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Central and Eastern Europe beyond Transition: Convergence and Divergence in Europe

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POST-COMMUNIST CAPITALISMS IN CRISIS:

SCENARIOS FOR CENTRAL AND EASTERN EUROPE

SCENARIO 1: ECONOMIC RECOVERY AND EU INTEGRATION

- After a period of crisis the EU establishes a credible system of fiscal and monetary oversight in 2014 in return for richer states continuing to help poorer ones
- This Europeanization of policy includes clamping down on flat tax regimes and other practices used by neo-liberal countries such as the Baltic states to establish competitiveness
- Austerity measures in the Baltics lead to mass protests in 2013, forcing the countries to shift to more socially-oriented policy
- Visegrad countries gain from new European approach
- Growth in EU recovers by 2015-1016
- Euroscepticism and populism in CEE declines as new European model delivers renewed prosperity

As Chancellor Claudia Lichtenegger delivered her final address before the European Parliament at the conclusion of Austria's presidency of the European Union, she could not help but add a personal note looking back at how Europe had changed since her country's last period at the EU's helm some thirteen years ago in 2006. Lichtenegger recalled how as a mid-level Finance Ministry planner she had been involved at the time with helping to finalize the EU's Financial Perspective for 2007-2013. The reference immediately drew some embarrassed looks from amongst the MEPs, as they all remembered the painful collapse of the Perspective in late 2012 and the distressing standstill that would result for more than a year as member-states would squabble over new monetary and fiscal rules within the EU.

To relieve the parliamentarians' unease, the Chancellor quickly followed up with memories of the EU's Thessaloniki summit in May 2014, where Europe's leaders had finally realized the sheer gravity of the situation. Taking a somewhat bizarre, yet effective 'shock-choreography' approach to the meeting, the Greek government had intentionally chosen the country's most downtrodden city to plead its case for a political breakthrough. As delegations were driven through streets piled high with uncollected garbage (a result of severe public service cuts), the summit itself was held across the street from an unemployment center in full view of the throngs of jobless gathering daily to apply for minimal benefits. Against the backdrop of this misery, Chancellor Lichtenegger called to mind, a historic compromise had been reached, in which the EU finally established a credible system of fiscal and monetary oversight within the eurozone in exchange for a concerted effort by Germany, Netherlands and Sweden to re-balance their inveterate trade and current account surpluses that had widely been seen as a key aggravating condition for the economic crisis. Member-states who were net contributors to the EU also agreed

on a fiscal equalization mechanism supporting poorer EU states and their citizens.

In concluding her address, the Chancellor noted that the Financial Perspective she had now had the honor as EU chair to prepare (for the years 2020-2026) would see the last of the EU's Special Recovery Supports for Latvia and Hungary be phased out within a year, while the organization's Formal Monitoring Mechanism in relation to Ireland would also end within six months. In a remark that elicited final chuckles from her audience, the Austrian leader quipped that this time she felt her contribution to the EU's financial planning would stack up better than her work in 2006. Europe, she said, had reached a new level of economic and political integration, one which had helped revive growth across the Union to an average rate of 3.4% by 2015-2016.

For the MEPs sitting in the chamber from Central and Eastern Europe, the Chancellor's thoughts evoked mixed feelings. Countries such as Estonia, Latvia and Lithuania that had followed a neo-liberal economic model before the 2008-2009 financial crisis continued to suffer years of painful internal devaluation until finally seeing living standards improve slightly in 2015. Initially governments in all three countries appeared to weather the political challenges well. Both the Latvian leader Valdis Dombrovskis and the Estonian prime minister Andrus Ansip were re-elected to office following elections in 2010 and 2011. Estonia's accession to the euro zone in January 2011 also seemed to boost national confidence. However, when each leader attempted to impose a fifth year of fiscal retrenchment on their populations as part of the adoption of a 2013 state budget, the first major social protests erupted in Riga and Tallinn, causing the cabinets to retreat. Both leaders were forced into coalitions with center-left parties (Harmony Center in Latvia and the Center Party in Estonia), which set the stage for a major shift in their economic policy orientations toward more social spending.

Two years later, the countries were further altered by the EU's demand (following the Thessaloniki summit) that they abandon their special flat-rate personal income taxes as well as low corporate income taxes, widely seen as incommensurate with the EU's new, more integrated economic model. Since this model aimed at aligning social protection spending across countries with their income levels (in order to limit countries trying to undercut), the Baltic states had to expand their welfare states, and, given the new tight EU control over fiscal policy, their only remaining source of financing became higher tax revenues. Still, this combination seemed to work, as social inequalities began to diminish and the countries settled into a more Nordic model of welfare statehood, which many thought only natural given their tight links to this region. Euro accession for Latvia and Lithuania became possible in 2015. Out-migration worsened during the years 2012-2014, as both skilled and unskilled workers sought better opportunities in Scandinavia and the UK, where economic recovery was faster. However, this tapered off after the Baltic economies themselves stabilized during the second half of the decade.

The Visegrad countries and Slovenia generally took heart from the EU's turn toward deeper economic policy integration. At a minimum, they found their embedded neo-liberal models strengthened by these trends, since the more reliable framework of economic policymaking provided incentives for companies to make long-term investments. Germany's and Netherland's reequilibration of foreign trade and investment activity meant that FDI flows to their industries would be slower than they had been in the 2000s. Higher EU transfers from the expanded equalization scheme compensated for spending cuts that were necessitated by tougher EU oversight of budget deficits (particularly in Hungary). A "prosperity though integration" model took hold again, which by 2015 had reinforced the position of mainstream political parties. Eurosceptic or right-wing nationalist parties (such as Jobbik in Hungary) reared their head during 2011 and 2012, but were contained by the authorities as the latter were able to deliver on the prosperity gains they had promised as part of European integration, until they declined in the face of economic recovery.

SCENARIO 2

- EU suffers split between Northwestern states and an alliance of Southern and East European member states
- The poorer and less competitive states use their power to negotiate huge financial compensation packages in return for their compliance with EMU rules and a right for the European Commission to vet government budget drafts
- The Baltic states pursue deregulation and tight fiscal controls, as no EU coordination in this area can be agreed, but politics in the region remains volatile
- The Visegrad countries successfully introduce the euro, but see their competitiveness decline as foreign investment into their economies slows.

Chancellor Klaus Wellenberg tore his hair at the improvised late night press briefing. This European Council meeting had consumed his last reserves of patience and politeness. Together with other Northwestern EU states, Wellenberg's German government had been trapped in an unpleasant standoff with the Madrid Alliance of Southern and East European member states. The Alliance had been formed in 2015, five years ago, in reaction to the first ordered sovereign insolvency proceedings that were imposed by the EU on Greece. The Alliance represented a majority of EU member states and was thus able to block all EU decisions. Poorer and less competitive member states now effectively used this organization to negotiate huge financial compensation packages in exchange for their compliance with the fiscal rules of the Economic and Monetary Union.

Despite hours of bargaining and verbal confrontation, this European Council had failed to achieve an agreement between the Madrid Alliance states and the Northwestern EU states on the pension reforms both sides had initially agreed in order to ensure the long-term financial stability of eurozone states. Although Wellenberg and other heads of government from solvent countries offered significant financial support, the beneficiary governments insisted on a far higher sum. To Wellenberg's particular dismay, none of his colleagues honestly cared about the troubles his government would face explaining such a commitment to Germany's increasingly EU-hostile mass media, voters and Constitutional Court.

For the Visegrad states, the failure of this European Council was also disappointing. To avoid exchange rate volatility and fulfill their accession commitments, they had all entered the eurozone by 2016, although real convergence was limited by successive years of sluggish economic growth. For them, eurozone membership meant accepting a much tougher Stability and Growth Pact than had existed before 2011. Their finance ministries had to send budget drafts for approval to the EU Commission, and deviations from the framework projections resulted in control visits of Commission officials that visibly demonstrated the loss of national sovereignty in this area. The most humiliating sanction was the public condemnation and grey-listing of governments that failed to comply with EU-approved rules.

Governments in the Baltic states fundamentally agreed with tightened fiscal controls, sweeping deregulation and severe cuts of redistributive policies in the EU. Their own taxation and enterprise policies were criticized as 'beggar-thy-neighbour' practices by some richer EU member states, but persisting unanimity requirements and differences between the member states prevented any EU coordination in these areas. In the course of the years, the Baltic states had attracted larger shares of financial services and trade with Eurasia. But the growth of these sectors did not spill over to the non-tradable sectors of their national economies. While small segments of bankers, brokers and IT specialists boosted their incomes, low-skilled workers became more decoupled and caught in structural unemployment. These marginalized groups either abstained from political participation or tended to support populist centrists. These politicians were either power-hungry businessmen or charismatic speakers supported by business groups. They conceived politics as a PR challenge and won electoral majorities through highly professionalized campaigns, but, once in office, regularly failed to deliver their promises of more inclusive economic and social policies due to pressures from the business community and financial markets.

The embedded neoliberal economies of the Visegrad states did not benefit from a less generous EU environment. In the past, these countries had been quite successful attracting greenfield investment of transnational industrial corporations. Eurozone integration had removed

their foreign exchange risks, but also undermined the competitiveness of the local industries that were envisaged as partners to the local plants of transnational industrial corporations these countries had attracted. As most of the industrial production moved to China and other emerging Asian countries, the medium-skill industries in the Visegrád countries stagnated or declined. Governments initially managed to stabilize middle-income groups which had suffered from the previous decade's economic crisis. But they failed to consolidate domestic business as a broad social stratum. Mainstream political parties lost confidence among many voters since they did not manage to realize the prosperity gains expected from eurozone integration. Their economic policy strategies were increasingly contested by neoliberals on the one hand, nationalist eurosceptic critics on the other.

SCENARIO 3

- Prolonged difficulties among the non-euro countries of CEE to reach the EU's monetary convergence requirements means the area languishes in economic lethargy
- Many of the foreign banks who control the finance market in CEE become concerned about the effect of delayed accession on their loan portfolios
- Populist politicians emerge demanding a relaxation of the convergence rules. Germany and other hawks resist, leading to a crisis in the EU, which remains unresolved.
- CEE countries threaten to renounce their obligation to join the euro.

Standing amid the throngs of shoppers teaming Bucarest's Piata Obor produce market, Stefania Petrescu gazed at the image of St. Andrew emblazoned on a promotional version of what eventually was supposed to come the symbol of Romania's euro coins. Moreover, engraved next to the patron saint was the number '2017', the year President Petru Munteanu had promised to take his country into the common European currency. Along with 63% of her fellow citizens, Stefania Petrescu had voted for Munteanu when he captured the presidency in 2014 through his up-start "Romania Breakthrough" party. Though many outside observers feared Munteanu would soon follow Viktor Orban's style of 'hegemonic democracy' (for which Hungary had already undergone a period of sanctions from the rest of the EU during 2013), the 41-year-old Romanian leader retained a high degree of popularity in his country. Moreover, his ability to speak both English and French fluently (thanks to periods of study abroad in the mid-1990s as part of the EU's Erasmus exchange program) often meant he was able to break the image of most Western Europeans that Eastern Europeans were all maladroit and narrow-minded.

Indeed, Munteanu had been part of a broader wave of populist politicians rising to the surface in Central and Eastern Europe, beginning with Lithuania in 2012, Bulgaria in 2013 and the Czech Republic in 2014. All of these countries had agreed to undertake a series of tough austerity measures during 2010-2011 in order to stabilize their fiscal situation and maintain their prospects of entering the eurozone. Yet, by 2012 these hopes were stymied when it became clear that none of these economies would actually meet the EU's convergence criteria for some time to come. The chief culprits remained continually high inflation and sluggish growth rates which prevented government revenues from rising and thus easing government deficits.

Slowly these non-euro countries of the region had begun to feel trapped in a twilight zone of continual belt-tightening without the prospects of a pay-off in terms of eurozone stability. Strike action by miners in Poland and auto workers in the Czech Republic dramatized the social costs of what was going on. Populist politicians began demanding the EU relax its euro-accession conditions or else the countries would renege on their obligation to adopt the common currency. "Loosen up or we'll go the Hungarian Way", they warned, referring to Viktor Orban's formal repudiation of the euro in early 2013.

Germany remained the most adamant in rejecting these new demands. But Angela Merkel suffered a blow, when Axel Weber withdrew from the race to become head of the European Central Bank and a second-rank candidate was put forward. Eventually Berlin felt besieged from both East and West when other euro-states called for a multi-dimensional compromise to move the debate forward. Jean-Claude Juncker, head of the Eurogroup of finance ministers, agreed to give up his proposal for the creation of eurobonds and other measures to move the EU toward a real fiscal union. In exchange, he insisted that Germany be more solidary with other eurozone countries as well as facilitate the entry of new members as a way to 'revive' (others said 'salvage') the monetary union.

Echoing these concerns were also a number of prominent Western banks, who lobbied eurozone governments to ease up on their accession criteria so that the risk involved with the banks' loan exposure in the region would be relieved.

Romania's Petru Munteanu thus took the lead in early 2015 to campaign for this new deal on behalf of those Central and Eastern European members still not members of the euro. Bolstered by the coincidence of Latvia holding the EU presidency, Munteanu cited the numerous problems the region had suffered because of languishing progress toward the euro, while also pointing to how Estonia had recovered from the 2008-2009

crisis partly thanks to the stability gained by euro accession.

Yet, even after a 2-hour tête-à-tête with French President Strauss-Kahn, Munteanu was not able to achieve his ‘breakthrough’. The leaders of Poland, Czech Republic and especially the tempestuous Bulgarian Prime Minister Ognyanov demonstratively left Riga early. Although these countries never formally renounced their euro accession obligations, it was obvious that they had decided to enter into a period of non-compliance. Gradually they let their inflation rates rise and budget deficits slide in an attempt to secure some kind of renewed growth.

The populist leaders in these countries remained in power, since voters appreciated the new tough stance toward Brussels and the core eurozone countries. Yet, social welfare and development did not improve so long as the core issue of euro accession remained unresolved.

SCENARIO 4

- Economic and financial failure strike Greece and Portugal. Together with the bailout for Ireland, the EU is overwhelmed with crisis spending and is paralysed politically.
- Investors forsake both Southern and Eastern European countries, preferring either high-rate Western European bonds or dynamic investments in Asia.
- Renewed recession in Eastern Europe puts severe strains on social welfare. Pressure among the unemployed to migrate to Western Europe becomes so great that Germany and many other countries re-impose border controls toward CEE member-states, causing a major split within the EU.
- Populist politicians gain power across the region, and anti-EU sentiment becomes pronounced. Democracy as such does not collapse, however, the governments become more and more manipulative and repressive in an easy struggle to maintain control

"Restricting the free movement of persons is a severe breach of the Treaty". Bitterness and anger exuded from the words of Prime Minister Stankiewicz as he declared Poland's protest against the re-establishment of regular controls at the German-Polish border. A group of Northern and Western EU member states (led by Germany, but tacitly supported by the UK under its EU presidency in late 2017) had used the Treaty provisions on enhanced cooperation to re-introduce a border control regime. These states claimed that the only way to limit the growing influx of immigrants was to means-test all East European travellers entering the core area of the Union. From 2020 onward, only visitors who would not have to rely on social assistance from their country of destination would be permitted entry.

This harsh and unprecedented measure had been triggered by an escalation of violence against East European labor migrants, but it also reflected the interest of right-wing populist governments which now dominated in core EU states. These political forces sought to replace what they perceived as overly communitarian EU institutions with more inter-governmental agreements among sovereign nation states.

Indeed, no one had expected this development when several East-Central European countries joined the eurozone and Schengen area in the previous decade. It was the economic crisis of 2008 that triggered a persistent instability in financial markets and a steady decline of Eastern Europe's economies. Foreign investors and banks became much more risk averse and directed most of their capital to the more dynamic Asian economies or to AAA-rated EU member states. The disengagement of private investors generated huge balance of payment deficits for East European states and jeopardized their financial stability.

To reduce their current account deficits and maintain their solvency, East European governments chose a restrictive monetary and fiscal policy that curbed economic activity. Output declines entailed higher unemployment and lower tax revenues, necessitating tighter austerity measures that in turn deepened the looming depression and brought several highly indebted countries to the verge of insolvency. The richer West European EU member states refused to channel more transfers to Eastern Europe, as they felt overburdened already with the costly Irish bailout of 2011 and later the actual withdrawal of Greece and Portugal from the eurozone and the commensurate challenges of debt restructuring.

Prime Minister Stankiewicz's Law and Justice party had returned to power in 2015, after Poland's initial economic recovery was reversed despite the austerity measures maintained by the second government of Donald Tusk. The country became a textbook case of how the lack of investment and the withdrawal of foreign capital made Polish enterprises unable to modernize their capital stock and sustain their competitiveness. Many companies in the manufacturing sector had to close down which entailed not only rising unemployment but also a loss of technical skills and professional experience required to fabricate more complex goods. The core industries that Poland and the other Visegrad countries had been able to modernize during the initial period of economic growth associated with EU accession quickly whittled away. In effect, these countries became similar to the Baltic and Southeast European states as their industrial base became confined to light manufacturing and the processing of raw materials. Companies in these sectors remained competitive only by retaining low wages.

Incomes closely above the poverty line and permanent structural unemployment caused many East Europeans to seek jobs in the wealthier core EU member states.

However, the opportunities for employment in Western Europe became increasingly limited, East European migrants were perceived as threatening the economic survival of poor people in the recipient countries, social conflicts erupted, and the political environment worsened. The phrase "Polish plumber" now took on even more frenzied overtones. Economic decline, protracted impoverishment and widening income disparities also radicalized politics in Eastern Europe. Populist and hardline anti-EU parties largely replaced the moderate, pro-European political forces that had formed the mainstream of political parties in the first decade after EU membership. Given the visible stagnation and decline of Eastern Europe, many disappointed citizens viewed the mainstream parties as deeply discredited. Their promise of achieving prosperity by opening towards Western markets and capital had utterly failed.

During the last Polish elections in 2011, Piotr Stankiewicz had been a complete unknown. But he soon became emblematic of the hard-edged, yet savvy style of the new populism that was emerging. Stankiewicz had inherited Law and Justice's leader-centered organization, but he added to it a personal background in media relations, which professionalized the party's message. Following in the line of Italy's Berlusconi and Hungary's Orban (and some even said Russia's newly re-elected President Putin), Stankiewicz proceeded to slowly monopolize political power and use manipulative techniques to control the mass media, marginalize opposition parties and secure political influence over the courts, public administration and civil society.

While Eastern Europe's new generation of political leaders claimed to be committed to democracy, their governing style tended to erode democratic institutions and run roughshod over constitutional checks and balances. One of their strategies of maintaining power was to cooperate with violent racist and nationalist movements that mobilized impoverished groups in society against ethnic and other minorities. Often these groups attacked persons belonging to minorities, prompting the latter to form their own protective organizations and sometimes take revenge. Stankiewicz in particular used these incidents to increase the size of police and security forces, claiming to re-install law and order, but these measures did nothing to address the underlying problems.

In the aftermath of the EU decision to suspect certain Schengen provisions, Prime Minister Stankiewicz declared that a Rubicon in the EU's history had been crossed. Although he promised to lodge one final appeal before the European Court of Justice, Stankiewicz prepared his cabinet and other East European governments for a boycott of all EU institutions.

The upcoming 30th anniversary of the collapse of communism and the reunification of Europe threatened to become rather gloomy.