultures around the globe." Fukuyama (1992): p.XIII.

[2] "During the cold war the world was divided into the First, Second and Third Worlds. Those divisions are no longer relevant. It is far more meaningful now to group countries not in terms of their political or economic systems in terms of their level of economic development but rather in terms of their culture and civilization". Huntington (1993): p.23.

[3] Such a belief explains the 'one-size fits all' approach of the Washington Consensus on which the approach to the transformation of the region was based and which was unanimously supported by international organizations and the majority of scholars. On the other hand, the original idea of the Washington Consensus was based on the poor Latin American economies, not East Central Europe. John Williamson, "What Should the World Bank Think about the Washington Consensus?" *The World Bank Research Observer*, vol. 15, no. 2 (August 2000), pp.251-264.

[4] Kornai (1994): pp.39-63.

region resulted in several positive structural changes and a number of negative consequences described elsewhere in several studies and analyses.[5]

The significance of the transition from a geopolitical, security, macroeconomic and business perspectives made Central Europe a challenging and interesting region to analyze for at least a decade. The broader East European region also attracted international attention. In South East Europe, the breakup of Yugoslavia resulted in a chain of unexpected events in Europe and led to unsolved political and economic difficulties including the birth of still non-viable states.[6] Political and economic developments in the territory of the former Soviet Union, not to mention political changes that could threaten the democratic transitions, like the one in Slovakia during the Meciar government, remained complex. North Atlantic political, economic, and security policy interest was very strong during this period and resulted in active involvement in the region's affairs with the aim of stabilization.

But the situation later changed and around the millennium international attention started to turn to other important issues such as terrorism or the rapid growth of several large emerging markets threatening the leading role of advanced countries in global competition and international organizations. The new developments slowly but continuously changed international power relations and attracted much broader interest than the economic and political developments in Central Europe. When membership in the European Union had become certain for several countries in the region, their importance declined even further. Even the term Central Europe started to lose its relevance and the region was sometimes considered as Eastern Europe, or simply as the EU new member states.[7] For a while there were expectations

[5] See for example: Berend et. al. (1996). The assessment of the transition based on the Washington consensus and the impacts of the chosen transformation method in individual countries is still quite controversial.
[6] On the difficulties and unsolved problems in the Western Balkans, see for example: Džihić–Hamilton (2012).
[7] The term Central Europe may be justified if it has a different economic or geopolitical significance from East and West. By entering the EU, it was thought that these countries are would undeniably become part of the West, and no longer Central Europeans, but rather

that new member states would frame a common Central European interest within the EU. But it soon became clear that the formulation of common interests and their successful coordination was relevant only for a limited number of issues.[8]

The first years of EU membership saw diverging economic performance within the region. Some countries achieved exceptionally dynamic economic growth (sometimes above ten percent), increasing 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 in the Baltic States and sovereign debt crises calling for IMF-EU programs in several countries.[9] 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[10] gave rise to growing dissatisfaction with

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Hungarians, Slovaks, etc. This explains continuous efforts for example to find common ground for joint interests in the V4 cooperation.

[8] For example the Visegrad four did not elabourate any priority of as great importance as integration into the EU and the NATO during the pre-accession period. The most obvious case for individual approaches was observed during the last days of accession negotiations. There are initiatives in energy policy, Eastern Partnership, or the Western Balkans, and in common research areas. However, none of them has achieved real breakthroughs. In addition, they have not been able to formulate strong proposals regarding the future of the EU. See for example: *Strategic issues for the EU10 countries main positions and implications* (Feps-MTA KRTK, 2012). http://vki.hu/kiadvanyok.html On the other hand, the strategy and operation of the Visegrad Fund is a good example for joint initiatives, projects and researches in areas crucial for the V4.

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

[10] 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.

the EU itself. Voices questioning the success and rationale of more than twenty years of transformation and EU accession started to become stronger. In addition, the divergent macroeconomic performance of the region's countries further weakened the almost non-existent solidarity across them. Deepening domestic economic problems and discontent with international crisis management led to more active government intervention in several countries. Some countries embarked on tough restructuring programs in order to rapidly adjust to the new circumstances and introduce the euro.

All these changes have led to the (re)emergence of new-old issues in the region and to problems that many thought had already been solved. Skepticism regarding the success of economic transformation increased; negative perceptions of the EU's role in the catching-up of Central European countries emerged, lending space to very divergent strategies regarding relations with the EU. In several countries, populism and nationalism began gaining strength. In addition, crisis management in the EU may be judged as a very weak, incompetent and slow attempt that is unable to address the basic problem of development heterogeneity within it. Development and competitiveness problems make the operation of the Eurozone far from smooth and, instead of convergence, the position of countries using the single currency in international competition continues to diverge, in some cases without any realistic hope of catching up in the current framework. The trends in the eurozone and crisis management may lead to the conclusion that the future marginalization of the EU in world economic and political affairs, also forecast well before the crisis, may be quicker and deeper than expected. This would mean that the EU role as an anchor in international political and

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." 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.

economic affairs for smaller, weaker neighbouring or newly acceded countries abandoned. This would also weaken the attractiveness of the European Union for current and potential future members alike. Parallel to the not so promising economic developments in the EU, the (temporary) crisis resistance of some emerging countries governed in many cases by autocratic politics may convince some country leaders that economic and political relations have to be more independent from the declining west (EU) and replaced by strong ties with fast growing emerging regions.[11]

Given this changing framework, for outside analysts, the region shows clear divergences, while inside the region many feel that the transformation has been unsuccessful and that EU accession has not answered previously expressed hopes. Instead of stimulating future-oriented debates within the EU, some Central European countries have looked more and more inward.

One might say that there is nothing special about these economic and political ups and downs in the region and, in previous decades, these countries have experienced similar economic and/or political problems. The ranking among the countries in terms of success has always been changing. The best-performing country can easily lose its positive image either due to internal political conditions (such as Slovakia during the second half of the 1990s), or economic problems (as in the Czech Republic at the end of the 1990s or Slovenia today). And sometimes economic and political problems cause dramatically worsening perceptions of the country. Government changes are easily able to turn countries here and in the wider East European region in a completely different direction. This should be taken into account when analyzing future prospects in Central Europe.

Recently several attempts have been made to theoretically describe the political and economic systems that have developed in the Central European

[11] "The Orban government has made enhanced Asian ties a cornerstone of its foreign policy and its diplomatic efforts have concentrated increasingly on reinforcing the country's contacts with a large part of the continent, from Northeast Asia through Central Asia and Transcaucasia, to the Persian Gulf." Kałan (2013): p.2.

region. The major lines of classification are based on relative endowment with production factors, a country's initial point of development and social structure. From this point of view, the Visegrad countries certainly present a relatively coherent group in CEE, although even within this smaller circle of countries, significant differences exist regarding policy objectives, economic policy strategy, etc. Their peculiar problems are related to their special development model, sometimes called "embedded neoliberalism". [12] Others may argue that the pattern of the division of labour is driven by the interest of larger and stronger partners being either other countries or foreign firms and resulting in an ever-increasing dependence. Several papers deal with the different forms of capitalism that have developed in CEE and an increasing number of studies refer to the dependent market economy position of Central Europe. [13] Dependent market economy theory tries to create a descriptive framework for the CEE countries, but has several variants within the region. In fact, it varies from country to country. The differentiation of Europe according to development paths is widely discussed by historians as well.[14] Detailed comparative analyses from other scholars based on the role of foreign capital, the pattern of international integration and the different political and economic transformations also point to the great diversities across the former socialist region.[15] The way a country in the CEE region integrates into the international economy is crucial from the perspective of its economic development path.

Dependency mostly considers trade relations and financing (foreign direct investment and foreign financial institutions).[16] Dependency, however, is not

[12] Bohle–Greskovits (2012)
[13] See for example: Nölke–Vliegenthart (2009) "...doubt may still be raised as to whether stabilization of the current position in the world economy is really desirable, given that few countries would explicitly choose an export-oriented development path with a medium level of technology under the domination of foreign capital." But obviously, the origins of this framework go back to Prebisch, Perroux or even earlier to Marx.
[14] See for example Berend (2005) He discusses theoretical issues surrounding different development paths in Central Europe.
[15] Drahokoupil–Myant (2009)
[16] On the other hand, by now it seems certain that the existence of a large foreign-owned financial sector has played a stabilizing role, as the owners "saved" local subsidiaries in several

at all a new phenomenon in Central Europe. In fact, Central Europe's entire economic history is about dependence, most importantly from the beginnings of the emergence of the capitalist economic system. This was related to the division of labour between West and East, and within the CEE region, between more developed and less developed parts. It was hoped this dependent structure would ease during the last period of socialism when countries specialized within the CMEA (Council for Mutual Economic Assistance) and new industries were developed, many of which depended on cheap energy and raw materials imported from the Soviet Union. The scarcity of capital and the lack of technology imports, however, prevented an upgrading of the competitiveness of these countries.

After the systemic changes, the previous West-East pattern of dependency emerged again. But the current dependencies, probably for the first time in the economic history of Central Europe, were supposed to help some parts of the region close the development gap with the economic core of European development, as long as adequate policies were pursued. Upgrading and a measure of success are clearly visible in current export structures.[17] Without the presence of technology intensive multinational firms, no similar performance could have been achieved.[18]

Regional differences in Europe (and today within the European Union) have been a permanent issue on the continent. Its origin goes back to the well-

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countries while Slovenia, which had the largest state ownership share in its financial sector, faced the tremendous burden of consolidation in the banking sector. For more on this, see: Slovenia: 2013 Article IV Consultation—Concluding Statement of the Mission. IMF, Ljubljana, October 28, 2013.

[17] There has been a continuous improvement of the export structure in Central Europe during the transition years. The fastest change took place in Hungary, followed by the Czech Republic and later Slovakia and Poland after the millennium. The value of high tech exports (as defined by the OECD) in percent of GDP in 2011 was 16.5% in Hungary and 11.7 in the Czech Republic, while in Germany it was 5.3%. Regarding the high tech share in the total volume of exports in Hungary it was 17.3%, in the Czech Republic 15% and in Germany only slightly above 10%. (Own calculations based on OECD data).

[18] A very telling example is the shockingly small share of high tech in Greek exports reflecting the competitiveness and structural problems there. In Greece the share of high tech products in total exports was only 1.7%, while the export/GDP ratio was also very small (27%) in 2011.

known concept of two Europes.[19] Immanuel Wallerstein's type classification of European countries, including the peripheral and/or semi peripheral positions (of CEE and Southern Europe), also serves as a credible theoretical background for understanding the unequal and subordinated situation of the region in international relations. The history of CEE was entirely different from that of the West. As a result, the region was not able to follow the rise of the modern, merchant, industrializing Western capitalism, and shares a number of common characteristics. From the point of view of the international division of labour, the region itself became the raw material and food-supplying periphery, preserving traditional elements, and old social layers and structures. This dividing line between West and East strongly separates the two regions.

Speeding up nation-building and industrialization was the core objective of Authoritarian, Fascist and Communist regimes in the region in order to catch up at least partially with the more advanced, competitive West. However, none of these state-driven attempts succeeded. A Europe of different speeds is the official acknowledgement of the historically and institutionally existing differences in Europe. From another perspective, Francis Fukuyama classifies the concept of two Europes as a basically different path between Northern and Southern countries, defined by a clientilistic and a non-clientilistic Europe.[20]

What makes the case of Central Europe interesting is that it is the area where both concepts of the two Europes meet. Economic backwardness can be burdened by the tradition of clientilism.[21] Economic backwardness can be mitigated with certain successes in catching up. But with the slow rise of living standards and the "propensity to clientalism", an uncertain international environment can be the source of increasing risks to democracy

[19] From an historical point of view, the idea of *two Europes*, West and East goes back to the historiography of Leopold von Ranke. See: Leopold von Ranke (1981)
[20] Fukuyama (2012)
[21] "There is a real degree of accountability in a clientelistic system: the politician has to give something back to supporters if he or she is to stay in power, even if that is a purely private benefit." *Ibid.*

and to long term success in catching up. The problem is further complicated by the recent emergence of North-South divergence regarding prudent fiscal policy and competitiveness in Europe. The junction of these diverging lines in Central Europe makes the fate and future of this region far more risky than anticipated by anyone a decade ago and should now attract greater attention from scholars, politicians and international actors alike.

Today the Central European region faces challenges that many had thought already resolved. The future is far more vague than it was at the beginning of the transformation or upon entering the European Union.

A New Framework in Central Europe

Since the beginning of the transformation period, more than two decades have passed. The V4 countries have been integrated into the European Union. But perceptions of the success of more than two decades of transformation have changed substantially over the last five years. After a period of quick catching up, the last few years have brought slow economic growth and falling or slightly rising living standards with sharpening income differences. The Eurozone has fallen into recession and its breakup has become a possible alternative regarding its future. Emerging markets [22] have exhibited an economic growth that has changed the global economic power balance between continents and regions. These trends and their extrapolation into the future [23] 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 these divergent lines of reasoning:

[22] There are several classifications of emerging markets, but from a geopolitical perspective, fast growing countries are the most important and can change global economic and political balances because of their size and high rates of growth. Generally, these countries are: China, India, Turkey, Brazil etc.
[23] See: OECD, *Looking to 2060: Long-term growth prospects* (2012), etc.

1. Small countries like the Central Europeans that would like to increase living standards should establish strong economic ties with faster 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[24];
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 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 democracy and the 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 neighbouring, less developed countries. However, the economic crisis that

[24] 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. (In order to be fair, we have to mention that Hungary has run a budget deficit above 3% for a very long period of time). 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.

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. These doubts have led to increasing scepticism about the future of the European Union. Scepticism 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 re-emergence 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.

There is an additional interesting issue that, in contrast to previous experience[25] and what was forecast in extreme financial and macroeconomic imbalances leading to long-term restructuring policies ("reforms") in several countries, short-term political objectives prevailed. Probably the right terminology for capturing the core of this approach is the "postponement oriented" policy. An opposite strategy is for example the one that has been introduced by the Baltic States after the economic crisis revealed unsustainable economic imbalances. Postponement policy[26] can be very risky, as this is the path by which negative consequences are accumulated, making the choosing of rational and long-term oriented policies even more difficult. From the accumulation of negative impacts, there is a straight line to populism, nationalism and hostile attitudes towards third countries or international organizations, including the European Union. Several authors have pointed out that the result of these approaches is stagnating growth and

[25] It has been a common belief that, in some countries, painful political decisions are only taken if there is no other solution. For example, macroeconomic imbalances may only be tackled adequately when there is an increased risk of sovereign default.
[26] The traces of postponement policy can be easily found in Hungary where political fights led governing elites not to introduce stabilization oriented economic policy measures for several years. More details on that: Ivan T. Berend, *Europe in Crisis: Bolt from the Blue?* (Taylor and Francis, Routledge, 2012), pp.42-46.

structural distortion.[27] On the other hand, a number of researchers have tried to demonstrate that the position of countries trapped on this development path can be changed, but only with significant effort, and the necessary steps can be very different depending on the phase of economic development and the international economic environment.[28]

Besides external and internal economic and political challenges, one additional factor relating to the mentality of the population should also be mentioned that more and more influences policy decisions.[29] Just to mention an example for the importance of mentality issues in economic and political transformation: Hungary's development during the 1970s and 1980s made this country well advanced by the beginning of the 1990s compared to its fellow countries, because of the appearance of the first forms of market and enterprise at that time. At the same time, it also meant very weak regulation that made people believe they could use state properties for their own profit (that was the case in initial forms of private enterprise), and there was no need to pay taxes (instead of paying taxes that is an unnecessary burden for the entrepreneur, and makes the product or service much more expensive to the customers it is much more profitable to avoid paying taxis). Another example: if people believe that their problems are not associated with their faults, but only those of others, then consolidation within the society (between losers and winners) and between countries that have long disputes over several

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[27] For example see: Anders Aslund, "Putin's Conservative State Capitalism", *The Moscow Times*, December 17, 2013.

[28] The proposed solutions can be classified either with respect to the theories that put an emphasis on domestic markets and resources, thus suggesting a protectionist approach (each of today`s strongest economies started their development applying this strategy) or on rapid integration into the global economy. Neither solution has been a panacea for less developed countries. But with the help of the international environment (direct political or economic support from larger countries, or international capital flows) a sizeable catching up has been achieved. Countries that can be mentioned include Asian Tigers, Finland, Estonia, Slovakia etc. Each case is different. What is common is the adequacy of their economic policy strategies.

[29] In V4 countries this has much to do with the generous welfare state agreements developed during the eighties and at the beginning of the nineties in order to counterbalance the negative implications of marketization. This system made the V4 countries fundamentally different from the Baltic States or the countries in South Eastern Europe. See more detailed analysis on this: Bohle–Greskovits (2012), pp.154-161.

questions (ethnic minorities, territorial problems), and making concessions and agreements between them, can become almost impossible. The problem with people`s thinking and the institutions that do not operate properly can make catching up or successful development very difficult, i.e. the price to be paid for misguided policies is extremely high. If people were always ready to blame somebody else for their problems, this feeling would easily be exploited by politicians. This has a long history in Central and Eastern Europe and it has much to do with the significant role the state has played in modernization and industrialization over the past one and a half centuries. The pattern of development followed a top down approach and lacked organic economic development and nation building. People felt that the problem of development was a result of external involvement or the negligence of the region when it needed help. In fact the people in the region have always been betrayed by the large Western or Eastern empires or coalitions of smaller countries. According to this reasoning, only a strong state able to protect national interests and only its intervention can be a solution to their existential problems.

This mentality also denied the benefits of competition and acknowledged political and economic clientelism as the most efficient path to success. The economic and political transformation could have led to the marginalization of this mentality. But the slower than expected rise in incomes and later the strong impact of the economic crisis prevented deeper mentality change. As a result, openness to state intervention in the economy and everyday life has remained strong, a feeling that can easily be manipulated by local politicians. On the other hand, it is false to say that this type of mentality cannot be changed. The Baltic states are clear evidence of this. They have been very forthright in implementing adjustments at the expense of political popularity and the public has accepted the hardships associated with the chosen 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.[30] I am afraid, however

[30] For more details on that see: Åslund (2010), pp.111-114.

that this is not entirely the case in the Visegrad countries, where the picture is much more complicated and the differences between the countries from every aspect are increasing instead of converging.

The changing attitudes, perceptions and behaviour of Central European countries are a part of a larger transformation process that was speeded up by the economic crisis of 2008. A number of important global trends have shaped the future international economic and political environment, and these should be carefully analyzed. Without taking them fully into account, no country can elaborate a realistic future-oriented economic and international strategy. Understanding international trends is becoming more and more important for Central Europe, which covers a small region and is becoming ever smaller and smaller regarding its share in global output. And the countries therein, probably with the exception of Poland, cannot influence international economic and political developments.

Given these interdisciplinary factors behind the economic, political, mentality and social developments in Central Europe, first of all, I look at the most important economic trends that CEE countries have to be aware of when elaborating their domestic and international strategies.[31]

1. The shift in the global economy continues. The advanced countries are expected to face slow economic growth. But their growth prospects may be better than expected due to their access to financing and new technologies. The availability of means of development, at least in some of the more prosperous EU countries, is coupled with new promising initiatives aimed at

[31] The list of decisive trends can be extended. I have emphasized those that are likely to influence the next decade of development in Central Europe most. For an interesting analysis regarding the global megatrends sees for example: *Global Trends 2030: Alternative Worlds* (National Intelligence Council 2012-001, December 2012). http://www.dni.gov/files/documents/GlobalTrends_2030.pdf

speeding up growth.[32] The dividing line between advanced countries regarding their economic development is sharpening, as is already evident in data for the eurozone countries and the need to consolidate public debt. This will limit prospects for outstanding performance in a number of countries. On the other hand, the stability of growth in emerging economies and their continuous quick catching up cannot be taken for granted in the years ahead. This expectation is supported by economic development experiences as well, according to which it is much easier to reach a medium development level from a very low starting point, than to achieve significant catching up from a middle-income level. Between 1950 and 2010 the overall per capita income differences between advanced and developing countries has not decreased, and the gap between the advanced and the poorest countries has reached record high levels.[33] Obviously there have been countries or country groups that have successfully decreased these development differences, but the picture is very complex.

2. The future of the EU is a decisive question not just for the Central European countries, but also regarding its global implications. The EU has played a very important and undeniable role in anchoring the region`s countries. A few years ago it was believed that EU membership had the disciplinary force required for real convergence within the EU. And this has occurred in a number of countries. A similar expectation relates to the introduction of the euro. Although the future of the whole EU is much more uncertain than it was a few years ago, it is quite probable that the core of the Eurozone will try to further deepen integration. In spite of the expectations of several scholars during the Greek crisis, the euro has survived. Whether other countries will join this core

[32] One of these initiatives is the Transatlantic Trade and Investment Partnership. " T-TIP will aim to boost economic growth in the United States and the EU and add to the more than 13 million American and EU jobs already supported by transatlantic trade and investment," White House Fact Sheet: Transatlantic Trade and Investment Partnership (T-TIP). http://www.ustr.gov/about-us/press-office/fact-sheets/2013/june/wh-ttip

[33] Sharma (2012): pp.2-8.

may form the most important element of future economic policy strategy in the region.

3. The future development of the multilateral international institutional system and the consequences related to this are also a key questions. If regional trade agreements become more and more important and a major shift takes place in the international trading system, countries with development and catching up objectives should focus on the utilization of opportunities connected to this. For small countries it is worth considering active participation in those multilateral or regional initiatives that bear the potential for rapid development. What is almost certain is that the overall openness of the global economy will not decrease. International firms continue to segment their production, leading to even stronger ties between countries. The further strengthening of network economy prevents tariff increases and the increase of protectionism at global level. From this perspective, countries that try to limit international competition by direct or indirect protectionist measures probably worsen their economic development prospects.[34] The level of openness will be the decisive international economic key for the Central European countries. Their choice of economic model for the next decade has to observe this condition.

4. Technology development, innovation and education play an increasing role in successful economic and social development. Technology has always been of key importance for countries to achieve successful or unsuccessful levels of global competition. Economic theory also acknowledges the increasing role of continuous technology development as one of the most important sources of competitiveness growth.[35] The speed of technological development is

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[34] See more on this in the 2013 World Investment Report, which describes the current international economic development by its title: *Global value chains: investment and trade for development*. The existence of global value chains explains the rare appearance of open protectionist measures, despite the deep negative economic impact of the economic crisis.

[35] I could not agree more with the early explanations of the importance of technology and innovation; “The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation – if I may use that biological term – that incessantly

increasing, product and technology cycles are becoming shorter, and increasing global competition bolsters the demand for new technologies and innovation. Having the most modern technologies instead of cheap labour within the boundaries of a country and large pools of educated people who can invent new technologies are preconditions for any substantial future catching-up. Besides government policies that support the mass inflow of modern technology, high-level education is the other starting point. This has undeniably been one of the most evident consequences of the global transformation in recent decades and the technological changes underlying this process. Obtaining competitive technologies is one of the most important national interests of less developed countries. Long-term sustainable catching-up for Central European countries is more and more conditioned by the availability of the latest innovations.[36]

5. Social change, the core of which is increasing tensions and differences between countries and within individual states continues. Increasing income inequality and the long-term negative impacts of unemployment have begun to characterize the next phase of the economic crisis. Increasing social problems, partly related to the long term consequences of the economic transformation, partly to the economic crisis and partly to bad economic policies could be easily manipulated by politicians, especially when middle income groups are also negatively affected. Social differences are only partly responsible for increasing tensions. The major problem is related to the generally low level of income in several Central European countries, which makes large segments of the population extremely vulnerable to shocks as

revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in… " See: Schumpeter (1947), p.83. Obviously, the role of technology and innovation has become even more important since his theory was first formulated.

[36] This issue is extensively discussed in: Aghion et.al. (2011)

living standards have fallen considerably. The management of this internal problem becomes more and more challenging.[37]

There are many other trends that may play a role and have an impact on the region's countries. But probably the above-mentioned factors are the most important ones directly linked to development prospects in Central Europe, because they require strategic responses from governments. Rational evaluation of these very powerful framework conditions and adjustment to them are the starting point if a country from the region aims to achieve significant development in the coming decades. It has to be emphasized that in small countries like those in Central Europe, inward-looking policies that disregard external conditions or do not adequately analyze them can have serious negative impacts. In the short-term, disregarding these trends can make the utilization of favourable business cycles difficult. In the longer term, however, this may cause structural changes that destroy the ability to adjust and could cause a delinking from international trends, including the utilization of most recent technological trends and favourable growth opportunities. If adjustment is the objective, a fair analysis of external conditions has to be undertaken. If not, then this creates the potential for a completely different development path. This latter perspective requires the understanding of political aspects as well since disregarding them when analyzing the Central European trends could be misleading,[38] a mistake that has been committed by several economists and analysts in the last two decades.

The cost of misguided steps that lead countries to fall behind in certain periods may cost more than in other periods. At important turning points of innovation and change in global competition, mismanagement may result in

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[37] Per capita GDP in the Czech Republic and Hungary between 2003 (the year before EU accession) and 2012 remained around the same level as percent of EU average, while Slovakia and Poland have experienced significant catching up. (Slovenia has worsened its position in the same period.)

[38] See for example Dani Rodrik, *The Tyranny of Political Economy* (2013). http://www.project-syndicate.org/commentary/how-economists-killed-policy-analysis-by-dani-rodrik

faster and deeper fallback. Today we are witnessing one of these periods, when the external challenges for advanced countries are large. The revival of economic growth is a precondition for preventing a larger fall in living standards in many countries. In these periods, the advanced countries were only able to escape by restructuring their economies toward a higher innovation trajectory and creating larger markets. We may expect that if the objective of the most advanced countries is to slow down their shrinking economic importance within the global economy, then they must become the drivers of global innovation all over again.

Given this assumption, it should be asked what the prerequisites for catching up in the middle developed, semi-peripheral countries are. The export orientation (of oil exporters) or high domestic investment in the development of a competitive, strong domestic industrial base by applying import substitution strategies can, if executed properly, be good examples for breaking out of the vicious circle of underdevelopment. Integration into global supplier chains is also a viable option if foreign investors consider the country a place worth investing in. On the other hand, the value added level at which a given country can be built into global production networks is also a very important question regarding a country's upgrading prospects. The higher the value added the more educated and innovative the labour force must be. Regarding this prerequisite, educational spending is a crucial question. In this respect, Visegrad countries` records are not very competitive. In these countries the principal source of most modern and competitive technologies are foreign firms (because of the lack of domestic investments or a weak domestic R+D system). Thus a realistic way of preserving international competitiveness is to support technology intensive investments and their upgrading, and modernize education.

Strategic Questions

Regarding successful catching-up, during the last 2-3 centuries only a few dozen countries have been able to reach a high development level and maintain this success for a longer period of time, even when external conditions are favourable.[39] The case of Central Europe proves that smaller, semi-peripheral countries that have only a limited domestic market and are not endowed with the crucial factors of production (capital, natural resources or a large pool of very cheap labour) can very easily be marginalized in the international system due to their own faults or unfavourable internal and external conditions (the negative impacts of which are based on inappropriate domestic capabilities). Only in exceptional circumstances can these countries achieve faster and sustainable growth rates in the long run. If the opportunity is missed leading to an inward looking political strategy or to one that is based on temporary advantages without the prospects of long-term modernization effects, the negative trends can only be turned back very slowly and with great difficulty here. This is especially true in countries where domestic growth potential is low due to the lack of capital and profitable business opportunities. As a result, a vicious circle of low savings and investment evolves,[40] which––with few exceptions––characterizes the situation of peripheral, less developed countries where the mobilization of domestic savings sooner or later faces market barriers and state-directed investments often lack rationale or modernization impacts. The realistic evaluation by the elite of the position of small Central European countries' and their options has rarely succeeded during the past one and a half centuries. This phenomenon, along with the geopolitical conditions and the dilemmas of participation in the international division of labour, is one of the principal reasons why most countries in the

[39] Kolodko (2002)
[40] Nurkse (1961) http://www.questia.com/library/book/problems-of-capital-formation-in-underdeveloped-countries-by-ragnar-nurkse.jsp. But a similar way of thinking can be observed in the works of Rosenstein Rodan or Kurt Mandelbaum and was expressed by Adam Smith as well.

region could only reach the development level of middle-income countries in the last few centuries. Interestingly enough, the fastest catching-up took place between 1945 and the late 1960s for very specific reasons.

Economic history proves that less developed countries have pursued basically two different economic strategies in order to achieve catching up and faster economic growth in recent centuries. These strategies root either in a classical-neoclassical approach emphasizing the advantages of liberal external economic relations, even in the case of less developed economies, or in development economics understanding the special needs of less developed countries. Drawing from economic history one can conclude that none of the theories applied in practice led to universal success in every country. Either import substituting economic policy based on domestic resources and long-term vision of economic development was the underlying economic philosophy, or quick liberalization with a strong export orientation was the core of the approach, success generally depended on certain special favourable conditions. The first strategy, for which the earlier example can be the Friedrich List type approach, proved successful for example in the United States and Germany, and much later in some of the emerging Far Eastern regions. And it was supported by large domestic savings used for large scale investments, knowledge accumulation and technology development.[41] The other model could only be successful if it was based on competitive advantages, large investments or favorable endowments with resources valued by the global market etc.

In fact, this should be the basic question of economic theory: which of them best serves a given country's long-term development? Simply copying

[41] "In the first stage they must adopt free trade with the more advanced nations as a means of raising themselves from a state of barbarism and of making advances in agriculture. In the second stage they must resort to commercial restrictions to promote the growth of manufactures, fisheries, navigation, and foreign trade. In the last stage, after reaching the highest degree of wealth and power, they must gradually revert to the principle of free trade and of unrestricted competition in the home as well as in foreign markets, so that their agriculturists, manufacturers, and merchants may be preserved from indolence and stimulated to retain the supremacy which they have acquired." List (1909)

successful models has only very rarely led to the same results in other countries because of variation in the internal, international and geopolitical environment. Success can also be attributed to the domestic propensity for capital accumulation. Small countries with relatively unfavourable endowments of production factors cannot successfully repeat the economic policy strategies of large economies. They have to find the most adequate way of utilizing favourable options created by the international economic and political environment.[42]

On account of the two enlargement waves of the European Union that created new conditions for economic development and convergence, we have witnessed a radical change in the international economic relations of countries in Central Europe between 2004 and 2007. EU accession lent new momentum to economic growth and therefore convergence in all the new Member States, including the V4 countries. In contrast to the dynamic growth recorded in the other countries, Hungary, where the initially relatively higher rate of growth had been substantially subdued by 2007 while living standards measured in terms of per capita GDP have merely stagnated since joining the EU, provides the sole exception.[43] The causes of this significant divergence of economic growth had several reasons leading to the accumulation of negative implications that led to a dividing line within the Visegrad group regarding their development path.

For two decades, Central Europe's pre-crisis economic model was based on export orientation led by large inflows of foreign direct investment. This was the case for each of them, sometimes leading to strong competition for FDI,

[42] We cannot forget, however that no general recipes exist, especially for the long term, and elements of a successful approach have to be based on the fair evaluation of the geopolitical situation and the drivers of international economic and political development. It is important to note also that the term "small state" is very difficult to define. Sometimes small states can play an important role, as for example in the European Union because of the voting system and EU decision-making, and due to their peculiar problems related to their development level.

[43] Another aspect of path dependence that can explain worsening macroeconomic performance in Hungary is explained by Benczes (2011), pp.118-131.

not least because of the expectation of associated economic benefits in terms of employment, growth and competitiveness. 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. 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. In the previous two decades, 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. Coordination has been almost non-existent during the past two decades and only serious (economic) security policy threats could alter this situation. 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 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.

In the past few years, however, instead of similar strategies for responding to the same challenges the countries in the region faced, divergence was already observed well before the economic crisis hit. During the past years (since the beginning of the crisis) the development of the Visegrad countries has begun to show greater signs of divergence than in the 5-6 years before. This is 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 levels and the level of integration into the production network of large multinational firms.

The crisis created an environment previously unknown to many of the EU countries. And facing the challenge of this almost unprecedented problem and the unexpected processes that took place within the EU, countries' room for manoeuvre paradoxically seems to have increased their policy choices. While the external financing constraint forced the countries to focus on improving government 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;[44] 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); very expensive bailouts in the Eurozone to save countries from sovereign default. There was no other choice than to introduce instruments that had not

[44] Countries chose different strategies regarding private pension funds. The reason why this issue became important is that the EU for a long time (until 2012) did not take into account the negative budgetary impact of private pension transfers in calculating budget deficits in excessive budget deficit procedures. In order to meet Maastricht criteria, countries started to introduce administrative and other measures to channel private money back into the government budget. The long-term implications, however, are very different in individual countries depending on the details. In the Baltic States, where a part of the private money was redirected to the budget, still meant a better position on the budget in the long-term. In Poland, though spending was redirected into the budget, the state pillar was fundamentally reformed, achieving long-term sustainability. In Hungary fundamental reform of the state pension system has not taken place, thereby worsening the long-term sustainability of the pension system.

previously been used in market economies. 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.

The rapid pre-crisis development was very much been based on huge capital inflows (including FDI and financial capital),[45] while savings rates were generally very low. 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.[46] 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

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[45] The most dynamic phase of FDI inflow took place *before* the accession. Bevan–Estrin (2004)
[46] Charles Roxburgh, Eric Labaye, Fraser Thompson, Tilman Tacke and Duncan Kauffman, *Investing in growth: Europe's next challenge* (McKinsey Global Institute, December 2012).

cause a slowing down or cessation of the catching up process.[47] If these issues are not addressed properly in order to manage the problems associated with long-term trends, 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.

Certainly, the 2008 crisis makes the forecast of future trends regarding the successful development and catching up path more difficult. But the most likely scenario is that the chances of middle and high-income countries with low tech and an undereducated labour force for overcoming development gap will deteriorate. According to the most recent trends, the advantages of cheap labour have been seriously questioned in the short and medium term. There are basically two reasons for this. For one, for large international firms that locate their activities where they can operate most efficiently, labour cost and the international division of labour only represent one factor among several important factors that influence the location decision. Secondly, cheap labour locations become more and more expensive as they catch up economically and gradually lose their advantages, causing firms to reconsider their investment strategies. Instead of operating in a country where production costs are quickly increasing (but still lower than elsewhere) firms prefer to invest in countries where technology and educated human capital are easily available. As a result, the largest development impact is supposed to come from the networks of international firms only if a given country enters this network chain at higher value added levels.[48] This has three consequences. First, the most promising growth potential is still related to countries that have the

[47] 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.
[48] See for example: UNCTAD (2013): pp.133-139.

greatest potential to develop new technologies.[49] Second, since today's competitiveness is more and more linked to large firms operating worldwide, it is imperative for less developed countries to attract high value added production or services firms and to offer a business-friendly environment and stability in economic management. Third, the creation of a business-friendly and innovative environment is more and more important for the support of small and medium sized domestic high tech firms and their ability to become competitive on a global scale.

As a result of the changing international environment and the crisis, the effects of national economic choices are gaining increasing importance. The quality of politics and economic policy has gained increasing importance, but 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. This is currently the case in an EU that has lost most of its credibility as an external anchor. Given the weakening attractiveness of the EU and the political culture, as well as the negative experiences with economic transformation and crisis management, populist approaches can easily be strengthened.

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.[50]

[49] Large R&D expenditure as a percent of GDP is measured in Finland, Sweden, Denmark, Japan, Germany, Norway, Switzerland, South Korea, US, at around or above 3 percent. More on that see: OECD Research and Development Statistics. http://www.oecd.org/innovation/inno/researchanddevelopmentstatisticsrds.htm

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

This can also be the source of increasing uncertainty about the strategy of the countries in question. And this may lead to differences partly related to the current economic indicators (growth, public debt level, investment trends etc.). But more importantly, divergence in economic philosophies must also be identified.

Strategic Decisions

In the past five-six years the countries that have sunk into the most difficult situations are those, whose economic growth was largely fuelled before by external funds –– regardless of the actual reasons that underpin the need for external financing (large trade deficit or external debt service). Therefore, long-term economic policies and strategies go hand in hand with the room for manoeuvre and the means chosen in the course of crisis management. And they also call for a need to adjust the direction of the economic policies pursued before the crisis, although to varying degrees. The situation however, is much more severe now than it was before the crisis––particularly when we look at individual countries––since the shrinking or moderately increasing GDP figures are coupled with decreasing living standards at a time when drastic budgetary and structural adjustments had and still have to be introduced and implemented in most countries of the region. An increasingly divergent development trend can be observed within the region, with its favourable macro and microeconomic 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, like the size of firms.[51] 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

[51] See: Deloitte TOP500 Central Europe 2013. 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.

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 (but in these two countries also there are warning signs).[52] The Czech Republic is somewhere in between but its structural features make it more like the Northern countries. [53] 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.[54] The picture is even more complicated in the case of the Baltic States.

Because of the lack of strong democratic traditions and institutions in Central Europe, increasing tensions within the societies and open scepticism regarding the development model pursued since the beginning of the nineties that resulted in declining living standards for large segments of the society and was further burdened by the negative economic impacts of the crisis, could turn back time in a number of countries. The result would be a fundamentally different development path compared to that of Western Europe. The once integrated countries, depending on the policies pursued by their governments, could easily become less integrated. This previously unimaginable scenario has today become an option. Weakening integration can have very different meanings ranging from strong anti-EU political attitudes to institutional

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[52] The changing strategies and policies are well reflected, for example, in changes in EBRD transition indicators. EBRD Transition Report (2013). p.112.

[53] 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.

[54] 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.

disintegration. This latter option was not entirely ruled out for example during the most severe period of Greek crisis management, and it probably cannot be avoided if realistic economic calculations regarding the country's development options are taken into account. The well-known concept of two Europes, according to which Western and Eastern Europe follow fundamentally different development pathways, can again become stronger in the next decades if this disintegration (broadly understood) takes place and already integrated countries loosen their ties significantly within the EU. This can renew the peripherisation of countries that have moved closer to core Europe in recent decades.

What Future for Central Europe?

Today's very rapidly changing environment makes it almost impossible to make business forecasts for the next quarter or half year. Short-term developments are always overwritten by very sudden changes that cannot be anticipated even with the most sophisticated econometric models. On the other hand, major drivers of development in the international and domestic environment have to be identified for strategic planning reasons. In spite of uncertainties, we must undertake the framing of the most important geopolitical, economic and political drivers of trends for the Central European region. Simply describing trends does not help policy-makers, economic strategy planners and the business community very much in a period when Central Europe once again reached a turning point. Much depends on the responses to the new challenges that will decide the fate of the regions' countries for the next decade.

As a starting point for elaborating a probable future for Central Europe, reference must be made to the multiple geopolitical developments noted above that will influence their strategies and manoeuvring room.

1. The enlargement process towards the East has ceased (even if Croatia was admitted to the EU), and there is only a very slight chance

additional countries will join the European Union in the next 8-10 years. The fragmentation caused by development heterogeneity may also slow down accession talks with potential new members. Failure to manage economic crisis in a sustainable way can cause further weakening in the attractiveness of membership.

2. The eurozone crisis has not been solved; competitiveness and structural problems in the South may persist for a long time, although to varying degrees across the countries in question. Less competitive countries in the eurozone will face long-lasting economic problems that can only be solved with underlying structural reforms, which even in optimal cases will take a decade. On the other hand, most probably the EU's core region will again become a relatively fast growing, global competitive development centre in the next few years. If we consider all 18 members, development gaps in the eurozone will further increase and its structure will become even more fragmented.

3. The eurozone crisis may represent a turning point in European political and economic history. High-performing EU countries like Germany can exert a positive impact on countries that have strong economic ties, including both trade and investment. In fact, Germany has become the leading country in the region and, due to its competiveness oriented policy, it has all the instruments that make it able to become even stronger economically and achieve an increasing role in international affairs, including relations with Russia and the Central European region. The increasing role of Germany in Central Europe is a very important framework condition for the next decade.

4. Russia has been able to strengthen its position in international relations and to take part in halting the enlargement process. It has become strong enough to try to regain and increase its influence in some parts of the CIS. Russia's efforts to reintegrate a part of the CIS will continue and strengthen as a number one priority of Russian

foreign policy.[55] Regarding economic issues, Russia is becoming an increasingly important player in the Eastern part of Europe, despite the many structural problems scholars refer to that the Russian economy faces in the long run.[56] Russia has gained strength recently during the economic crisis as a result of its energy resource exports that have shielded the country against the international storm. Besides economic development and the stabilization of the authoritarian Russian regime, the country clearly signals its increasing will to regain its economic and political importance in international matters, at least in its neighbouring regions.[57] In recent years, Russia has become one of the most important capital investors in the world, mostly through state-owned enterprises, though obviously not independently from politics, and it has become the number one investor in the East Central European region. In addition to achieving economic penetration, it is also more and more in its interest to stop the spread of Western-style democracy, perhaps even in countries where democracy seemed to be solidly rooted.[58]

5. Given the changing geopolitical situation, a potential breakup of the Eurozone would not just cause economic problems; it would also further strengthen the possible influence of Russia, especially in

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[55] After his recent presidential election, Putin framed to achieve a more complete reintegration of the CIS with Russian leadership as a number one strategic objective. Russia initiated the Customs Union within the Eurasian Economic Community in 2010 now called as "Single Economic Space," and with the final goal of creating an Eurasian Economic Union.

[56] For a very detailed analysis on this issue see Berman (2013).

[57] See World Investment Report (UNCTAD, 2013), pp. 8. 13.

[58] See the citation from an interview with Francis Fukuyama: ""I think that's right, that Russia doesn't have an interest in having a healthy democracy on its borders because that's going to give the wrong signals to its own people. So I think it's probably right that Russia would prefer to have other authoritarian neighbors around it.
And I think [that] increasingly you're seeing a lot of cooperation between Russia and these other dictatorships in terms of trying to re-create a single trade zone or economic space and unifying it through energy policy and through transportation and so forth." Interview: Fukuyama on Democratization in Eastern Europe. *RFE/RL.* Augustus 27, 2013. http://www.rferl.org/content/interview-fukuyama-democratization-eastern-europe/25087539.html

economically weaker EU countries. As a result, completely new security policy uncertainties would emerge again. This is why the division between north and south countries within the European Union bears risks in addition to the associated economic woes. But precisely this risk and the fear of geopolitical consequences make a breakup of the Eurozone less likely, at least during the coming decade. This is especially important in the Central European region, where, in addition to the risk of economic backsliding, there is both open and partly hidden support for nationalism and populism. Authoritarian regime changes in a disrupted Europe may not be avoided.

6. The American interest in Europe and in particular Central Europe has declined after the millennium. American attention has turned to other regions (the Middle East and Asia). This has also been encouraged by a politically and economically weak Russia. Given the past few years of economic and political development in Europe, Russia`s intensifying involvement, the North-South division of Europe and the persistent periphery position of Central Europe or a part of it, developments here are less predictable than a decade ago. As was the case after the collapse of the Soviet Union, what happens in the region does matter.[59] The role of the United States in the region is still and increasingly will be important for the whole of Europe.

What these countries must achieve in the next decade in order to re-open the window of opportunity is to provide clear-cut answers to the questions that have emerged within the framework of international and domestic change and

[59] I completely share the view expressed in a detailed analysis on why the US has to reconsider strategically its interests and presence in Central Europe: "Preventing a new fault line from emerging on Europe's northeastern periphery is in America's overriding strategic interest. It not only ensures that the process of democratic transition may again be strengthened in its journey eastward, not only in Eastern Europe but possibly, one day, in Russia itself. This is what a very great power with a supreme interest in supplying common global security goods ought to be about. To not see this is to be strategically blind." Andrew A. Michta, "Back to the Frontier", *The American interest* (November/December 2013)

the conditions analyzed above. The answers are not at all obvious and this creates economic, political and security risks for the future.

1. Decision on strategic partners. Central European governments' choice of economic and political model may be influenced by success or failure in economic performance of advanced and emerging countries. There is an increasing need on the part of the most advanced countries for counterbalancing the increasing power of emerging markets that, more and more frequently, re-evaluate the importance of transatlantic relations. If this occurs, then the transatlantic region has a good chance of remaining at the core of future global economic development. Though these countries probably cannot avoid declining shares in global economic output, this region could still gain new momentum. Such developments seem unavoidable, despite fears and reservations in this regard in some of the European countries. There is a danger that regional governments and politicians see the EU as a weak economic centre whose economic and political model is not adequate to current global trends. The conclusion may easily be that, instead of the European model, emerging countries should follow potentially more successful strategies. This view is also supported by a belief in the successful decoupling of emerging fast developing countries from the developed world. The most important strategic partners for the countries of Central Europe are in the transatlantic region. Anti-EU economic and political strategies in the countries shattered by economic difficulties and characterized by relatively poor economic outlook and declining standards of living, however, are on the increase (quarterly economic data that sometimes displayed more positive data is not worth drawing long-term conclusions on; high level and stable Central European economic growth simply cannot be achieved in a sustainable manner over the next two to three years).[60]

[60] The deteriorating positions cannot be described better, than the EBRD Transition Report (TRANSITION REPORT 2013: Stuck in Transition?) in which several indicators of the

2. Striving for Eurozone membership may express the will of a country to join the core euro area. This is also a complex economic and political strategy and a new development model. Instead of a kind of inward-looking policy that tries to close the country (i.e. reducing openness to the world economy, including international trade and the free movement of capital and labour), the principal aim in this case is to fully open a country's economy. In order to be successful in the core of Europe, significant structural change and increasing competiveness is required. This is the key question in Central Europe for the next 5-10 years that will decide the fate of the region's countries for the long-term. Poland seems to be interested in adopting the euro in the foreseeable future, while, under the current political situation, Hungary and the Czech Republic will not seriously consider this option during the forecast period.
3. There are persistent problems with the understanding of short- and long-term consequences. There is a very strong temptation to look at short-term issues in order to gain political advantage. The lack of a consolidated long-term strategy to which politicians must stick creates a framework for daily intervention into structurally important fields. This can harm some sectors, resulting in huge distortions and poorly operating institutions. Any political force that really wants to change the mentality of the population in a way that can be adapted to the coming decade's changing environment (the major features of which have been explained above) must focus on a long-term approach. Obviously, the vicious circle of populism is not easy to break. But it must be done if we wish to distinguish Central European countries from the more Eastern countries.

countries that joined the EU in 2004 (Hungary, Slovakia) have been lowered, which is almost without precedent in the last ten years. (p.112). Regarding growth uncertainties, see: pp.104-105.

4. Growth must follow a more balanced pattern. Though from a sustainability perspective small countries should give priority to exports, healthy, balanced and long-term growth can only be secured with the stability of domestic demand factors (investment, consumption). From the perspective of growth and convergence based on both internal and external factors, it is evident that new Member States that have coped better with catching up challenges are those that have produced high but not overheated growth, coupled with appropriate levels of external and internal financial stability, low budget deficits and healthy public debt indicators. But first of all, corporate investment must be increased.
5. Social mobility and labour force upskilling represent increasingly important tasks in managing social "dualization".[61] Low incomes and relatively high unemployment rates require steps that avoid limiting social mobility and strengthening the cementing of society's social structure into winners and losers. Failing to do so may result in huge losses of human capital made possible by freer movement of labour within the European Union. Negative examples can easily be mentioned: due to the civil war, social mobility in the former Yugoslav territories was reduced and several hundreds of thousands emigrated, permanently weakening the qualified labour force endowment; millions have emigrated from Bulgaria and Romania during the decades following the transformation due to economic hardship and the lack of opportunity. In countries where, besides economic problems, decision-makers have reduced mobility through changes in the educational and other systems, they have eliminated the most important element of a successful country: flexibility and the ability to

[61] Gini coefficients may not demonstrate extreme income disparities within the region's countries. A more important problem is related to income levels. Differences in income are increasing, but still oscillating around the EU average. But average income levels are too low to overcome poverty lines.

adapt to an ever-changing environment. Social mobility can only be improved if education also becomes one of the top priorities.

6. The role of technology and the capacity to utilize it in growth and modernization has become increasingly important. Without this, no country in the region will be able to leave behind the phase of extensive growth. The changing international strategies of global firms can also be extremely relevant from this perspective. Many firms are forced to search for further cost-cutting measures in order to regain their competitiveness in an economic environment where demand in several sectors is expected to stabilize at lower levels than before the crisis. In such circumstances, firms are eagerly looking for cost-saving measures that may result in a re-thinking of their global presence, lead to the shuttering of high cost production facilities and to their partial relocation in lower-cost countries. As large multinationals in some cases are deterred from closing facilities in home countries (due to government warnings, as has occurred for example in some major Western European countries), they may choose to downsize production in other high wage countries. Visegrad countries are low cost locations and the capacities in some sectors (the car industry for example) are technologically modern and very competitive, so they can expect some additional investment as a part of multinational's global cost optimization strategies. Strategies related to foreign direct investment remain one of the most important factors in the modernization of the region. In the meantime, the role economic policy plays in supporting the business environment (investment friendly, non-distortive etc.) has become more and more important.
7. The management of public finances. Public debt and budget consolidation are some of the most difficult economic issues, and it is certain that the debt problem will pose a continuous challenge, both for the Visegrad 4 countries as well as for the global economy. When analyzing Visegrad country challenges in this respect, several unique

features must be taken into account and the significant differences regarding debt management and outlook must also be considered. 1. State debt indicators are the highest in Hungary, while the other three V4 countries exhibit indicators that are favorable even in European comparison. Debt indicators for Slovakia, Poland and the Czech Republic are relatively positive, despite increased budgetary spending during the worst periods of the crisis. 2. Improving budget balances in Europe, including the V4 countries, is one of the most pressing necessities for at least three interrelated reasons: a. the EU approach toward balanced budgets; b. uncertainty and volatility with respect to international financing; and c. the unpredictable future economic, political and social consequences of the crisis. Debt issuance has led to many non-conventional measures being introduced, especially in Hungary. But other countries have also chosen similar interventions and they will do so increasingly if additional waves of economic disruption emerge. Countries are running out of options regarding the management of public debt. This leads to the discussion of more and more non-conventional measures.[62] As soon as the very favourable international financial environment worsens, monetary policies and fiscal policies are likely to face sudden pressures.

8. The logic of capitalism and its advantages and disadvantages are not adequately explained. It is important to openly provide the population with clear and balanced views on the pros and cons of different measures. This relates first to the important differentiation between democracy and Russian (or other similar) types of governance. The second point is the explanation of the structure and shape of capitalist systems. These explanations are very important because of the unfavourable consequences of the transformation over the past two

[62] "The tax rates needed to bring down public debt to precise levels, moreover, are sizable: reducing debt ratios to end-2007 levels would require (for a sample of 15 euro area countries) a tax rate of about 10 percent on households with positive net wealth." In: IMF Fiscal Monitor (October 2013). http://www.imf.org/external/pubs/ft/fm/2013/02/pdf/fm1302.pdf

decades and due to mentality. In several countries or regions in East Central Europe, people need and want to have a strong state that intervenes forcefully: its democratic nature is less important. It is much easier to solve problems in Eastern Europe by force than through democratic and well elaborated cooperative processes – at least this the perception of large numbers of people. In several countries, many policies have simply not been clearly explained or defended.

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