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Dear Reader,

It is my pleasure to welcome you as you are holding in your hand the first issue of IMBusiness, the periodical of the Faculty of International Management and Business of Budapest Business School. The Faculty has a long and rich tradition in research in four fields: Economics and Management, International Politics and Economics, Communication and Media and Applied Linguistics and Literature.

The main objective of IMBusiness is to provide a regular forum for the publication of the Faculty's colourful research output. With this, we intend to enlarge the tradition of our former publication series (EU Working Papers) to a broader range of international business-related topics, thus widening the circle of potential contributors, as well. It is also our firm intention to approach these topics from a special Central European angle – it is through the specific filter of our Central European traditions and experiences that we can add new and valuable substance to scientific literature in the topics we intend to deal with.

Bearing all this in mind, we also intend to be faithful to the slogan of the Faculty, so we intend to be „Open to the world” in IMBusiness, as well. This slogan reflects our approach to the topics and also to the authors of the articles to be published in IMBusiness. As you can see in this first issue of IMBusiness, beyond the contributions coming from the Faculty staff, we also present you articles written by colleagues from other institutions.

I would like to thank you very much for your interest in IMBusiness and I do hope that the first issue you are holding in your hand now is just the opening chapter of a long and fascinating story.

Dr. Tamás Szemlér

Dean

Budapest Business School

Faculty of International Management and Business
A CULTURALIST PERSPECTIVE ON TRILATERAL TAIPEI-BEIJING-WASHINGTON RELATIONS

Dean Karalekas, Adjunct Professor (National Cheng-Chi University) 
Executive Editor at Strategic Vision, Canada

In many Western nations, official policy on the Republic of China (ROC) on Taiwan often seems to be conducted on an ad hoc basis, and would benefit from a proactive footing derived from a more accurate understanding of the forces in play in that nation and, more importantly, the motivations that drive its foreign policy, especially with regard to Western powers.

The most important relationship, through which all policy making in Taipei is filtered, is the trilateral relationship between Taipei, Beijing and Washington. The People’s Republic of China (PRC) hovers ever-present over Taiwan in deliberations of legislation, trade and foreign policy in no less palpable a way than it does on the map. The only counterpoint to this enormous influence is the relationship Taipei has enjoyed with Washington, which up to the present time has helped to balance the Chinese influence and, through its policy of strategic ambiguity, provides the basis for the current tenuous status quo that defines the cross-strait situation. In Taipei, all foreign policy issues are examined through the prism of its relationship with these two giants, and as a result there can be no bilateral negotiations with other parties that don’t factor in their effect on the trilateral relationship.

The relationship that exists today can best be encapsulated by using the strategic triangle conception for describing relations between three moderately equal powers, which offers significant advantages over the more conventional dyadic model (Woo, 2003). Although Taipei is currently the minor player among the three, the paradigm was adopted at a time when the ROC and the PRC were much closer in terms of economic and military strength. Today, Beijing’s diplomatic blockade and the United States’ role as the sole global superpower, as well as its stated commitment to providing for Taiwan’s defence through the Taiwan Relations Act (TRA), have created conditions whereby all of Taipei’s interactions with the outside world are conducted in such a way that their effect on these two key relationships are factored into the decision-making process. “How will America respond?” “Will this upset Beijing?” These are the questions that policy makers in Taipei
ask before taking almost any step. It is therefore imperative that Western analysts develop an accurate understanding of this relationship if the nation is to effectively navigate its interactions with this economically important country. To do this, a culturalist paradigm must be employed by analysts and policy makers with a Taiwan portfolio.

The culturalist approach is not an easy or clean one for analysts to adopt, any more than it is for the theoreticians and scientists engaged in the study of comparative politics. What is required is an intersubjective cultural approach (Ross, 2009), one defined by shared meanings and identities. Geertz’s conception of culture famously focuses on symbols and symbolism to transmit meaning, with culture as a medium for shared meaning and meaning-making. As will be seen, such symbols are hugely important in the way Asian states communicate with their polities, and with each other.

In the following sections, this paper will describe the competing cultural forces at each point of the triangle (Taipei, Beijing, and Washington) and analyze how policy is formed in each, not as a single unitary perspective, but as an equipoise between polar viewpoints, which at times shifts back and forth along the continuum, making the task of analyzing the trilateral relationship far more complex than how it is currently conceived. The first section examines some commonalities between the cultural factors at play in Taiwan and China. The following three sections will define each country’s cultural poles; provide examples of influential policy makers and advisors who best represent the viewpoint of each pole; briefly describe the cultural roots and prevailing worldview of each; and describe how the tension between each country’s poles affects its policy making. The final section offers an argument for how the trilateral relationship can be better understood through this method of analysis.

**Commonalities**

In both China and Taiwan, politics and the structural approach to how governance is conducted are informed by a Confucian worldview, an appreciation of which helps to understand phenomena such as the unique form of the Taiwanese semi-presidential democracy, which varies greatly from other, structurally similar semi-presidential systems around the world (such as those in France, for example, and around Africa).
The Confucian worldview is far from uniform across East Asia, but in broad strokes, it emphasizes the hierarchical makeup of the public administrative sphere (as this reflects the hierarchical makeup of the realm of heaven) and even extends to the family. Of the many spheres of human interaction that are moderated through the Confucian worldview, it is the Confucianism of the family, rather than political Confucianism, that has formative power (Bell, 1995). Indeed, familization is a familiar technique, often employed in Taiwan and China, as a means of understanding and establishing relationships in group dynamics. The idea that members of a collective are akin to a family is a subtle, psychological form of control in which those in charge are viewed as the father-figure, and are thus entitled to obedience in exchange for protection of the community.

This is exacerbated by the lower but equally level-oriented roles of big brother, big sister, younger brother, younger sister, and so forth, which are transmitted primarily, though not exclusively, through the Chinese language. In contrast, in America, the leader is seen (most often inaccurately) as the antithesis of an elite, but rather a peer: one of many. Even compared to the European practice of democracy, America’s is far more individualistic and bottom-up. As a result, public governance structures and operations reflect these divergent worldviews, with Western structures moving toward a networked model and in Taiwan one that is still very hierarchical. In the words of Marc Ross (2009), “culture frames the context in which politics occurs.”

The assertion that culture provides a framework for interpreting the actions and motivations of others (Ross, 2009) is an enlightening extension of this theme, at least insofar as helping to explain some of the problems with Western policy making vis-à-vis other nations, especially China and Taiwan. In the traditional Western analysis of Chinese actions and statements, there appears to be the assumption that the PRC government is employing a rational-choice framework, and yet this framework has led to dangerous misapprehensions. It is imperative for Western governments to develop a better understanding of Chinese culture, its fear of chaos, and its tendency to employ hierarchical structures and worldviews, in order to assess signals from Beijing and Taipei more accurately, especially in terms of motivations.

On the all-important issue of Taiwan’s democracy, popular religious expression provides an ideal blueprint for the development of an informal
political organization (Cohen, 1969). It has been noted by keen observers of Taiwanese culture that the celebratory patterns in place for centuries used in temple celebrations find expression in the exercise of democracy, to the extent that a political rally looks no different from a religious event: Both have beating drums, machine-gun firecrackers, chanting and cheering, sounding brass and clanging cymbals. It is perhaps no surprise that in a young democracy like Taiwan, people should lean on existing, comfortable patterns of communal interaction—those learned from the sphere of religion—when developing new patterns for new social output, such as what democratic expression was in the 1980s and 1990s. The result of this juxtaposition of forms and rituals is the unconscious conflation of democracy itself into an institution with the power and sacredness of a religion.

Yams and Taros

In Taiwan, the dichotomy of worldviews is perhaps the most pronounced among the three. Due to cultural and historical forces, each of the two distinct populations has its own perception of national identity and aspirations for the future of Taiwan. The first, let us call them the Yams, are traditionally those Han Chinese citizens whose ancestors settled the island beginning in the 17th century and who have lived under one colonizing power or another almost consistently ever since. During the Japanese Colonial Period (1895-1945) they developed a sense of Taiwanese identity as distinct from being Chinese, and continue to identify as such today, especially as they see themselves as having been, in effect, colonized by the second group on the island, the Taros. These are the mainlanders who have been living in Taiwan since their forebears were expelled from China by the Communists in 1949 and who sought refuge in Taiwan just long enough to mount a counterstrike to retake the mainland, which of course never happened.

The recent presidential election that took place in Taiwan provides an excellent opportunity to observe how these two groups interact and differ. The Taro viewpoint is represented by the victor, incumbent President Ma Ying-jeou, whose stated goal is eventual unification with China. The reason for this ambition is not so much one of political expediency but deterministic ideology: he is head of the Chinese Nationalist Party (Kuomintang, or KMT) which became the successor to the Qing Dynasty when it was overthrown in 1912. As such, the KMT holds the Mandate of Heaven, which is a traditional
precept of Chinese political philosophy that lays out the foundations of political authority over the Middle Kingdom (Wu, 1959). The signals pointing to this phenomenon are plentiful, with perhaps the most obvious being repeated references to himself in speeches as a descendant of the Yellow Emperor. The symbols of the Mandate of Heaven and the Yellow Emperor are powerful ones in Chinese consciousness, and they speak to his culturally predisposed view that he, as well as all of Taiwan, is Chinese.

In contrast, a Taiwanese identity pervades the worldview of most members of the official opposition in Taiwan, the Democratic Progressive Party (DPP), whose candidate Tsai Ing-wen represents the Yam perspective of Taiwan and the Taiwanese people as distinct and separate from China and the Chinese people, in much the same way that Canada is distinct and separate from the United Kingdom despite our surface commonalities. From this perspective, the KMT is a foreign power representing China and thus excluding by definition those with a self-identification as Taiwanese (Indeed, the DPP grew out of the Tangwai, or “outside the party” movement that began during the 38-year long martial law period). Thus, they see themselves as being outside the alien concept of the Mandate of Heaven, and Taiwan as being outside of China. This is expressed in DPP policy as an acceptance of the need for economic engagement with the PRC, but a resistance to talk of political unification.

The different worldviews of these two groups are derived in large part from their cultural roots and differing notions of identity arising from a complex historical narrative of which many casual observers in the West are not aware. When the ROC took control of Taiwan in 1945, the first mainlanders to arrive were poorly educated, war-weary troops who had spent years fighting the Japanese aggression. Due to events little appreciated or understood in the West, such as the Rape of Nanking, these individuals perceived of the Japanese much the way Europeans perceived of the Nazis once the full extent of the Holocaust was revealed, and yet they arrived on an island ostensibly populated by their fellow Chinese only to find them speaking Japanese, dressing like the Japanese and living much the same way they do in Japan.

This created an immediate animosity among the two groups, which was exacerbated by the dashed hopes of the Taiwanese who, finally rid of their Japanese colonial masters, looked forward to being reunited with their fellow Chinese, whom they assumed would be as educated, refined and civilized as
they themselves had become under the highly cultured Japanese. Instead, they were confronted with uneducated, thuggish soldiers and incompetent administrators who systematically looted everything of value on the island for the war effort against the Communists on the mainland.

Any hope that these two groups would eventually mix were dashed by the policies of the ROC government that placed their fellow Taro refugees in positions of societal advantage and authority: they were given the civil service jobs, were made teachers, and staffed the police forces—all the better to control a subject population, through administration, education and force. The Taros felt victimized by the Communists and resented having to live on a remote island with a Japanified subject population, separated from their families on the mainland, and far away from the Middle Kingdom that the refugee ROC government nominally controlled. For their part, the Yams likewise resented being subjugated by their fellow Chinese. Over the decades of Martial Law and the White Terror period, the gulf of identity between the two groups grew, and it continues to define domestic relations to this day.

Although these populations are now defined more along ideological rather than ethnographic lines, the two groups each have their own aspirations for the long-term future of Taiwan, with the Taros seeking unification with China and the Yams desiring a wholesale acknowledgment of their de facto independent Taiwanese state as separate and unique from that of China.

**Dragons and Pandas**

This polar dynamic is mirrored in China. Indeed, conceptualizing a polarity in the political forces operating within the People’s republic is a time-honoured method of analysis employed by China Hands in the West, with only the names being assigned to the two groups (radicals vs. moderates, conservatives vs. reformers, and so forth) having changed. (Bachman, 1988) While this simplification is in many ways misleading, given the Byzantine and ambiguous processes in play in the halls of power at Zhongnanhai, it is worth revisiting insofar as it best encapsulates the two major worldviews that are emergent concomitant with China’s rise. In sum, aspirations for the nation’s future are split between those who perceive that the time is fast approaching when China will once again resume its historically dominant role in the region, and
those who are more enthusiastic about China’s ascension to the community of modern states.

The former, let us call them the Dragons, are acutely aware of the historical cycle that, for thousands of years, has seen the Middle Kingdom experiencing cyclical reversals of fortune marked by roughly 300 years of absolute and uncontested regional dominance followed by 300 years of fecklessness. They perceive the previous period of weakness from which they are emerging, referred to as the “century of humiliation” at the hands of Western powers, as coming to an end and paving the way for the inevitable period of dominance that this deterministic view of history promises will follow.

From either a constructivist or neorealist perspective, this conception would hardly factor in, however a culturalist perspective provides an understanding of the importance of such nebulous concepts as faith in destiny, even in formulation of foreign relations policy at the strategic level, and analysts utilizing this framework would thus perceive its existence and give it more credence.

In contrast to the Dragons are the Pandas, who are the forces within the PRC pushing for, if not full-fledged democratization, then at least some degree of heed to liberal-democratic values such as freedom and protection of human rights. These voices are often swiftly silenced, but there is a sizeable silent mass that sees China approaching the West in terms of economic development and conceives of the next stage as an embrace of modernity and the values that go with it.

The worldview and aspirations of the Pandas can be perceived (not unmediated by the influence of the Dragon forces) in such events as the Beijing Olympics and various other international events and fora, for which the largely inexperienced Chinese participants are gradually coming to understand—and thus through the mechanisms described by constructivism, could come to internalize—the norms and operating practices of the liberal democratic community of nations.

A leader who famously espoused the Panda view was Hu Yaobang, a former party general secretary as well as chairman who championed a number of political and economic reform measures and who was known for his liberalism. For example, on the Tibetan issue, his policies had the aim of
reviving Tibetan culture after it had been seriously degraded by Chinese rule. In addition to making a public apology in Lhasa for the way the Communist Party had been administering Tibet up to that point, castigating the cadres for their ethnic Han Chinese chauvinism, perpetuating the Cultural Revolution in the territory, and demonising the Dalai Lama, (Garnaut, 2010) Hu sought means of allowing the Tibetan people a greater hand in managing their own affairs. To that end, he ordered thousands of Han Chinese out of Tibet and insisted that those remaining in the region must learn the Tibetan language (Bass, 1998).

In contrast, the Dragon position is visible in the posture of President Xi Jinping. Still looking at the Tibet issue, Xi also gave a speech in Lhasa to mark the 60th anniversary of the Communist takeover of the country, in which he advocated a fight “against separatist activities by the Dalai clique by firmly relying on all ethnic groups... and completely smash any plot to destroy stability in Tibet and jeopardize national unity.” (“Xi Jinping: China will ‘smash’ Tibet separatism,” BBC News Asia-Pacific, 19 July 2011.)

Since the Tiananmen Massacre of 1989, Pandas have not only been a largely disenfranchised minority in China’s leadership elite, but their forms and language are often co-opted by those influences with a Dragon bent, mostly because they understand that it has a certain resonance in the West. It has been argued that Beijing uses neoliberal endeavours on a regional level to advance an agenda formed by a realist worldview. Moreover, a comingling of domestic and foreign policy can be seen in the very underpinnings of the current regime’s justification for rule. Having necessarily jettisoned socialism as its axiological underpinnings to legitimize its rule, the Communist regime in Beijing has turned to a powerful yet inherently dangerous policy of employing a race-based official nationalism to hold the vast Chinese nation together.

There are several reasons for this, illuminated by a culturalist analysis. For one, the concept of Chinese nationalism is a relatively new phenomenon: it developed rather late in world-historical time, at or around the time of the boxer rebellion, and was predicated on a racial (anti-foreigner and anti-Manchu) basis (Anderson, 2001). Today, the prefabricated nationalism employed by the Chinese Communist Party is founded primarily upon a racial hatred of the Japanese: America’s strongest regional ally and, by some
estimations, its security proxy in the Asia-Pacific. This dynamic all but rules out any possible praxis for the Panda worldview and essentially concretizes the trend toward regional polarization within the Chinese national identity.

In order to develop an appreciation for the ways in which the Dragon perspective drives China’s Taiwan policy, and in broader terms, its entire foreign policy, Western analysts must understand that its adherents have a cyclical view of history, not a linear one as is prominent in the West. Dragons see a parallel between today’s world and the fragmented pre-Qin Dynasty era of Chinese history (Yan, 2011). They draw on the lessons learned from that period of warlordism and anarchy, which ended only when the Qin people from western China conquered their rival states of Han, Zhao, Wei, Yan, Chu and Qi, after which they declared an empire in 221 B.C. and put all of China under a single yoke. China today, like that ancient tribe of Qin people, is looking at consolidation as a means of eliminating chaos and maintaining regional harmony, and the question remains exactly how other states in the Asia-Pacific region will react to this threat of a rising hegemon.

If we rely too strongly on the Western conception of the dynamics of structural realism, analysts will expect states to engage in balancing, rather than a bandwagoning behaviour, in order to ensure their security and survival (Waltz, 1979). In this scenario, we might expect to see a regional bloc form to counter the seemingly inexorable rise of China and counter its influence in the region. Clearly, this is the expectation behind the US attempt to establish the framework for a Trans-Pacific Partnership, which is designed to facilitate the creation of such a coalition.

The theoretical foundations driving this policy might prove to be in error, however, as they fail to take into account the cultural—in this case specifically Asian—conception of realism. If we step outside the box defined by a Western view of realism, we can see how nations in the region might opt for a strategy of avoidance of responsibility; preferring instead to allow the power struggle to proceed and a victor emerge before bandwagoning with the potential hegemon (Wei, 2006).

In terms of viable competitors to Western-style liberal democratic systems, there are four: fascism, political Islam, neo-Bolshevism, and Asian paternalistic authoritarianism (Fukuyama, 1995). Of those, only the latter has been able to master the modern technological world and embrace viable forms of
capitalism where the others have failed. Moreover, this political trend has been able to force the West to examine weaknesses of its own systems.

In sum, Western prognostications about China have been largely inaccurate, predicated as they are on a lack of appreciation for that government’s motivations and desired outcomes. These misunderstandings are often engendered by simply imposing Western values and aspirations on Chinese words and actions. A closer analysis of China’s limited embrace of multilateralism demonstrates three things: 1) that the forces of history play an indispensable role in framing the foreign-policy goals and aspirations of leaders in Beijing; 2) that efforts by Western powers to adopt China policies designed to entice political liberalization have not worked; and 3) that Beijing employs a realist framework when setting regional plans and priorities, but is adept at using techniques predicated on a neoliberal viewpoint in order to achieve these goals.

Hawks and Doves

It might be tempting for analysts and policy makers in European capitals to dismiss the importance of factoring US Asia policy into their calculus on the Taiwan question, however it must be remembered that Taipei’s view of all foreign relations is refracted through the prism of the trilateral relationship, and therefore an understanding of the dynamics of that relationship are of primary importance in conducting Taiwan policy.

Just as the discussion of both Taiwan and China has revealed the influence of a dichotomy of opposing paradigms operating in each of these two countries, a similar dichotomy is at play in the United States, and it has no less of an impact on how Washington deals with the cross-strait issue. The first group is made up of those whose analysis leads them to conclude that China is a rising power which, through engagement and induction into the international system, will adopt Western values and can thus, in the long run, be entrusted to gradually assume more responsibility for peace and security in the Asia-Pacific region. They are often referred to as Doves.

The other group, who are Hawks on the China question, subscribe to an analysis which leads them to believe that China is engaged in a neocolonial form of empire-building and will, in the long run, lead that country into a
position where confrontation with America over influence in the region is inevitable. US policy can best be understood not as a single point of perspective but as a continuum, along which tensions between the two poles determine the perception through which policy is formulated.

China specialist and Princeton University Professor Aaron Friedberg is well known as a Hawk on the China question. At the time of his appointment in 2003 as deputy national security adviser and director of policy planning, his writings had characterized China as a Strategic Competitor to the United States—in contrast with the Bill Clinton-era narrative of China as a Strategic Partner—and predicted even then that Beijing would mount a challenge to Washington’s political and military dominance of the Asia-Pacific (Lobe, 2003).

The viewpoint of the Doves meanwhile is well represented by such individuals as Brent Scowcroft, a foreign-policy adviser to President Barack Obama and a student of Henry Kissinger, himself a notoriously realist China Dove. The highly credentialed Scowcroft is considered an international relations guru who holds that relations with powers such as China are to be managed. Traditionally, the Democratic Party tends to adopt a pro-China stance, which is why other Asian nations such as Taiwan and Japan to whom China poses a threat are generally wary about a Democratic White House. Indeed, Obama’s foreign policy team on Northeast Asia is composed almost entirely of pro-China realists in the Kissinger mould (Jang, 2008).

The Hawk/Dove dichotomy is not merely contingent upon political party, however, and should not be conceived of as a temporal oscillation depending on who is in power in Washington. There are US government agencies, such as the State Department and the Central Intelligence Agency, that are consistently strong Doves on the cross-strait issue, while other arms of the government such as the US Navy, which in many ways administers US policy in the Asia-Pacific with a high degree of independence, are more Hawkish.

From Taipei’s standpoint, Hawks are preferable to Doves because they generally inject a values-based component into their foreign policy calculations, and the functioning democracy in Taiwan that shares to a degree the same values of respect for human rights and freedom of speech, assembly, and religion as enunciated in the US Bill of Rights, represents an ideological as well as strategic ally in the region. Taipei fears US Doves because of their
perceived willingness to eschew such values-based identification as they pursue a strategy based on realpolitik and the need to manage China at all costs, including through recent talk of a reassessment of the TRA and the US security guarantee that has helped Taiwan maintain its fragile de facto independence.

While the Hawk/Dove nomenclature is widely employed to refer to the policy standpoints of two broad groups, its roots go much deeper into the cultural makeup of American society. The United States is currently in a period of self-reflection and on the cusp of identity change where the very question of what are America’s most fundamental values is being put to the test.

The popular expression of this identity crisis is most evident in two grassroots movements that are finding expression (or at least being co-opted by the two major political parties): the Tea Party movement and the Occupy Wall Street movement. Both have served to further the political and ideological polarization of American society, and each has its own conception of what the American government’s role in the world, as well as at home, ought to be. Thus, from this long-term aspirational perspective, competing influences on foreign policy can be seen, even though they are not enunciated as such.

Indeed, to those who would argue that a culturalist approach is ill-suited to foreign relations, and that simple zero-sum-game of realpolitik yields the greatest results, the leadership ranks of democratic nations have to answer to the electorate—especially in the modern world of technology-enabled instant communication and 24-hour news networks thanks to which very little can be made opaque—a principled foreign policy that reflects that nation’s mores and values is imperative.

In terms of domestic roles, the state is more than simply a government: It is more about the Weberian perspective of the state being an administrative, legal and bureaucratic entity that structures the relationship between civil society and public authority, as well relationships within civil society (Evans, 1985). The state’s role is not limited to the domestic realm, but influences foreign policy, especially in the modern, globalized world that is, every year, defined less by a traditional Westphalian preoccupation with borders and more by common perceptions of living on a shared planet. As a result, a less homogeneous policy regime has taken root in modern states that defy simple attempts at categorization and instead are shaped by a multitude of influences.
Multidisciplinary Approach

Clearly, a multidisciplinary approach is needed to best capture the nuances of such systems in policy making, as it has been in academia. An eclecticism is replacing the traditional adherence to a single doctrinal conception, be it nationalist, culturalist, or structuralist, and as a result, academic research into these phenomena is becoming more layered and rich (Migdal, 2009). Likewise, policy making must be similarly attentive to these phenomena, even more so given the high stakes that are involved in today’s international interactions.

Those steering policy in Taiwan would likewise benefit from a more proactive and less reflexive foreign policy, which today is based as much on wishful thinking as it is on perception of manifest destiny.

For all its faults, China’s foreign policy is perhaps the most consistent and coherent of the three, due in large part to the suppression of the Panda’s agenda and the dominance of the Dragons in steering relations. This is a luxury that is unavailable to democratic nations, and while it is seen as strength in China, it is not without its drawbacks. This is not to say that democratisation would solve all of the region’s problems: In many ways, liberal democratic theory can compound rather than alleviate the governance problems faced by East Asians (Ling, 2000). Nevertheless, the inherent lack of transparency in a system like that in China today could lead to worst-case readings of the intentions of neighbours. The dynamics of the security dilemma as well as the secrecy and suspicion that underlie policy making in Beijing threaten to produce policy imperatives to act against powerful neighbours like the United States and Japan simply because they are deemed capable of, and presumed willing to, do evil against it (Friedman, 2000).

What the Chinese leadership hopes to attain is not empire, as it is conceptualized in the West, or even the sort of “informal empire” that defines the role of the United States during the Cold War (Mann, 2004), but hegemony. This is defined by a leadership of sovereign states in such a way that it is acknowledged by them to be normal or legitimate. This word is often employed by the leadership in Beijing to denounce the role of the United States in Asia not because it best reflects reality, but because it represents the status to which Beijing aspires, and one on which it is fixated. The reason for this is
that it is essentially the modern-day equivalent of the tributary system enjoyed by the Han Dynasty at the height of Chinese political dominance of the region.

Western nations must therefore develop a policymaking paradigm that incorporates a culturalist perspective in its calculus and takes these tension-attenuated continua into account. In doing so, policy makers would be better prepared to deal with and more likely to anticipate the developments largely seen as unexpected, but which are in fact not surprising to those familiar with the cultural dynamics in Taiwan, China and the United States, and how these play out in the all-important trilateral relationship.
References


CROATIA – OUT OF THE CRISIS?

Gábor R. Szűcs, Associate Professor, Budapest Business School, Department of International and European Studies

Croatia had a long and from time to time painful road to the 2013 EU accession. The country had to face both unexpected and more or less expected obstacles, partly due to the resistance of Slovenia, partly as a consequence of the low intensity of co-operation with the International Criminal Tribunal in The Hague – but mostly because of the illusion that the historical tradition in itself can substitute the objective pre-conditions and the accession criteria. The Croatian economy (in spite of the ideological and formal differences and the earlier reforms) inherited the basically socialist or even “quasi-Stalinist”-type internal structure of the Tito-era¹: the overweight heavy- and old fashioned steel- and chemical industry, combined with the dominance of public ownership and state subsidies. The latter has proved to be the greatest difficulty that Croatia has to overcome even after the accession. Due to these weaknesses the 2008 world economic-financial crisis caused enormous damages to the country – a long term recession that lasted even to today. In spite of these difficulties and the bad shape of its economy, Croatia joined the European Union and it was considered a great success. About two thirds (66.25%) of the population voted for the EU membership: most of them presumably in the hope that the integration in itself would help the country to overcome the troubles they were in. The truth is however, that the illness can only be cured by Croatia.

The pre-crisis Croatia

The overall picture of the Croatian economy prior to the world economic-financial crisis was that of a rapidly increasing country. The real GDP growth in 2006 was as fast as 4.8, in 2007 even 5.2%. The growth rate of the industrial production reached 4.1% in 2006 and 4.9% in 2007. In the beginning of the crisis, however, one could realize certain signals in the economy showing that something had gone wrong: the GDP growth rate fell to 2.1% and that of industrial production to 1.2%. Retail sales decreased by 0.5% as a sharp

¹ The Tito-era is often referred to as „Stalinism without Stalin” by political scientists.
contrast to previous years’ growth rates of 3.2-5.2%. (Gospodarska Kretanja, 2015 p. 2.)

The reasons for this sudden change was due to the vulnerability of the Croatian economy can be summarized as follows.

- The independent Croatia had basically the same economic structure as the Yugoslav republic of Croatia. After the Western Balkans civil war, neither the right- nor the left oriented governments made use of the opportunity given by the peaceful circumstances to modernize the economy. Due to earlier illusions and a certain kind of enthusiasm caused by the newly gained independence, they preserved the old-fashioned structure based on the relatively high proportion of non-competitive branches of industry. The Croatian governments were deeply convinced that the relatively high level of development of their country within Yugoslavia was a result of the cultural and social background and remained unchanged even in the independent country. Croatia (and Slovenia, by the way) used to be the “aristocrat” of Yugoslavia and the Croatian leaders believed that this position could be preserved in the new situation.

- However, except for tourism and port/transport services Croatian products were not competitive in external markets. This fact was clearly shown by the balance of trade: the deficit became traditional even prior to the crisis: in 2006 it mounted to 8.9, in 2007 about 9.8 billion Euros. The ex-Yugoslav countries as export markets remained important: in the pre-crisis years and even after\(^2\). The proportion of the CEFTA-countries (practically the previous Yugoslav republics) exceeded 20.2% of the Croatian exports, while only about five per cent of the imports.

- The tendency went on even after the outbreak of the crisis. It has remained approximately the same in the second decade of the 21st century. This orientation was undoubtedly very comfortable: in the markets of the less developed ex-Yugoslav countries Croatian products were competitive enough, yet it contributed to the

\(^2\) „Despite not joining the EU until 2013, Croatia experienced similar adverse macroeconomic trends as in the pre-crisis years” (European Commission 2015.p. 3)
conservation of the old-fashioned industrial/production structure. When Croatia, after the EU accession lost the preferences ensured by CEFTA membership, Croatian exporters found themselves in the middle of a real market with a sudden increase in competition from the EU- (and EEA) countries.

- The role of foreign direct investments (FDI) is traditionally rather low. In 2006 it amounted to 0.9 billion USD, and in 2007 1.5 billion US dollars (Gospodarska Kretanja, 2015 p. 4.). This tendency is characteristic of the majority of the ex-Yugoslav states: the governments are afraid of losing control of the economy even if it is partly owned by foreigners. The low level of foreign capital made the economy more vulnerable from the point of view of both modernization and capitalization.

- As for the general government debt, Croatia was in a relatively favourable position: as a result of the so-called succession talks of 1995 on the distribution of the Yugoslav debts the country inherited only a part of the Yugoslav indebtedness (Tranzitológia 2009. p. 129): in 2006 it was 35.9%, in 2007 37.1% of the GDP. The budget deficit was also rather low: in 2006 2.6%; by 2007 it even decreased to 2.3% of the gross domestic product.

Thus, Croatia, apart from the indebtedness issue had to face the world economic crisis with a rather unfavourable economic structure. We will see the results below.

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3 In Slovenia f.ex. the official explanation of not privatizing the commercial banks is that the government would „lose the control over the monetary policy“, minister of finance Mr. Andrej Bajuk explained during a lunch given by Austrian Embassy in Ljubljana late 2006. It has been often quoted by other government officials and economists.
Croatia in the crisis – government reactions

The table below presents the basic effects of the crisis for Croatia. As a consequence of its economic structure and other circumstances the Croatian economy is in a long-term recession. Though the numbers speak for themselves, we have to add that since the shocking year of 2009 practically none of the indicators improved significantly\(^4\).

<table>
<thead>
<tr>
<th>Table 1. Key indicators of the Croatian economy 2008-2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
</tr>
<tr>
<td>Private consumption</td>
</tr>
<tr>
<td>Public consumption</td>
</tr>
<tr>
<td>Exports of goods and services</td>
</tr>
<tr>
<td>Imports of goods and services</td>
</tr>
<tr>
<td>Gross external debt % of GDP</td>
</tr>
<tr>
<td>Balance of payments % of GDP</td>
</tr>
<tr>
<td>Trade balance % of GDP</td>
</tr>
<tr>
<td>Consumer price index (y-o-y)/x</td>
</tr>
<tr>
<td>Unemployment rate %</td>
</tr>
<tr>
<td>Activity rate %</td>
</tr>
<tr>
<td>General government balance % of GDP</td>
</tr>
<tr>
<td>General government gross debt % of GDP</td>
</tr>
<tr>
<td>Gross fixed investments (y-o-y)</td>
</tr>
</tbody>
</table>

/x forecast

\(^4\) As an evidence of this statement we can mention tourism as one of the most important branches of Croatia: the income of tourism in 2009 decreased by 20.9 per cent, in 2010 by further 10.2 per cent and the growth in 2014 was 9.8% only – that means that in spite the increase the incomes did not reach the pre-crisis level. (Gospodarska Kretanja, 2015 p. 42.)
It is extremely interesting to follow the events of the past years, the reactions and comments of the Croatian government during the crisis in chronological order to see how quickly the leadership reacted to the events in the world and in the country. (2015, pp 2-5; Szücs 2011, pp 39-40).

- November 2008: in a speech held on the Congress of the Croatian Trade Unions, Prime Minister Ivo Sanader, recognizing the first time since the outbreak of the crisis that there were problems in the economy of the country, emphasized that “there is no need to dramatize the situation”. January 2009: the Prime Minister promises: “the government will do its best so that (the economy of) Croatia should not fall into recession”. He did not even mention the measures necessary to realize this promise.

- February 2009: in the shadow of the dramatic fall of all economic growth indicators, Minister of Finance Ivan Šuker, answering to the question on the expected length of the crisis said: “nobody is speaking about a decade, - the vast majority of the experts predicted the end of the crisis by 2010”.

- In March 2010, the government accepted “the budget of the truth”, in which both the incomes and expenditures were reduced. He mentioned that “the rich ones” have to contribute to the solution of the problems to a much greater extent than previously, but again no concrete steps were followed by this statement.

- April 2009: economists proposed that Croatia should turn to the International Monetary Fund (IMF), but officials denied the necessity of this step. The governor of the National Bank of Croatia, Željko Rohatinski said: “it is true that the Croatian economy will decrease by four per cent this year, but due to its stable internal structure, Croatia will not need the help of the IMF”.

- July 2009: Ivo Sanader resigned, Jadranka Kosor (also HDZ) became Prime Minister. The government accepted a new budget that contained the introduction of a “crisis tax” of 4.0 per cent, the increase of the highest VAT rate from 22% to 25% and strict measures against non-payment (“Fiscal Responsibility Act”- an amendment to the earlier Fiscal Act). However, in the third quarter the GDP fell by 5.7% compared to the same period of the previous year.

- November 2009: the Minister of Finance declared “the relevant financial institutions foresee an economic growth next year. We cannot ignore this fact in connection with our next budget.”

- February 2010: high-rank government officials confirmed that in 2010 “a smooth increase of the GDP of 2.0-2.5% can be expected”. 

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• March 2010: the Prime Minister presented “The Economic Recovery Programme” containing the abolishment of the “crisis tax”, the reduction of the highest rate of the personal income tax and a rationalization of public service: the reduction of the number of public servants by five per cent. This could be considered as the official recognition of the fact that Croatia was in a deep crisis.

• May 2010: the Statistical Office of Croatia declared that the in first quarter, GDP fell by 2.3%.

• August 2010: Croatian economists in a common article emphasized that the government “missed the opportunity of the crisis to change the structure of the economy. Without the solution of the structural problems of public finance and the economy as a whole the situation will not change”.

• September 2010: new public discussion began about the necessity of the IMF to participate in a solution to the problems of the Croatian economy. The governor of the National Bank of Croatia did not oppose this solution, but prime minister Jadranka Kosor said: “all the economic indicators of the country clearly show we are on the best road to get out of the crisis. We can solve our problems ourselves. An economic growth of 1.5% can be expected next year”. There was a GDP growth of 0.3% that month, but economists drew the attention of the government to the fact that it must be considered a temporary improvement only, mainly caused by the favourable start of the tourist season. Some weeks later the Statistical Office of Croatia corrected the number, saying in a statement that the methodology was wrong and the GDP in fact did not increase.

• The trade unions requested a dialogue with the government to solve the problem of non-liquidity, the bureaucratic legislative and administrative system that was in their opinion responsible for the fact that the sum of unpaid obligations increased by 32% during the past several months and amounted to HRK 33.6 billion. The representative of the Trade Union Congress stated that this situation could result in the collapse of the whole Croatian economy.

• February 2011: GDP had fallen again in the fourth quarter by 0.6%, the annual reduction was 1.75%. The government was still optimistic. “The signs of economic improvement are present” the Minister of Finance Martina Dalić said, predicting an increasing growth rate for the rest of the year.

• June 2011: the Prime Minister was convinced that the “Economic Recovery Programme” would work and said that “without this programme the situation would be much worse than today”.

• December 2011: the central-left “Kukuriku Coalition” won the general election. The new Prime Minister, Zoran Milanović promised a reduction of unemployment and economic growth of five per cent in 2015.
The programme of the new government was based on three elements: dynamic economic growth, the reduction of public consumption and the “change of priorities in social values”. This latter certainly meant a more rigorous social- and healthcare system (Program vlade, pp. 3-10). Economists emphasized that the government had to begin to realize basic reforms without delay. The chief analyst of the Raiffeisen Bank Austria was in the opinion that without rapid and effective reforms the international financial institutions would have to change the credit rating of Croatia in a negative direction (Šjaus, 2014. p. 3).

February 2012: according to the new central budget the highest VAT rate was increased to 27 per cent and the government decided to reduce public expenditure. Economists, however, foresaw a further fall in GDP.

August 2012: government members said, they predicted that the first months of the new cabinet would not be easy; however, they confirmed earlier optimism.

December 2012: Standard & Poor’s (S&P) reduced Croatia’s long term credit rating from “BBB-” to “BB+” because of the lack of structural reforms and the deficiency of the fiscal policy. In their opinion as a result of the new central budget the deficit was going to increase. S&P emphasized that the 1.8% GDP growth rate predicted by the government was far too optimistic.

February 2013: Deputy Prime Minister, Branko Grčić declared that the fall of GDP was not unexpected and that the economy would grow again in the second half of 2013. No concrete measures were mentioned. Other government members were “expecting the turn of unfavourable trends”.

July 2013: Croatia became a member of the European Union. The Prime Minister emphasized that reforms had to go on. The European Commission, however, stated that if the situation did not improve in a very short time, it would be extremely difficult for Croatia to make use of EU funds. In addition, the Commission drew attention to the increased competition Croatian exports had to face after leaving the CEFTA.

August 2013: S&P reduced the outlook of the Croatian economy from positive to negative. The long term credit rating was reduced from “BB+” to “BB”. Reason: the GDP was decreasing for the sixth year in a row.

In 2013 both Moody’s and Fitch reduced the Croatian credit rating.

September 2013: excessive deficit procedure (ECD) of the European Commission against Croatia.

December 2013: according to the new budget the GDP growth in 2014 was going to be 1.2%.
Having looked at the above chronological order of events and measure, two basic consequences can be drawn. The various Croatian governments either ignored the measure of the crisis or its effect on the economy of their country. When they realized the danger it was either too late or they did not act effectively enough. This is clearly shown by the fact that in spite of government plans and steps the GDP steadily decreased. Croatian leaders simply could not or did not want to realize that the roots of the vulnerability of the economy were in the old-fashioned economic structure, and the overwhelming role of the state, including state subsidies and ownership. The European Commission summarized the situation as follows: “subdued growth, delayed restructuring of firms and dismal performance are rooted in inefficiencies in the allocation of resources...The unfavourable business environment is a major drag on the adjustment of the economy” (European Commission, 2015 p.3.)

The social/communist type of bureaucracy, nepotism and corruption (including the highest ranked officials) also contributed to the long lasting crisis that can be considered as an economic, social and moral one.

The Croatian membership of the European Union (in spite of the hopes) did not solve the problem. On the contrary, Croatia had to face greater competition both at home and in its traditional markets of the Western Balkans. Besides, taking into consideration the bad shape of the economy it was doubtful that the country would be able to absorb the financial contribution offered by EU funds. Not only the European Commission, but also Croatian experts had serious doubts in this respect. Thus, it is rather obvious that the Croatian accession was premature. But in the light of the antecedents (the matter of general Ante Gotovina, the necessity of presenting a good example and perspective for other countries in the region, the long-time blocking of negotiations by Slovenia– and yes, the precedent of Romania and Bulgaria) prove that it was not an economic, but rather a political decision.
Recent developments

“The economy is not out of the woods” the IMF report of early 2015 states: (IMF, 2015. p. 1). Croatia remained in recession in 2014 (see table), though the GDP declined to a lesser extent than earlier. Since the outbreak of the economic-financial crisis the country has lost approximately 13 per cent of its output and according to the World Bank Group recent analysis “facing increasing poverty” (World Bank Group, 2015 p. 2.). In this respect the overall picture of the Croatian economy is in a sharp contrast with that of the Eastern European region, where a slow, but remarkable recovery has started in recent years. Unemployment rate has almost doubled between 2008 and 2015. Investment activity is extremely low. In 2008 investments represented 28% of the GDP, while in 2014 19% only – there was an especially great fall in construction. “The most negative contribution to GDP growth came from the decrease of construction”. (IMF, 2015, Ibid).

The recently approved debt relief scheme related to the loans of families indebted in Swiss franc (CHF) fixed the CHF/HRK exchange rate for one year and opened the door for the bilateral talks between the borrowers and the creditors. It is a certain relief for the lowest income households with a monthly earning below HRK 1.250 (though they represent around 4% of the population only) and a debt sum of less than HRK 35.000 (Poslovni forum, 2015, p. 3.). However it can be considered a temporary and partial solution – bilateral personal negotiations should end quickly. The consumer bankruptcy law also increased legal certainty. According to bankers the position if the Croatian banks can be considered is to be rather strong.

The outcome of the 2014 ECD however is uncertain. The European Commission in 2014 estimated a budget deficit of 4.6% of the GDP (IMF, 2015, Ibid), but the real number was almost 5%. The level of public debts is also increasing and higher than that of the Eastern European countries (see table). Experts underline that most countries in the region successfully decreased the proportion of public debts, but Croatia had to face a fiasco in this field.

A further unsolved problem is the situation of the state-owned companies. The greatest difficulties are caused by the steel- and shipyard industry. The modernization and privatization was a pre-condition of the country’s EU membership, however, due to the world wide crisis situation neither the Sisak
Steel Works, nor the Split Shipyard Company (the biggest ones in their industry) could find a reliable buyer. The steel industry got a financial contribution for the reconstruction from the EU Commission in as early as 2006 which must be paid back if the privatization proved to be unsuccessful. The chemical giant Petrokemija is also in a difficult situation. The authorities now foresee professionalization of the management of the state owned companies so as to increase effectiveness and reduce administration. But the “red tape” (the bureaucratic obstacles) remains strong, especially on the local government level and the co-ordination among public organs (ministries, authorities) is rather weak.

Unemployment is one of the greatest problems. It is possible that the increase of the number of unemployed can be stopped, but the predicted low economic growth does not promise a short term increase in the employment level. It cannot be ruled out that the period for registering the unemployed is too short and as a consequence the official numbers are not reliable enough. However, “a moderate reduction in unemployment” (World Bank Group, 2015 p. 7.) can be predicted for 2015 and 2016.

“Croatia has an extensive but costly and fragmented social system...that was ...protected during the crisis” [World Bank Group, 2015, p.14.) The government had to change this situation. Social benefits were cut in 2014: a penalty for early retirement for members of the armed forces (police, army, fire-service) was introduced but local benefits often overlap with the central ones. The health system was reformed in 2013. The Croatian Centre of Health Insurance (Hrvatski Zavod za Zdravstveno Osiguranje, HZZO) was streamlined and the number of services paid by the central budget was cut (HZZO, 2015, p.2-4.). According to the IMF, however, further measures are needed in this field, as well (IMF, 2015, p. 5.), especially in local level.

Future prospects and conclusions

The fiscal measures presented by the government in the Convergence Programme with the European Union (Program Konvergencije Republike Hrvatske, 2011. pp.19-20.] represent about 0.6 to 1.0% of the GDP: the new gambling tax and the taxation of interest earnings will be 0.15% each, the increased energy tax is estimated to be 0.13% in 2015 and 0.4% in 2016, the growth of excise duty on tobacco and gasoline in 2015 will represent about
0.1%, while state subventions will be decreased from 0.4 to 0.1% of the GDP during 2015 and 2016. (Precise numbers are not yet known, because the detailed measures for 2016 are not yet fully specified). In spite of these measures according to both the EU Commission (Commission Staff Working Document 2015, p. 20.) and the IMF (IMF, 2015, p. 6.) the central budget deficit could exceed 5.5% of the gross domestic product.

There are question marks however in this field, too. By the realignment of tax burdens the 2015 budget envisages an income tax cut of 0.6 of the GDP that would be balanced by the increase of the excise on tobacco- and gasoline and a new tax of income from interest mentioned above. The programme contains a far too optimistic forecast for the revenues from the dividends of state-owned firms. Moreover, the whole programme is uncertain due to the deflationary tendencies in the Croatian economy.

Parallel with the income tax cut or instead of it a personal income tax reform would be more effective: there are still too many exemptions from income tax (for example child tax allowances also for persons/families with higher revenue). A better absorption of EU funds (structural and cohesion fund) would also be helpful. The direct or indirect subvention (tax holidays for reinvested corporate profit) of state owned companies has to be further reduced. A property tax was planned to be introduced in 2016, but the preparations have recently stopped.

State subsidies and transfers in Croatia are high and ineffective. They preserve the old-fashioned economic/industrial structure of the mid-20th century. Their structure and targets are based on political and not economic decisions.

The new structure of the health insurance also includes some risks. According to the new system, the insurance fund, though rationalized, operates outside the central government direction. As a consequence there is a real danger of losing control over the health care budget. Experience, however, is “so far so good”. The rationalization of hospital care and the incentive system applied to the hospitals proved to be successful. In case of unfavourable developments however the government has to be ready to act.

It is obvious that the slight and slow improvement expected in 2015 and 2016 (see table) does not seem to be durable without an effective privatization process and further deep and structural (though mostly painful) reforms.
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KOSOVO’S LONG WAY TOWARDS RECOGNITION AND INTEGRATION INTO THE INTERNATIONAL COMMUNITY*

László Szerencsés, International relations expert, Global Political Economy M.A., University of Kassel

Kosovo, as one of the newest states of the world has not reached full sovereignty yet. Though the governance itself has already been carried out by local bodies; the international community still has advising and monitoring rights and the state building is still under process in the region. The attitude of countries that do not recognise Kosovo has an impact on the state’s development, as these countries are holding back the country’s integration into international organisations. To be integrated into the international community is crucial in terms of both social and economic aspects. Political consolidation could give the country the chance to maintain a sustainable economic model. Furthermore, it would pave the way for completing European integration, which is in the interest of Serbia, Kosovo and the European Union.

This study examines Kosovo’s situation from the standpoint of international politics, European integration and economy. The paper aims to diagnose whether or not Kosovo is ready to govern itself on its own and what areas could primarily help Kosovo to maintain a sustainable economy. I do not intend to go into details of the EULEX mission’s activity and domestic politics of Kosovo beyond an extent which is indispensable to understand the context. We believe that even though Kosovo has made strides towards local governance and European integration, there is still a long way to go until the completion of European integration.

The international administration of Kosovo and the disputes around independence

INTERNATIONAL ADMINISTRATION PRIOR TO INDEPENDENCE

In Kosovo, the professions related to civil administration, police, economy and judiciary were carried out by ethnic Serbians until 1999. This may be explained

* The paper was submitted to the Editorial Board 23 of August, 2015.
by the fact that it was much easier to find a job with Serbian background under the Yugoslavian regime†. After the conflict of 1999 most of the Serbians fled to Serbia for mainly two reasons: they did not want to work in Kosovo due to ethical principles or they could not get a job there. Because of the latter it was impossible to fill in the empty positions with local citizens, thus the international community decided to establish a peace-building mission in Kosovo. Kosovo's future status has been temporarily settled by the United Nations Security Council (Security Council) Resolution (UNSCR) 1244, adopted on 10th June, 1999. The resolution reaffirmed the territorial integrity of the Federal Republic of Yugoslavia and placed Kosovo under interim UN administration (UNSCR 1244, 1999). This was the United Nations Interim Administration Mission in Kosovo (UNMIK).

Figure 1

The first constellation of the international administration (UNMIK+KFOR) 1999-2008

† According to a decision of the Serbian parliamentary assembly in 1989, the autonomy of Kosovo which had been in force since 1974 ceased to exist. Consequently, the Serbian parliament centralized the powers to Belgrade, and Albanians were not represented in a significant number in civil administration, police and judiciary. After entry into force, a parallel institutional framework emerged in Kosovo and Albanians neglected the Belgrade oriented institutions like schools or universities. Among others, this phenomenon led to the present low rate of literacy in the country.
There was a significant change in the administration of Kosovo in May 2001, when according to the 2001/9. decree of UNMIK, the Provisional Institutions of Self Government (PISG) were established. The PISG served as a constitution; however, some powers remained in the hand of the UN Secretary General’s Special Representative, such as dissolution of the parliament and electoral announcements. Though issues of foreign and defence policy stayed under international authority, the consultation with self-governing bodies was obligatory (Czifra, 2010).

Kosovo did not have a constitution between 1999 and 2008, therefore the PISG defined the Constitutional Framework (CF) on which the territory’s governance was based (CF, 2002). During this time a Constitutional Court did not exist in Kosovo. The main criticism from Kosovars pointed out that the new statutes were not obliged to adapt to the local system, which barely existed. Legislature, the judiciary and the executive powers were largely concentrated in the UNMIK. Western models were forced on the Kosovars and failed in most cases. On top of that, the legislative staff wrote the statutes in English that lost the meaning and became ambiguous in some cases. Furthermore, the society did not know the content or even the existence of the statutes as there was no public debate on it. In case of a dispute between locals and UNMIK, Kosovars could not turn to the Council of Europe, of which they were not a member, or to a local body as Constitutional Court either, as it did not exist yet. If the employees of the international organisations committed a crime, they were not accountable and the imposition of any sentence on them depended on the person’s delegating country. The reason behind the immunity of UNMIK employees was the legal framework’s attempt to assure them an uninterrupted work; however, sometimes they abused it. By contrast, the fact nuances the picture that neither the Albanian, nor the Serbian labour force was employable. Albanians were not able to be employed as lawyers thanks to lack of education between 1989 and 1999, while Serbians did not want to work in an Albanian oriented system. In spite of the difficulties, UNMIK carried out a satisfactory job in the

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4 In 2001 after Martin Palmer, an Austrian UNMIK police officer allegedly participated in torturing an ethnic Albanian, the Austrian government evacuated him while referring to medical reasons (BBC, 2002). In 2008, a former leader of UNMIK handed a person participating in a witness protection programme to criminal gangs (Spiegel, 2008).
field of peace-building, but there are still a lot to do in the state building process.

Obviously, on the other hand the local authorities also have responsibilities in this area. The former Kosovo Liberation Army (KLA) members were recruited to three main career paths: the political elite, organised crime and the police. It is clear that the relationships which had been established during the war did not cease to exist afterwards, which resulted in a corrupt state structure. Despite the presence of international organisations, Kosovo remained unstable, which was well reflected by the clashes in 2004. In 2007 Belgrade refused the Ahtisaari Plan§, which proposed an internationally monitored statehood for Kosovo.

INTERNATIONAL ADMINISTRATION AFTER THE DECLARATION OF INDEPENDENCE

The declaration of independence was declared by the parliament of Kosovo on 17th of February, 2008 referring to the right to self-determination. As this act is in conflict with another principle of international law, namely with state’s sovereignty on the basis of status quo, the independence is disputed by many states around the world.

The European Union Rule of Law Mission in Kosovo (EULEX) began its deployment on 16th February 2008, and its responsibilities were divided into three categories: rule of law, police and customs**. Under the terms of the Constitution an International Civil Office (ICO) was created. The office was headed by the International Civil Representative (ICR) who represented the International Steering Group’s (ISG) †† 25 countries and monitored the

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§ The Ahtisaari plan did not declare Kosovo’s independence, but could have opened a path for Pristina towards full membership in international organizations. Though Serbia and Russia refused it in 2007, after Kosovo declared its independence on 17th February 2008, the newborn country tried to shape its status under the terms of the plan.

** Although EULEX’s activity consists mainly of mentoring and monitoring, it has some executive power in the field of judiciary, especially when it comes to investigate war crimes and corruption. With regards to the mission’s future, it is important to highlight the influence of the Special Court, which is going to be established pursuant to the decision of the parliament of Kosovo on 4th August 2015 (EU Observer, 2015).

†† The ISG which was established pursuant to the Ahtisaari plan, appointed the ICR in compliance with the decision of the Security Council. Under the Ahtisaari plan the ICR was authorized with monitoring the settlement of the plan and if necessary, prevent the violation of its principles.
fulfilment of the Ahtisaari plan. In 2012, the ISG formally ended its supervision over Kosovo, closing the ICO, but the EULEX continued its mission. The parliament of Kosovo approved a resolution‡‡ to help the EULEX lift its mandate until 15\textsuperscript{th} June 2014, however, it has not happened yet, and the mission is expected to go on until 14\textsuperscript{th} June 2016 or beyond.

If we examine the international administration of Kosovo on a timeline, it is conspicuous that, while from UNMIK we arrive at EULEX, the powers had been transferred to local powers in a stepwise process.

<table>
<thead>
<tr>
<th>International administration body</th>
<th>Onset of the administration</th>
<th>Main responsibility areas</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNMIK</td>
<td>1999</td>
<td>Police, rule of law, civil administration, building democratic institutions, economic reconstruction, customs management, border management, foreign policy, security systems.</td>
</tr>
<tr>
<td>UNMIK+PISG</td>
<td>2001</td>
<td>Rule of law, police and customs management. The local bodies are elected through a democratic process and consultation with local decision makers is obligatory in foreign and defence policy issues. The PISG serves as the Constitution of Kosovo.</td>
</tr>
<tr>
<td>EULEX+ISG</td>
<td>2008</td>
<td>Rule of law, police and customs management (with limited executive powers). The ISG is able to veto any institutional or personal decision taken by local bodies.</td>
</tr>
<tr>
<td>EULEX</td>
<td>2012</td>
<td>Rule of law, police, customs management (with limited executive powers).</td>
</tr>
</tbody>
</table>

Source: Edited by the author

‡‡ See more: Assembly of Kosovo. 2013
STATUS OF KOSOVO FOLLOWING 2008

One of the main provisions of Kosovo’s development is its integration into the international community. The new-born state needs political and financial capital, which can be obtained partly through the help of international organisations. In addition, the reforms carried out in hopes of winning a membership might lead Kosovo towards a sustainable political and economic system. Nevertheless, the international organisations have to be aware that the unconditional aid assistance may result in the state’s dependence on those, rather than becoming a productive economy and society in itself. It is because of Kosovo’s heritage in connection with the lack of statehood and democratic governance.

In 2008 the International Court of Justice (ICJ) was requested by the UN General Assembly to give its non-legally binding opinion on Kosovo’s declaration of independence. According to the Court, the declaration did not violate any international law, the UNSCR 1244 from 1999 or the constitutional framework which had been adopted by the Secretary-General’s Special Representative on behalf of UNMIK (UN, 2010).

Three permanent members of the Security Council – the United States of America (USA), the United Kingdom and France – quickly recognised Kosovo, but the other two, Russia and China did not (UN, 2009). The USA had already showed its commitment towards Kosovo in 1999 when they supported the NATO intervention. Moreover, it was in their interest to have another ally in the Balkan regions in addition to Bosnia-Hercegovina. In the end, Kosovo proved to be a suitable place for a military camp, namely Camp Bondsteel, which has been in use since then. However, Russia has more reasons not to recognise the self-declaration of independence. On one hand, Moscow feared that the recognition would fuel separation movements on its own territory, and on the other, they have shown solidarity towards Serbia.

After Kosovo’s independence had been declared, the EU arrived at a crossroads. Most of its member states recognised Kosovo, but 5 countries, Cyprus, Greece, Romania, Slovakia and Spain, did not. These countries have minorities within their borders; therefore, they are afraid that Kosovo’s case could set a precedent. As a result, the refusal has weakened the EU’s position in the region as it cannot sign any, for an instance, trade related, legally binding treaty with Kosovo.
Kosovo is not a member of the UN and in 2013 the Serbian president, Tomislav Nikolic said that despite the positive results of the Belgrade-Pristina dialogue, Serbia was not intending to recognise Kosovo (B92, 2013). The main argument behind it is that Kosovo is the homeland of the Serbian Orthodox church, as the city of Pec became the centre of the first Patriarchate in the 13th century. On the other hand, the battle of Kosovo Polje was fought in Kosovo in the 14th century, which foreshadowed the loss of the Serbian statehood and gave a symbolic significance to the region. As time passed, Kosovo lost its Serbian majority since Albanians were fleeing north from the Ottoman occupation in the Balkans. The ethnic distribution of Kosovo changed vice-versa depending on which nation exercised power in the region, and today approximately 90% of the population is Albanian, while only 5% is Serbian. In July 2015 the Serbian Minister of Labour shed light on the fact that Serbia opposes Kosovo’s UNESCO membership. According to him, it is feared the Serbian cultural heritage in Kosovo would be presented by Pristina as if it were Kosovo’s, which is unacceptable to Belgrade (B92, 2015c).

One important condition of Kosovo’s development is the consolidation of regional relationships and building sustainable economic links. Kosovo became a full member of the Central European Free Trade Agreement (CEFTA) in 2007, but the document was signed by UNMIK. Since independence was declared, Kosovo has been represented by UNMIK in the organisation §§. Taking into consideration that Kosovo’s future development is strictly determined by its ability to export, CEFTA seemed to be a useful tool to reach that goal. As a member of the agreement, Kosovo is open to a market of 20 million consumers and to the inflow of trade and technology related innovations. However, Kosovo could not seize this opportunity. After the declaration of independence, Serbia and Bosnia-Hercegovina blocked exports coming from Kosovo, and even prevented the use of their territory for transit purposes. This caused a 9.8% setback in exports in 2008. Companies from Kosovo had to find a third country to be integrated in the regional market but it resulted in an increase of costs. This phenomenon led foreign investors to avoid Kosovo and look for cheaper markets (GAP, 2011, p.4). Later on, Kosovo imposed an embargo on Serbia and set a 10% import duty on Bosnia-Hercegovina. As the situation was unfavourable for both sides, the parties

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§§ According to UNSCR 1244, UNMIK continues to represent Kosovo in different international forums, like the Security Council or CEFTA.
agreed on 2\textsuperscript{nd} September 2011 in Brussels that Kosovo was able to send goods marked “Kosovo Customs”, however, in such cases Pristina was not allowed to use state symbols and the word “republic” (Balkan Insight, 2011).

The settlement of the situation within CEFTA adumbrates the consolidation between Serbia and Kosovo. Though Serbia does not recognise Kosovo de jure, some of its actions can be interpreted as a sign that de facto they handle Kosovo as a sovereign state. The EU facilitated dialogue for the normalisation of relations between Belgrade and Pristina showed some results on the level of politics. For an instance in March 2015 the first ministerial conference was held in Pristina, where both sides were represented by high ranked officials***. In comparison to that the rapprochement does not show up on the citizen’s level. At the end of July 2015 the Serbian parliament once again confirmed that cars from Kosovo could only travel through Serbia if they had “status-neutral” licence plates††† (B92, 2015d). In order to understand the debate it is worth looking at both sides of the coin. On the one hand, as Kosovo is still at the beginning of the state building process, they are trying to seize every opportunity to strengthen their identity. Hence, the licence plates are labelled with RKS (Republic of Kosovo), rather than with KS (Kosovo). On the other hand, Serbia deems it as a provocation, since they do not recognise Kosovo as a sovereign state; consequently, the word “republic” is unacceptable to them. Peaceful coexistence will need a bit of permissiveness from both sides, although it is not easy to carry out as the tensions of the war are still in the air. Moreover, the present political climate hinders the rapprochement too.

It is of high importance that the political elite have remained more or less the same in both countries since the conflict of 1999. Aleksandr Vučić the prime minister of Serbia has the antipathy of Muslims thanks to his negative statements during the Serbian-Bosnian war. Furthermore, the situation has become more complex when the radical Vojislav Seselj was released by the ICJ this year. Though Seselj does not have any political power at the moment, his

*** According to an agreement from 2012, Kosovo can use its own name in regional forums, however, she has to use a footnote in every document with the following text: “This label [ie ‘Kosovo’] does not prejudge the status of Kosovo and is in accordance with Resolution 1244 and the opinion of the ICJ on Kosovo’s declaration of independence.” (Balkan Insight, 2012)

††† Between 1999 and 2009 the license plates in Kosovo were issued with a KS (Kosovo) sign. In 2009 they changed it to RKS (Republic of Kosovo), which is not recognized by Serbia.
views and statements radicalise the Serbian public opinion and make reconciliation more difficult in the Western Balkans.

Hashim Thaçi, former prime minister and current foreign minister of Kosovo used to be the leader of KLA. On the top of that, the government of Kosovo has more former KLA leaders in its ranks that enjoy unconditional respect from the society. As it might be obvious from history, rebels are not always able to govern a country after winning their independence. In addition, the KLA used illegal sources as well legal to finance the fights; however, the links were still intact as the debts had to be repaid recently. This phenomenon lays the foundation for corruption, which is one of the biggest obstacles for Kosovo’s development. Though on 4th August 2015 the parliament decided to establish a Special Court investigating war crimes and corruption, but its effectiveness is remains to be seen.

Kosovo and the European integration

ENLARGEMENT OF THE EU

The EU’s enlargement policy seems to have slowed down during the Juncker committee due to the so called “enlargement fatigue” of the community. In the Western-Balkans the hope of winning membership to the EU has always sustained the will to carry out democratic reforms and to extradite war criminals. However, the end of hope could induce instability in the region and Kosovo and Bosnia-Herzegovina may become a crisis zone once more. The EU has a role in it, as it assured these states that European integration was a real possibility, and now they feel left in the lurch which is well reflected by the statements of politicians in the region††‡.

Kosovo is the last country from the Western-Balkans that has not signed the Stabilisation and Association Agreement (SAA) yet. The signed SAA§§§ opens a free trade area between the EU and the signatory state. Even though the European Commission approved the SAA with regards to Kosovo, it still needs to be presented in front of the European Parliament and the European Council. In case of getting a signature, this could be the first contractual relationship

††‡ See more: B92, 2015e; B92, 2015f; Tanjug 2015
§§§ The following countries in the Western Balkans have already signed an SAA: F.Y.R.O.M., Albania, Montenegro, Bosnia-Hercegovina, Serbia
between the EU and Kosovo, but as 5 member states of EU do not recognize Kosovo, the SAA may face obstacles in the European Council. By contrast, according to the EU’s position, the Union’s ability to conclude international agreements is not restricted to independent states or international organizations, but it can sign agreements “…with any entity with regard to which the other contracting party accepts that it can enter into an agreement that will be governed by public international law” (European Commission, 2012, p.2). Though there is no precedence with SAA, in theory not every member states’ acceptance is required in order to sign the agreement. The case of visa-liberalisation also reflects Kosovo’s difficulties with integration into the international community. Despite the fact the EU shows support of Kosovo’s financial status, the civil society, the political status and institution building, it is still the only country from the Western-Balkans whose citizens still need a visa to enter the Schengen-area. The visa-liberalisation process is run within the framework of the SAA, but it is in question whether the two could be managed separately or if Kosovo needs to wait until the SAA is signed in order to be deleted from the Schengen-black list.

The visa-liberalisation process was started on the 19th January 2012 by the European Commission. Prior to liberalisation, the EU expected Kosovo to integrate its minorities and returnees into the society and economy (EEAS, 2012, p. 2). Furthermore, Kosovo is asked to integrate the statutes required by the roadmap into its legal system in line with EU acquis. The roadmap touches upon, among others things, the security of documents, border management and migration (EEAS, 2012, p. 5). At the conclusions of the December 2011 European Council, it was said that Kosovo will benefit from the visa liberalisation if all the criteria are met. The European Commission will present the results to the European Council and European Parliament “without prejudice to the Member States’ positions on status” (European Council, 2011, p.11). As in practice the European Council does not make decisions without consensus, it is not likely they could reach an agreement. Thus, the authorities and the government of Kosovo can become demotivated as even if Kosovo meets the criteria, it is not guaranteed that the liberalisation will come into effect****.

**** If the visa liberalization came into force, the recognition of Kosovo’s passports would pose a problem in the 5 countries which do not recognize Kosovo. However, there is a precedent
In comparison to other Western Balkans states, the road-map for Kosovo contains 50 additional points (GLPS, 2012, p.17). The reasoning behind the higher expectations is the high-rate of migration from Kosovo. Though Kosovo aims to become a candidate country for the EU, a high number of its citizens apply for asylum in the Schengen-area; therefore, the visa-liberalisation seems to be risky for West-European states.

BELGRADE-PRISTINA DIALOGUE

Formally, the European Union started its negotiations with Serbia on EU membership, but officially it has not opened any chapters yet (European Commission, 2015). From the perspective of Kosovo the 35th chapter of the negotiations is of high importance as it contains good neighbourly relations (EU Position, 2014 p.11).

Despite Kosovo’s independence, Serbia still maintains state institutions in Northern-Kosovo, such as telecommunication corporations, courts and police. Moreover, it is said that Northern-Mitrovica is the centre of organised crime in the region (Spiegel, 2008). Employees of international organisations have been working in the shadow of organised crime, often facing death threats. Many UNMIK police officers fell under suspicion before 2008; this is one reason why the EULEX needed to take over the task of mentoring police in Kosovo. On the top of that, as illegal money laundering creates jobs and improves infrastructure, the society does not feel that it is a security risk for the country (Márkusz, 2008, pp.42-43).
It can be drawn from above that both Kosovo and Serbia have an interest in cooperation: Serbia needs a dialogue in order to move forward in its EU negotiations, while Kosovo needs to settle the status of Northern-Kosovo. Above all, before 2013 the beginning of Kosovo’s SAA negotiations had been uncertain. The EU gave the parties a helping hand and the Belgrade-Pristina dialogue was started in 2012 with the facilitation of the then EU High Representative for Security and Defence Policy Catherine Ashton.

At the tenth round of negotiations on 19th April 2013 Belgrade and Pristina reached an agreement on Northern-Kosovo. According to the agreement Serbia is not obliged to recognise Kosovo’s independence, but it has to accept that Pristina has authority over the whole territory of Kosovo. In return, Kosovo gives regional autonomy to Northern Kosovo. The Serbians living in the region can nominate their own policy chief and the police must reflect the ethnic composition of Northern-Kosovo. Furthermore, the representation of

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See more: RTS, 2013
Serbians is also a must in the courts and all of the institutions have to be financed from Pristina (European Commission, 2013, pp. 5-6). The agreement is significant because the Serbian government abandoned its intention to keep Northern-Kosovo in the Serbian institution system. Through this act, Serbia de facto recognises Kosovo, though it has never been declared publicly. The community brings stability to the region and opens the door towards European integration. The agreement is a success for both the EU and Kosovo, however, on the citizen’s level it leaves much to be worked out. For an instance, Serbia still operates courts in the north and the integration of authorities should have been finished in 2013 but it has not happened yet.

Of the 16 points of the agreement only 4 have been fully completed. There has not been a statute on the settlement of Serbian communities yet, even though it would be the key to integrate Serbian institutions into the Kosovar system. As Serbia is still the biggest employer in the North and Pristina is unable to show an alternative for the case of dismissed employees, the society is not in favour of the agreement (CRTA, 2015, p.9). With regards to courts, the following bodies are present in Kosovo: EULEX, Pristina, Belgrade and the new Special Court funded by the EU. Because of the complexity of Kosovo’s judicial system, it would be crucial to integrate it, which would then help the effectiveness and the transparency of the judicial system. Table 2 shows the points where no agreement has been met yet. The 4 Serbian municipalities have already been established but their community and advocacy has not been worked out. It poses a huge problem that the Serbian inhabitants often boycott the elections. To solve this, Pristina tries to assure a given number of places for Serbians in institutions regardless of elections but this process is facing critics by Albanians.
<table>
<thead>
<tr>
<th>Points of the agreement</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishing an implementation committee</td>
<td>Completed</td>
</tr>
<tr>
<td>Civil Registry</td>
<td>Completed</td>
</tr>
<tr>
<td>Customs Stamps</td>
<td>Completed</td>
</tr>
<tr>
<td>Establishment of four municipalities</td>
<td>Completed</td>
</tr>
<tr>
<td>Mutual Acceptance of Diplomas</td>
<td>No progress</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>No progress</td>
</tr>
<tr>
<td>Association/ Community of Serb municipalities</td>
<td>No progress</td>
</tr>
<tr>
<td>Discussions on energy and telecommunication</td>
<td>Partially completed</td>
</tr>
<tr>
<td>Freedom of Movement</td>
<td>Partially completed</td>
</tr>
<tr>
<td>Energy</td>
<td>Partially completed</td>
</tr>
<tr>
<td>Police and Security</td>
<td>Partially completed</td>
</tr>
<tr>
<td>Cadastre</td>
<td>Some progress</td>
</tr>
<tr>
<td>Integrated Border Management</td>
<td>Some progress</td>
</tr>
<tr>
<td>Regional Representation and Cooperation</td>
<td>Some progress</td>
</tr>
<tr>
<td>Judiciary</td>
<td>Some progress</td>
</tr>
<tr>
<td>Not to block the other side’s EU integration process</td>
<td>Some progress</td>
</tr>
</tbody>
</table>

Source: Edited by the author on the basis of: CRTA. 2015
Economy and migration

During Yugoslavian times, Kosovo accounted for the less developed regions of the federation and the autonomous province was entitled to the largest share of the Federal Fund for Development of Backward Regions. Despite of the support, the backwardness of Kosovo did not decrease; it even grew (Juhász, 1997, p.39). For the time being the biggest challenges are ensuring convergence, job creation, poverty reduction and creating an attractive business environment. Kosovo does not have any substantial exportable natural resources and it lacks human capital as well due to brain-drain. Furthermore, the country is poorly equipped with sources of business financing. Therefore, shifting to a market economy posed a great challenge, which idea was based on the Washington Consensus\textsuperscript{###} from 1989 (Novák, 2014, p.3-4). According to the World Bank, the unemployment rate is 31%, but under the age of 24 it is above 50% (World Bank Database, 2015b). Even if not perfectly, the Visegrad Four (V4) countries adapted to the challenges of the “new world order” after 1990, however, the Western Balkans cannot show development thanks to the lack of experience with statehood and weak economic conditions that are crucial for the desired welfare society.

Kosovo’s GDP amounted to 7273 million USD in 2014. It is 1586 million USD more than it was in 2008 and 200 million USD growths in comparison to the data from 2013.

Figure 3

Kosovo’s GDP on current prices 2008-2014 (million USD)

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{kosovo_gdp.png}
\caption{Kosovo’s GDP on current prices 2008-2014 (million USD)}
\end{figure}

Source: Edited by the author on the basis of: World Bank Database. 2015b

\textsuperscript{###} Under Washington Consensus we mean the policies promoted through structural adjustment programmes (SAPs) by the International Monetary Fund (IMF) and the World Bank. The suggested reforms were driven by deregulation, privatization and liberalization of markets.
According to World Bank’s estimates from 2010, Kosovo’s economy would have to grow at 12% annually for ten years to reach Montenegro’s GDP per capita level (World Bank, 2010, p.3). By contrast, Kosovo’s GDP growth did not increase by more than 4.4% per year between 2010 and 2014. Although these numbers are still more favourable than those of other Western Balkans states to reach a higher level of development the FDI should be directed to the productive sectors of the economy; however, in Kosovo it goes to the services. The reason behind this is the unattractive business environment and the lack of proper qualification in the labour market. The society of Kosovo shows a mix of returnees and persons who were raised in Kosovo. Because of this atmosphere, a duality has emerged in the business sphere with regards to people’s attitude. This mixture is well reflected by the activity of the American Chamber of Commerce in Kosovo. The Chamber, which employs returnees as well, urges the corporations who intend to invest in Kosovo to take care of Corporate Social Responsibility (CSR), even if it is known that CSR has a huge cost. The investment sector in Kosovo is in no condition to deter potential investors and bear the lack of their money with such actions. At the other end of the spectrum, local corporations got used to the lack of statehood, therefore they consider tax evasion and corruption normal, and to respect the rule of law would be irrational for them.

| Table 3. GDP growth in the Western Balkans compared to the last year (%) |
|------------------|-----|-----|-----|-----|-----|-----|
|                  | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
| Albania          | 3.4  | 3.7  | 2.5  | 1.6  | 1.4  | 1.9  |
| Bosnia-Hercegovina | -2.9 | 0.7  | 1.0  | -1.2 | 2.5  | 1.2  |
| F.Y.R.O.M        | -0.9 | 2.9  | 2.8  | -0.4 | 3.1  | 3.8  |
| Montenegro       | -5.7 | 2.5  | 3.2  | -2.5 | 3.3  | 1.5  |
| Serbia           | -3.1 | 0.6  | 1.4  | -1.0 | 2.6  | -1.8 |
| Kosovo           | 3.3  | 4.4  | 2.8  | 3.4  | 3.0  | 3.0  |

Source: Edited by the author on the basis of: World Bank Database. 2015a; World Bank Database. 2015b
The economic crisis from 2008 did not hit Kosovo as much as it did other countries from the Western Balkans. This is due to Kosovo’s limited economic linkages to crisis affected countries. Despite the isolation the fiscal deficit widened following 2008, mainly because of a huge motorway project (Kóczán, 2015, p.8). Between 2010 and 2013 Kosovo spent 20% of its annual budget on the development of its traffic system (Jashari, 2010, p.18). Kosovo’s isolation can be explained by two main factors. On the one hand, the embargo imposed on Kosovo by Serbia until 2011 still has an impact on its economy. On the other hand, the SAA has still not come into force and the visa liberalisation process is still under negotiation, therefore it is extremely hard to build sustainable business relations with other parts of the world.

Compared to other Western Balkans states, Kosovo has lower levels of public spending but it also has fewer policy tools in terms of interest rates since it lacks an independent monetary and exchange policy. The lower amount of spending might be explained by the underdeveloped social structure and the high ratio of young population in the country. The IMF’s report from 2015 marked the fiscal sustainability and the worsening composition of the budget as Kosovo’s largest challenges (Kóczán, 2015).

The remittances transferred by Kosovars living abroad could ease Kosovo’s economic difficulties caused by isolation. One third of Kosovo’s population is under the age of 15, while more than half of it is under the age of 25. According to the Central Bank of Kosovo, unemployment accounts for 43% among the economically active population. Kosovo’s labour market is unable to absorb the amount of young people wishing to enter every year, therefore they are forced to migrate (Embassy of Switzerland, 2014). Kosovo’s economy is slightly dependant on remittances as that accounts for 13% of the GDP. Usually the migrants are from the upper levels of the social ladder and they help the ones staying home through remittances. It is interesting that this assistance widens the social inequalities, because the gap between the poor and the families having migrants grows (Möllers, Meyer, 2014, p.4). The 13% of the GDP accounted for remittances is a bit illusive, since money is spent on

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***** According to estimates about 800,000 Kosovars are living abroad of which 270,000 is in Germany and 160,000 is in Switzerland. This means that every third inhabitants of Kosovo’s 1.8 million population lives abroad, and every third household has at least one relative living abroad (Embassy of Switzerland, 2014 p.3.).

6666 The reason behind it is that Kosovo uses the euro without fulfilling the Maastricht criteria.
consumption rather than on production. In addition, it is important to emphasise that in Kosovo the number of persons per household is the highest in Europe, therefore even if someone has a lucrative job, it is extremely difficult to break out of poverty and make a difference.

On one hand the existence of remittances is a positive effect of migration but on the other there the disadvantage is that their society might get used to it. According to the Federal Department of Foreign Affairs of Switzerland in 2000, 30% of the households had access to remittances. As the number of migrants is higher in rural areas, there are more beneficiaries of the transfers. The amount of money transferred annually varies from 500 euros to more than 5000 euros per household. According to research, living conditions are affected by having a migrant in the family which is reflected in electronic goods and jewelleries. To spend that money on education is not so typical, as the consumers rather spend it on consumption. It is remarkable since travelling and communication possibilities have improved. The diaspora has been more aware of the fact that the money sent back home is not used properly. Consequently, some of them reduced the remittances and now spend more energy on integrating their own family into the new society abroad (Embassy of Switzerland, 2014, p. 6-7).

| Table 4. Remittances (million USD) |
|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 889 | 1161 | 1290 | 1359 | 1468 | 1495 | 1318 | 1156 | 1126 | 1027 | 1021 |
| Bosnia-Hercegovina | 2072 | 2038 | 2149 | 2686 | 2718 | 2127 | 1822 | 2958 | 2838 | 1913 | 2072 |
| F.Y.R.O.M. | 174 | 213 | 227 | 267 | 345 | 407 | 381 | 388 | 434 | 394 | 412 |
| Montenegro | 129 | 203 | 180 | 181 | 178 | 225 | 200 | 266 | 279 | 320 | 348 |
| Serbia | - | - | 2650 | 2754 | 3062 | 2708 | 3933 | 3349 | 3271 | 2763 | 3461 |
| Kosovo | - | 624 | 701 | 771 | 919 | 1042 | 1055 | 997 | 1122 | 1059 | 967 |

Source: Novák, 2014, p.9
In Germany, migrants coming from the Western Balkans are considered to be economic migrants, therefore they are not entitled to apply for asylum. The Federal Ministry of the Interior has begun a video campaign††††† aiming to inform citizens of Western Balkans’ countries about their possibilities. In the first half of 2015 Germany got 29 997 asylum seekers from Kosovo, which amounts for the second largest number in the country following the war-torn Syria. Though this number declined during the summer there are still migrants from Kosovo, but in July 2015 Albanians from Albania amounted for 21,9% of the whole number of migrants (BAMF, 2015, p. 7). The asylum seekers from the Western Balkans present in Germany are being offered a clean passport and a free flight ticket back home if they withdraw their asylum application as soon as possible (Balkan Insight, 2015). Besides, according to the video campaign the ones planning to migrate to Germany in the future will be forced to pay back the cost of their deportation to the home country. If they are unable to pay, they will not be given any visa to the Schengen-area until they fulfil the demand (BMI, 2015).

Summary

The first table shows that the powers are being transferred to the local governance and the international community is losing its authority in Kosovo. Despite this, though the number of countries recognising Kosovo is growing‡‡‡‡‡, the opinion of countries having a larger voice in international relations has not changed yet. Kosovars living in isolation can have their voices heard through the organisations carrying out the state building process; however, if they leave the new-born country they will have limited possibilities for interaction. Kosovo is a small country and therefore depends a lot on the international environment. Due to the relative isolation of Kosovo, its dependence on the economic sector is not that substantial, but in the field of security the country is quite vulnerable. This is reflected in its lack of military or membership in any international organisation providing collective defence. On its own, the small degree of economic dependence has only one advantage, namely avoiding the financial crisis, but the reason behind it is a

††††† See more: BMI. 2015
‡‡‡‡‡ At the moment, on 9th August 2015 111 countries recognize Kosovo as a sovereign state (Kosovo Thanks You, 2015).
cause for concern: Kosovo is not integrated into the international capital flows.

The state building has not finished yet, neither in institution nor in economic terms. Although the powers are in the hands of locals, the separation of them has not been solved due to the tight institutional and human connections in the small country. The economic fundamentals are not given to maintain statehood on the standard of an EU candidate country and Kosovo is too dependent on remittances. If Kosovars working abroad start to invest at home in a greater volume it might be a reason for hope, but the present trends show that they would rather turn towards integration in the host country.

Kosovo is a potential candidate country to the European Union. However, she stands in second place behind war-torn Syria with regards to asylum seekers in Germany. The reason behind migration is the unemployment that accounts for more than 50% under the age of 24. Until Kosovo reaches a certain level of economic development, the EU will not ease its visa policy. On the other hand, until all of the EU countries have recognised Kosovo, economic relations are not expected to to intensify and the SAA will not be signed. Kosovo’s EU membership is a question for the distant future, but it seems indispensable to consolidate the Serbian-Kosovar relations. This might incite EU countries to recognise Kosovo.

To solve this untenable contention, the Serbian and Kosovar Albanian sides should work together and agree on a common education system, thus eliminating any and all obstacles to integrating the Serbian schools situated in Northern-Kosovo into the Kosovar educational system. Furthermore, action should be taken in order to have university diplomas recognised on both sides, as at the moment this prevents people from undertaking jobs in Serbia and Kosovo. It poses a problem that the different ethnic groups do not know each other’s culture and language in Kosovo. Consolidation is in the interest of both sides, but politicians do not do enough to forget the memories of the war. Forgetting is not easy, maybe even impossible. As a new country building its own identity it is obvious that there has to be some historical symbols and figures. However, as long these symbols are representing figures

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In spite of the dialogue, the healthcare and education still stays under the direction of Belgrade until 2018 (CRTA, 2015, p.31).
who are considered to be war criminals by the other side, there is no room for consolidation******.

In the Western Balkans – not only in Kosovo – the educational systems are quite one-sided. Consequently, even students studying social sciences have a distorted historical picture when they finish university. It is hard to expect consolidation in a nation where even the intellectuals have a false picture of the past. The international community spent a large amount of money on building peace in the Western Balkans, but there is not too much efficiency in state building. Education should be used as the most effective tool for peace building, but currently it is not used enough - it has to be improved in the future.

The Western models with regards to state building failed, and one single change in the status quo – given the separation of Republika Srpska or the realisation of Great-Albania – can ruin the stability of the whole region. The peace is fragile, there are some states that barely function, unemployment is huge and the European integration process has slowed down. As the invested political and financial capital is too big, the euroatlantic community will not let the Western Balkans destabilise. However, there are some new factors of influence, such as terrorism and Russia, which differ from the environment in the 90s. The Serbian-Russian relations are a bit mystified, as there was no proved action from that side to destabilise the region, but the threat of terrorism is real. The so called “Islamic State” is active in Bosnia-Hercegovina and Kosovo since these countries have a Muslim majority. The terror organisations make use of the high rate of unemployment and show a way out for the youth, while presenting Europe and the West as the causer of their lack of wellbeing. Before the situation gets worse, it would be useful to review the Belgrade-Pristina dialogue from the EU and broaden it with points with regards to the new situation. Furthermore, as the social, administrational and economic state building has not finished yet, it is too early to leave Kosovo on its own from the international community.

****** In Kosovo the KLA enjoys a huge public support. Obviously not all of the former KLA members are war criminals, but just like among Serbians, Croatians and Bosnians some abuses happened. As the KLA undertook the dirtiest part of the revolution, namely the fight, they had a right to claim the leadership in 1999 and in 2008. Contrary, we have to be aware the former rebels are not always the best choice for becoming politicians.
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CENTRAL EUROPE IN THE SECOND DECADE OF THE 2000s

Tamás Novák, Ph.D, Associate Professor, Head of Department of World Economics and International Trade, Budapest Business School, University of Applied Sciences, Faculty of International Management and Business

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\textsuperscript{1} or the clash of civilizations\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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.

region resulted in several positive structural changes and a number of negative consequences described elsewhere in several studies and analyses. 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. 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. For a while there were expectations

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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.\textsuperscript{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.\textsuperscript{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\textsuperscript{10} gave rise to growing dissatisfaction with Hungarians, Slovaks, etc. This explains continuous efforts for example to find common ground for joint interests in the V4 cooperation.

\textsuperscript{8} For example the Visegrad four did not elaborate 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.

\textsuperscript{9} Hungary, Latvia and Romania in 2008-2009.

\textsuperscript{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.” Kalan (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.” 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. 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. 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. 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). Dependency, however, is not

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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.\textsuperscript{17} Without the presence of technology intensive multinational firms, no similar performance could have been achieved.\textsuperscript{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-

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

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

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

\textsuperscript{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)

\textsuperscript{20} Fukuyama (2012)

\textsuperscript{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.”\textit{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 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 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:

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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\(^\text{24}\);

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

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\(^{25}\) 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 taxes). 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

\textsuperscript{27} For example see: Anders Aslund, “Putin’s Conservative State Capitalism”, \textit{The Moscow Times}, December 17, 2013.

\textsuperscript{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.

\textsuperscript{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. For more details on that see: Åslund (2010), pp.111-114.

I am afraid, however
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. 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. 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

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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-ttpip

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. 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. 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.\textsuperscript{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

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

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

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. 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, 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.\(^4^1\) 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

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\(^{4^1}\) “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.\footnote{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.}

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.\footnote{Another aspect of path dependence that can explain worsening macroeconomic performance in Hungary is explained by Benczes (2011), pp.118-131.} 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,
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; 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

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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),\textsuperscript{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 today’s (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.\textsuperscript{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

\textsuperscript{45} The most dynamic phase of FDI inflow took place before the accession. Bevan–Estrin (2004)
\textsuperscript{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.\textsuperscript{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.\textsuperscript{48} This has three consequences. First, the most promising growth potential is still related to countries that have the

\textsuperscript{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.

\textsuperscript{48} See for example: UNCTAD (2013): pp.133-139.
greatest potential to develop new technologies. 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.

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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

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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). The Czech Republic is somewhere in between but its structural features make it more like the Northern countries. 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. 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 competitiveness 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
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. 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. 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.

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).


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

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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”. 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

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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. 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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ECONOMIC RELATIONS BETWEEN TAIWAN AND THE EU

Csaba Moldicz, Ph.D, Associate Professor, Budapest Business School, University of Applied Sciences, Faculty of International Management and Business

Despite the severe consequences of the global financial crisis (2008-2009), the EU and Taiwan have been able to strengthen their economic ties in recent years. Although both trade and investment activities are intense and growing, this cooperation is far from being fully-fledged. This paper argues that further deepening of economic cooperation between Taiwan and the EU and a comprehensive economic agreement (CEA) is necessary and inevitable in the process. The arguments in support of the agreement are of both economic and political in nature:

1. The manner in which the Taiwanese economy is interpreted is crucial in understanding the relevance of Taiwan within the world economy. Based on the size of the economy and the share of trade, Taiwan may be considered economically insignificant against European countries. The main reason behind this misconception lies in macroeconomic and trade data, which fail to reflect the fact that most added value generated by Taiwanese firms is exported to Europe via Mainland China. Similarly, a significant share of Chinese investments in Europe and the United States is generated by Taiwanese firms. Thelle and Mekonnen (Copenhagen Economics) also stress the importance of the economic arguments for the agreement. Their update of the 2008 Report points out that after the global crisis, the arguments in support of the comprehensive agreement have only become stronger and more convincing based on current trade trends. One explanation is the strong rebound of trade in the Asian region and as a result of this “Intra-European trade is still suffering, but European exports to Asia are increasing at a faster pace than before the crisis.” (Thelle, Mekonnen 2012, p. 2)

2. Another economic argument claims that up to this point no free trade or comprehensive economic agreement between the two parties has been signed; consequently trade between the EU and Taiwan has been determined by WTO rules, which mainly cover issues of international trade, but are less
effective when it comes to international investments, property rights, patents, etc. (On the other hand, the Korea and EU agreement entered into force on 1 July 2010 and includes comprehensive tariff reductions and addresses other non-tariff barriers as well. The EU-agreement with the close competitor of Taiwan puts the country under pressure, and it is likely to distort the EU-Taiwan trade.)

3. The political argument highlights that the ‘One China Policy’ seems to suggest a clear barrier to the comprehensive economic agreement. This question is one of the most debated issues in literature analysing economic relations between Taiwan and the European Union. Dreyer et al. argue that the European Union’s caution not to hurt the Mainland’s sensitiveness about this issue might be overemphasized. (Dreyer et al. 2010, p. 56) According to them, the Economic Cooperation Framework Agreement (ECFA) between the People’s Republic China (Mainland China) and the Republic of China (Taiwan) has provided a window of opportunity to negotiate and sign a comprehensive economic agreement. (Dreyer et al. 2010, p. 56, p. 59)\(^1\)

In most of the cases, the goals of foreign policy and foreign trade policy are determined by the same players, but it does not apply to the EU. This is the reason why European interests, formulated by the two policies, can vary or seem to contradict each other. International cooperation and hence foreign policy are often based on commonly shared values of the parties (e.g. democracy, free market economy), but they very often focus on short-term economic benefits. In the case of Taiwan, European countries could rely on both long-term and short-term economic benefits, whilst common shared values are the guarantee of a stable partnership. In recent years, the importance of this has been clearly proven by the case of Russia.

\(^1\) The agreement was signed in 2011 and it ushered in a new era of political and economic relations between Taiwan and Mainland China.
Arguments for Deeper Cooperation with Taiwanese Economy

GROWING MARKET, INCREASING PURCHASING POWER\textsuperscript{2}

In terms of GDP per capita (PPP), Taiwan overtook France, Italy and the United Kingdom and caught up with Germany after 2007. However, distinctive patterns of GDP per capita growth in current prices demonstrate that different price levels play a key role in this impressive picture. As a result of greater resilience to the devastating effects of the Global Financial Crisis, the Taiwanese economy could avoid the long economic crisis which had emerged in the EU and which had been compounded by political, institutional problems of the eurozone.

\textbf{Figure 1}

\textbf{GDP per capita (PPP, current int. dollars)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure1.png}
\caption{GDP per capita (PPP, current int. dollars)}
\end{figure}

\textbf{Source:} own compilation based on IMF data

\textsuperscript{2} Besides this argument, it is important to underline, that EU member countries and Taiwan share similar economic structures and both face the challenge of an aging population. Both Taiwan and the more developed part of the EU run knowledge-based economies. Recent technological innovations leading pose new challenges to these countries. The robotization is likely to reverse the trend of outsourcing. Technological innovations along with rising Chinese labour costs give fewer incentives to outsource. In contrast to earlier periods, the importance of manufacturing and the reliance on cheap labour is declining due the automation and robotization, while technology and knowledge continues to gain in importance. Technological changes, aging population and comparatively high wages have required the adaptation of European and Taiwanese firm strategies, and consequently these enterprises have increasingly invested in Mainland China.
Between 2000 and 2014 Taiwan’s annual average growth was much lower than in the 80s and 90s; however, it exceeded the economic performance of the large European economies. The United Kingdom, where GDP growth was the fastest among the EU economies during this period, could only reach an annual average of 1.73%, which is less than the half of that of Taiwan (3.77%). This resilience to economic shocks has been attributable to growing and deepening trade relations with Mainland China.

Figure 2

GDP per capita (current prices, US dollars)

As a result of the catching-up process of the past several decades, today Taiwan has reached the average development level of the core European economies.

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3 The core economies of the EU (Germany, France, the United Kingdom and Italy) and Taiwan experienced a Golden Age of economic development in the second part of the 20th century. As a result of this, the economies of these regions were able to grow at a breakneck pace over several decades. Taiwan is one of the few countries which avoided the middle income trap and it could increase its GDP by an annual average growth rate of 8.3% over nearly a half century. West Germany, the ‘engine of the European economy’ grew by 5.3% between 1948 and 1973. But during the 70s, and the 80s, Western European and Taiwanese growth became much more moderate; however, this slowdown was sharper in Europe than in Taiwan. (Brown, Hempson-Jones, Pennisi, 2010 p. 3)
economies, and it has clearly overtaken the Central European countries. By and large Taiwan’s economy is in a better shape now than most European economies. Growing purchasing power and openness of the economy make Taiwan an important partner of the European countries.

ROBUST GROWTH OF TRADE

Most of the Taiwanese economic growth stems from surpluses on the trade balance; of the core European economies only Germany has a similarly positive trade balance. Between 2002 and 2013, a very rapid expansion of international trade took place in Taiwan. During this period, Taiwanese merchandise export expanded by 226%, while overall European performance lagged behind. The export in services was able to expand by 239%. In the same period, the average EU merchandise export was up by only 175% in France, by 193% in the United Kingdom and by 203% in Italy. However, Germany’s merchandise trade grew by 236% during the same period.

Although Taiwan has only been the 25th export destination of goods, in recent years, export to Taiwan has grown faster than in any other trade relations. With respect to European exports to Taiwan, we find a 42% increase in goods exports between 2008 and 2013 while European export to the world could only grow by 32% in the period considered.

Taiwan’s dependence on external trade is remarkable. As table 1 indicates, the economy is based much more on export of goods and services than any other large economy in Europe. It is apparent too that openness was increasing during the period 2002-2013 and not only in terms of trade in goods, but also in services. Both in terms of services and goods, Taiwan was able to increase its surpluses on the trade balance over the period 2002-2013.

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4 As a result of the European crisis, balance of trade in Italy turned positive. Whether this surplus is a sign of long term adjustment or is it only short term in nature, it is difficult to answer.

5 Only Central European countries – Hungary, Estonia, Czech Republic, and Slovakia – and smaller Western European countries – the Netherlands and Belgium – have more open economies in the EU.
<table>
<thead>
<tr>
<th></th>
<th>Merchandise exports in share of GDP</th>
<th>Exports in services in share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2013</td>
</tr>
<tr>
<td>Taiwan</td>
<td>45</td>
<td>62</td>
</tr>
<tr>
<td>France</td>
<td>23</td>
<td>21</td>
</tr>
<tr>
<td>Germany</td>
<td>31</td>
<td>40</td>
</tr>
<tr>
<td>Italy</td>
<td>21</td>
<td>25</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>17</td>
<td>21</td>
</tr>
</tbody>
</table>

Source: own compilation based on WTO, IMF databases

**Figure 3**

Merchandise export (2013, 2000=100%)

Source: own compilation based on WTO data
In the context of the trade relations between the two regions, European advantages in services trade are apparent, but European disadvantages in goods trade are also clear. The latter balance shows European surpluses, but it cannot offset Taiwanese surpluses in the trade in goods.

Despite the clear Taiwanese surpluses in the aggregate trade balance, Europe as a destination of Taiwanese export has lost its significance in the last decade; according to data of the Taiwanese Statistical Bureau, Europe’s share was 13.06% in 2004, and it fell below 10% by 2012. The same trend is evidenced in the US and Taiwanese trade relations. The extent of the change is almost the same, however, the US share was higher in 2004 (15.77%), hence it could remain higher in 2012 (10.95%).

Figure 4

Export in commercial services (2013, 2000-100%)

This can be explained by the growing importance of Mainland China, which “compensates” Taiwanese firms, consequently China as an export destination grows more and more important. During 2004-2012, Mainland China’s share increased from 19.93% to 26.80%! (Adding exports to ASEAN countries, this share is about 55%). (Da-Nien, Hui-Tzu 2013) It will not come as a surprise to know that a similar pattern is observed in investor relations. Investment in Mainland China increased significantly between 2002 and 2013. The share of
Mainland China is approximately 80%; the accumulated value of this amounts to 58 billion US dollars.

Taiwan’s role in European FDI inflow hasn't changed so much although the size of investments capital almost tripled (301 million euros in 2011, 818 million euros in 2012). Both Japanese and Korean investments (3.9 billion euros – 4.3 billion euros) have clearly overtaken those of Taiwan. On the other hand, the EU has continued to be the most important investor in Taiwan.

Based on these data, the lessons and processes are clear, the rise of Mainland China seems to be inevitable, and advanced countries are expected to experience a decline. And only relying on these data could one jump to the conclusion that Taiwan should only focus on Mainland China in economic issues; moreover Taiwan should go via Mainland China to the world. This paper, however, argues in support of the direct opposite; it is the global supply chains that provide the basis for our understanding of why and how Taiwan and the EU could be much more important to each other than data would suggest.

TAIWAN AS LINCHPIN IN THE GLOBAL SUPPLY CHAINS

In a connected world economy, macroeconomic data presented above can be misleading. In the framework of global supply chains, altering patterns of trade are more indicative of the emergence of new strategies of Taiwanese firms rather than of a real change of the export destination.

Figure 5

Value of exports and imports by country (2013, total trade, share)

Source: own compilation based on the data of the Taiwanese Statistical Bureau
Intermediate products exported from Taiwan to Mainland China are goods that will be exported as final products from China to Europe or to the US. This process is described by Da-Nien and Hui-Tzu: “The United States and the E.U. have maintained their status as the most important markets for Taiwanese final consumption goods, but Taiwan’s exports of intermediates and capital goods to these countries have become less significant, and there has been a weakening in direct trade links between Taiwan and the E.U. and between Taiwan and the United States.” The decline in the export of intermediate goods to Europe and the US, but the prevalence of a constant level of final goods to these countries underline that indirect trade links between Taiwan and the EU and Taiwan and the United States have remained strong.

Morrison refers to a growing consensus among analysts on this question stating that this strategy not only characterizes Taiwanese firms: “Many analysts contend that the sharp increase in U.S. imports from China (and hence the growing bilateral trade imbalance) is largely the result of movement in production facilities from other (primarily Asian) countries to China. That is, various products that used to be made in such places as Japan, Taiwan, Hong Kong, etc., and then exported to the United States, are now being made in China (in many cases, by foreign firms in China).” (2014, p. 9) Another important source of relevant information is the report commissioned by the U.S. International Trade Commission, which states that Taiwan produces over 90% of its ICT hardware in China! (Koopman, Wang, Wei, 2008, p. 21)

Analyzing Taiwan’s economic relations, it is important to underline that Taiwanese investments in other countries are the implications of global supply chain (GSC) strategies, which have integrated these countries into world economy. In recent years, the emergence of global supply chains has altered successful economic policies. Earlier, a successful policy had to rely on building a broad industrial base – US, Germany, Japan, etc. –, but nowadays, it suffices to join a global supply chain. Latecomers such as China, Vietnam, and Cambodia did not have a choice but to join the global chain. The crucial point in the process of specialization is at which point of the added value chain the country is able to join in, and whether it is capable of moving up the value chain. The importance of global supply chains to Taiwan can be demonstrated by the share of intermediate goods in the export. More than 70% of Taiwanese exports comprise intermediate goods, which is mainly concentrated in the
information and communications technology sector (ICT). (Koopman, Wang, Wei, 2008, p. 2.)

As stated above, most Taiwanese ICT products are assembled in Mainland China. This model has been built on cheap wages in Mainland China; however, this general picture has significantly changed because of increasing wages in recent years. This is one of the important reasons why China needs a new economic policy or model, which will be able to maintain the rapid growth experienced after 1990, but at the same time, it ought also to encourage an increase in domestic demand. Export-oriented growth is expected to slow down, wage costs are rising, investment rates, saving rates have already peaked in Mainland China. The country had already joined the WTO, thus the consequent trade boom cannot be repeated. (Magnus 2013, p. 5)

Whether this change in policy will succeed is questionable, but the implications are clear regarding the strategy of Taiwanese firms. These firms are forced to move their firms to other low-wage countries (Vietnam, Cambodia and Laos) which have considerable cost advantages over Mainland China. The threshold wage which induces firms to move abroad may already have been reached and surpassed in many sectors of the Chinese economy.6

The economic model relying on cheap Chinese labour is, however, under pressure; the concept of ‘island hopping’ (developed by Puga and Venables) offers a plausible explanation regarding the consequences of this change. The starting point of the idea is a situation in which all industries are concentrated in one island. In the next stage, one sector is forced to move to another island because of rising wages. The concept not only highlights the significance of wage increases, but also the fact that the distribution of the sectors in question is uneven. After relocating the industry, the first island is not entirely deserted; some of the sectors (with higher added values) continue to remain and operate there. As a result of this relocation, the new sector will be concentrated on one of the earlier empty islands; however, there are other low wage islands in the model too which will not be industrialised at this stage, only later. (Baldwin 2012, p. 18) The model clearly predicts the inevitable change of economic structure which is already taking place in Taiwan.

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6 Rising wages have already pushed some of the clothing companies to seek lower labour costs in Vietnam, Cambodia.
While looking at global supply chains, the case of the European Union is a more complicated one. Not only because it is a much more diverse region, but also because traditional analyses based on the theory of comparative advantages and economics of scale suggest advanced European countries’ competitiveness has been worsening in the last decade. This assumption could only be confirmed by an analysis of the export trends. However, exports do not translate to domestic incomes, which means that exports with high import inputs generate much lower levels of income; in other words, size may matter, but so does quality. (In the regional supply chains, Central European countries have a similar position to that of Mainland China, and the Western European countries are the main sources of capital, knowledge to these countries.)

The EU’s advantage is apparent in the global production networks of non-electrical machinery, transport equipment, and in the decline of the advantages is seemingly strong in non-durables and food. As already mentioned, the problems of analysing European supply chains also stem from the fact that some regions do not count with equal weights, which can be important in the regional supply chains. The differing importance of Western and Eastern Europe can be explained by the structure of the hub and spokes, which are dependent on each other albeit asymmetrically. (Baldwin 2013, p. 20) The same can be observed in Europe, where Western European countries are the hubs and the Eastern European countries are the spokes. Not only does this structure characterize the European economy, but also Taiwan, which is a linchpin in the ‘Asia factory’. (Rojas-Romagosa, Veenendaal 2012, p. 21)

SERVICIFICATION

The economic relevance of global or regional supply chains must be interpreted in the light of ongoing technological changes and the above-mentioned pressure on the Taiwanese model stems from the need to relocate industries from Mainland China to other low wage countries, but future technological changes also influence this change.

This technological transformation can be summarized by the term ‘servicification’. In other words, along with this process, knowledge and

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7 More detailed data can be found at Timmer et al. (2013)
8 The term was first used first used by Vandermerwe and Rada in 1988 (Low 2013, p.66)
skilled labour (due to the spread of new technologies such as app-economy, 3D printing, etc.) become more important if not the most important elements in the manufacturing sectors.

The increasing robotisation of manufacturing processes leads to a new situation, in which labour costs (albeit under pressure) are attributed less significance in total costs. This is the reason why the process of de-industrialisation has posed challenges to labour markets in advanced countries during the past decade.

The experiences of these countries demonstrate that most of the new jobs are created in the service sector.\(^9\) According to a study conducted by the McKinsey Global Institute, instead of manufacturing and service jobs, it is more accurate to classify these jobs as interaction and production/transaction jobs.\(^10\) The study states that “For more than a decade, such interaction jobs – including both high-skill and low-skill ones – have been the fastest-growing category of employment in advanced economies. In the United States, for example, nearly all net new job creation over the past decade has been in interaction jobs; nearly five million interaction jobs were created between 2000 and 2009, while more than three million production and transaction jobs disappeared.” (McKinsey 2012, Global Institute p. 2.)

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\(^9\) The former main structural changes in the economy could easily be described by the transformation taking place between sectors, but these terms are of no use today, because since the 90s, all of the advanced economies have made the transition to service economies, but equally it should not be interpreted as if nothing had happened in the labour market since the 90s.

\(^10\) Production/transaction jobs can be standardised and scripted, that is why they are shifted to workers in low-wage locations while interaction jobs require knowledge, independent judgment, and experience. (McKinsey Global Institute, 2012 p. 2)
Table 2. Knowledge Economy Index (KEI) 2012 Rankings

<table>
<thead>
<tr>
<th>Countries</th>
<th>2012 Rank</th>
<th>2000 Rank</th>
</tr>
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<tbody>
<tr>
<td>Sweden</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Finland</td>
<td>2</td>
<td>8</td>
</tr>
<tr>
<td>Denmark</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Netherland</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Norway</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>New Zealand</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>Canada</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td>Germany</td>
<td>8</td>
<td>15</td>
</tr>
<tr>
<td>Australia</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10</td>
<td>5</td>
</tr>
<tr>
<td>Ireland</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>United States</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>Taiwan</td>
<td>13</td>
<td>16</td>
</tr>
</tbody>
</table>

Sources: KAM, Worldbank

Even after the global financial crisis, Taiwan could be characterized by relatively low unemployment rates.\(^{11}\) One of the reasons behind the success lies in the policy of focus on jobs with high added value.

\(^{11}\) The peak point of unemployment after the global financial crisis only reached 5.9% in 2009. Since then, unemployment dropped below 4% in July of 2014, while monthly unemployment was up by 11.5% in the Eurozone. But this difference doesn't apply in the long run; looking at long term series, by and large unemployment rate in Taiwan remained higher, only after the eruption of the eurozone crisis did European rates become significantly higher.
However, differences in economic structures indicate that there is enough room for Taiwan to boost the process of servitization. The share of services in GDP is 68.9% in Taiwan, while the same figure is 72.8% in the EU, and 79.4% in the United States. (2012) However, the share of services in Germany is lower than the European average, and most of the new Member States of the EU have similar economic structures in this respect.)

However, maintaining a central position in the global supply chains is dependent on Taiwan’s capability of running a service economy. Taiwan was ranked the 13th most knowledge-intensive economy in 2012, and most of the West-European countries ranked in the top 30, which gives these countries an obvious opportunity to cooperate. Other figures can be mentioned as well, one of the most impressive statistics is the number of patents divided by the number of the population. Between 2006 and 2012 Taiwan had the highest patent density in the world. (San 2013, p. 3) In 2012, Taiwan spent 3.06% of its GDP on research and development! EU 2020 plan, EU’s growth strategy for the decade to come sets the goal to exceed the 3%; however, most of the European countries struggle to meet this goal, which indicates that deeper cooperation in this particular field would benefit both parties. (Figure 6.)

Figure 6
R&D as of GDP

Source: own Science and Engineering Indicators 2014
Despite the great efforts and results, moving up the value added chains is demanding because it requires the building of own brands too. Although there are analogies between Taiwan, South Korea, and Japan with regard to economic development policy, Taiwan has been different in many respects. Taiwan had not imposed severe restrictions on FDI, only on the imports of goods, while Japan and South Korea had resisted both FDI and imports, in the emerging phase of their economic development. As a result, there are not so many big brands and firms in Taiwan. However, Acer is not the only notable exception. Companies like D-Link, Acer, and ASUSTek have put more focus on brand marketing. The existing lack of brands is addressed by the Branding Taiwan Plan.

The lack of brands is another reason why Taiwan’s economy is being misinterpreted. These Taiwanese firms had been working as suppliers to large European and American brands manufacturing goods requested by them. But in the late 90s the model had changed and Taiwanese firms had begun focusing on the management of the supply chains and on network orchestration. This strategic change can be demonstrated in the ICT industry best.

**THE ICT INDUSTRY IN TAIWAN**

The country has specialised in the ICT sector, which accounts approximately for one third of the manufacturing GDP; around 40% of manufacturing exports is attributable to the ICT sector. The concentration of the research and development expenditures is even higher with around 70% of the manufacturing R&D funds being spent in the ICT sector. (Chen, Wen, Liu 2012, p. 91)

Originally, the ICT sector of Taiwan was built as an outstanding example of local clustering (Hsinchu Science Park) with strong connections to the US (Silicon Valley), however, this sector has transitioned from manufacturing to an innovation centre, while instead of producing final products the country can be seen as a producer of important intermediate goods. (Chen, Wen, Liu 2012, p. 92) Along with this process, Mainland China has become one of the most important offshore production sites to Taiwan, in particular in the PC

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12 Da-Nien and Hui-Tzu argue that there has been a steady deteriorating in Taiwanese terms of trade, which can be traced back to an increasing reliance on OEM (original equipment manufacturer) firm strategies focusing on productivity of manufacturing rather than on research and development. (Da-Nien, Hui-Tzu, 2013)
and notebook production. Chen et al classify the types of R&D investment in Mainland China:

1. A significant part of Taiwanese firms concentrate their product development on Taiwan, while support and research and development related to production are concentrated in Mainland China. This is the most significant type of R&D portfolios in Cross-strait relations.

2. As a result of the investments, some firms carry out main research and development activities in Mainland China.

3. But some of the Taiwan-based firms relocate from Mainland China their software development services, which are strategically important to the firms, and should be kept within Taiwan.

4. It is another form of division of labour when firms keep their upstream R&D within the home country while China-based subsidiaries control downstream R&D. (Chen, Wen, Liu 2012, p. 96)

The fact that the most significant part of ICT R&D can remain in Taiwan reinforces the view that Taiwan’s outstanding role is sustainable even in the case of R&D activities. The emphasis is put on services in the future economy; these knowledge-based services are the key drivers in the transformation of the Taiwanese economy. Hence the future growth in the world economy has increasingly been determined by knowledge, Taiwan’s importance has been growing in the eyes of European partners as well. Chen et al highlight this analyzing the allocation of R&D: “There are even signs that China is playing a growing role in R&D. However, for most ICT firms, particularly the IC and LCD manufacturers, their R&D bases remain largely located in Taiwan. This together with the IC design industry makes Taiwan an innovation hub for the global ICT production network.” (Chen, Wen, Liu 2011, p. 1)

DEMOCRACY AND FREE MARKET ECONOMY

In recent years, ASEAN countries have become increasingly important to Taiwan, but not only as a destination of intermediate goods, but also because the export of final goods in these countries could accelerate at a much faster pace than exports to EU countries and the United States. That is one of the reasons why emphasis is placed on these countries in the short run, while European countries (in particular Western European and Scandinavian
countries) and the United States have remained important partners to Taiwan in the long run. The “soft argument” for deeper economic cooperation between the EU and Taiwan is based on the similarities of the parties.

<table>
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<th>Table 3. The connection between democracy and economic power (2013)</th>
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<tr>
<td>Number of countries</td>
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<td>Share of the country-group</td>
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<td>The aggregate GDP</td>
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<td>(Current prices, US billion dollar, 2013)</td>
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<td>Share of the country-group</td>
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Source: own compilation based on Freedom House’s report (Freedom in the World 2014) and on IMF database. Notice: Only the countries in the IMF database were considered in the compilation.

There are similar features in the way the economy and politics are interconnected in these countries. Taiwan and the EU can be viewed as examples of success with regard to economic development. In explaining the successes of the West, a number of researchers stress the importance of institutions – in a broader sense of the word. They argue that the way institutions within the society are organized is decisive in the outcome, in the productivity of the economy and the well-being of citizens. (Acemoglu, Robertson 2012)

An outstanding historian, Ferguson summarizes all these explanations under six headings: competition, science, property rights, medicine, the consumer society and the work ethic. (Ferguson 2011, p. 12) These “killer apps” not only characterize Western European countries, but Taiwan as well, which has been able to avoid the “middle income trap”.

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13 Central European countries have a different position. Based on these explanations it is assumed that the connection between political and economic institutions may be a crucial element in explaining Central Europe's long term economic backwardness. The competition
Economic benefits of running a free market economy and of having a democratic society are clear. (Table 3) When one looks at the share and the economic power of countries that are democratic in global comparison, an accurate picture of the economic success of democratic countries can be arrived at.\textsuperscript{14} Not free countries are usually unstable politically, which has an impact on their economic relations as well. This is the reason why one-sided reliance entails numerous risks to both the EU and Taiwan.

THE THREATS OF THE ONE-SIDED ECONOMIC POLICY

There are several reasons for including Mainland China in the analysis: (a) the deep integration with Mainland China along with great economic benefits pose economic threats to Taiwan and (b) the Taiwanese model is partly under strain because of changing circumstances in Mainland China. (c) European firms entering the Mainland market, often consider Taiwan as a springboard and sourcing base.\textsuperscript{15}

In the last twenty-five years, Mainland China has become an important investment location and trading partner for both Taiwan and the European Union; there is a growing dependence in both cases, but there is a significant difference between the EU and Taiwan with regard to the extent of reliance. In cross-Strait relationship, the biggest push came from the Economic Cooperation Framework signed in 2010. It not only had an enormous effect on the improvement of the trade relations, but it also emits a strong signal about the political stability of the region. Trade between Taiwan and Mainland China has been growing at an annual growth rate of over 18\% since 2000! Now, Mainland China is Taiwan’s largest trading partner, accounting for some 40\% of Taiwan’s exports. Taiwan’s foreign direct investment is also directed at Mainland China; approximately 80\% of the total FDI. (Wilson, 2014)

\textsuperscript{14}However, it is important to underline that “The state of freedom declined for the eighth consecutive year in 2013” which suggests that the spread of democratic values and the flourishing of pluralistic societies is not an automatic process in which democratic societies cannot fail, and similarly that the democratic and free market economy model is not something undemocratic societies will inevitably resort to. From time to time, changes in international political and economic relations may change the trend of democratisation. (Freedom House, 2014)

\textsuperscript{15}There are political risks too! (Morrisson, 2014)
Against the backdrop of the changing Chinese economic model, it is easy to see that there is a need to adjust the industrial and trade policies in Taiwan. Hard-landing of the Chinese economy could have devastating effects on the world economy, but the most diverse implications would be evident in the Taiwanese economy.

1. The short term economic risks of deepening economic integration with Mainland China may stem from the ‘hard landing’ of the Chinese economy as expected by many analysts. Whether this crisis will take place in the near future or not at all is difficult to forecast with precision. (Elliott, 2014) There are diverging prospects for China’s economy, for example, Eliott argues that “[...] anyone who has seriously studied China realizes that the leadership of the Communist Party and of the government is very smart and has analyzed the issues carefully. The path to power and wealth in China generally runs through the State and consequently most of the best minds compete hard for these positions.” However, the latest Chinese economic data have indicated a definite slowdown of the economy; industrial production, fixed investment has been hit by the processes of the last months. Recent data on the property market and lending have confirmed the deterioration of economic conditions.

2. In the long run, China is going to be a middle income country by 2020. The so-called middle income country trap poses long term threats to the Chinese economy unless the capacity of the Chinese political elite to continue political and economic reforms improves. (Aging population, eroding competitiveness due to increasing labour wages, growing social tensions, weak rule of law, political tensions caused by surging inequality within the society, etc. present threats to the Chinese economy in the long term.)

3. Technological changes taking place in recent years pose a medium term risk; they mark a shift in industrial structure, which creates new winners and losers within society. The growing significance of global supply chains along with the ‘servicification’ process is already strengthening the cooperation of advanced economies, this radical shift redefines the role of cheap labour in business decisions and it questions the sustainability of the rise of China.
GRINDING MULTILATERAL TRADE NEGOTIATIONS

In recent years, the deadlock of the Doha Round negotiations has forced countries to find new alternatives. And as a result, more and more regional economic integration initiatives have already found support of the countries, and many of them are presently being negotiated. In 2000, there were only 3 bilateral and multilateral economic agreements in force in the Asia Pacific region, but the number has increased to 119 in 2014.

Several large free trade agreements, such as the Transatlantic Trade and Investment Partnership (TTIP), the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP) have emerged in the past few years. The TTIP and TPP are both initiatives of the United States. Initially, the TPP started out as a free trade agreement between Brunei, Chile, New Zealand, and Singapore in 2005, but its widening into a 12 country agreement would encompass an area which produces 40% of the world GDP. The TTIP is an attempt to widen further economic cooperation between the US and the EU, which share similar market ideologies. All of these initiatives aim to go further than WTO rules. These initiatives do not only cover trade issues (tariffs), but also deeper issues of trade integration (investment, property rights, environmental regulations, etc.)

This new kind of trade integration has led to the growing economic isolation of Taiwan. For example, the EU signed a comprehensive economic agreement with South Korea, the agreement entered into force in 2011. The EU started negotiations with Japan in 2013. Both countries are strong competitors of Taiwan, while Taiwan is confined to WTO regulations in its trade relations and being a member of the WTO, it finds it difficult to break out of the diplomatic isolation as a result of the ‘One China policy’ accepted by the US and the EU member countries.

Wilson describes this isolation and its ramifications as follows: “Isolated economically, Taiwan will be increasingly harmed by the FTAs’ trade-diversion effect. Its exports will lose out in FTA markets, due to increased competition from imports from other FTA partners. The successful completion by Korea—a competitor with Taiwan across a wide range of

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16 Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States and Vietnam.
products—of FTAs with the European Union and United States provides a useful example of some of the costs to Taiwan of not participating in these Asian FTAs. (In total, Korea has managed to sign eight FTAs covering forty-six countries.)” (Wilson, 2014),

Taiwan would definitely benefit from taking part in one of these economic areas. Leaf states that “One lever is the Trans-Pacific Partnership (TPP) – a free trade agreement that is being negotiated amongst twelve Pacific Rim countries, including the United States, Japan, Vietnam, and Australia. It aims to promote economic growth through investment, trade, and job creation. Indeed, the twelve countries currently negotiating the TPP account for approximately 40% of global output and over one-third of world trade. And given that exports make up 70% of Taiwan’s economy, increased trade with TPP countries would reduce Taiwan’s reliance on the Chinese market.” (Leaf, 2014)

The recipe, i.e. the diversification of economic relations is always a good policy, but it is difficult to follow the recommendation when on the one hand, one of the partners (Mainland China) is rising economically, and the cooperation delivers overwhelming benefits, and on the other hand, the trade policy is constrained due to the political reasons!

CONCLUDING REMARKS

Not only does Taiwan but so does the EU need to diversify their economic relations. In the Taiwanese presidential election campaign, Ma Ying-jeou “[...] spoke of going to the world via Mainland China, while Ing-wen insisted the other way around, going to Mainland China see the world.” (San 2001, p. 12) As far as the EU’s China-policy is concerned, up to this point the EU has gone to Taiwan via Mainland China. This policy needs reconsideration from the European side and more efforts from the Taiwanese side.

The hard argument for the desirable change in policy in Europe is that technological changes have devalued economic activities with low added value and the pace of these changes will only accelerate the decline of classic manufacturing activities (assembling, machining etc.), while high added

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17 The classic book of Jacob Viner (The Customs Union Issue, 1950) clearly showed that economic integrations can have diverse effects on countries not participating in regional trade agreements.
value, down- and upstream activities (engineering, marketing, sales, research and development, design, etc.) will gain further in importance. In this context, it is easy to understand how and why cooperation, in particular in the ICT industry, can benefit both Taiwanese and European firms.

The necessary diversification of Taiwanese economic relations is the other side of the coin. In this process, a comprehensive economic agreement (CEA) with the EU would be the most important step. European interests in the CEA include:

- Taiwan is important as a springboard to enter the Asian markets. This aspect is more important to Western European firms, while Taiwanese firms could serve as a source of capital and knowledge to Eastern European firms, in particular in the ICT industry). Earlier, Taiwanese firms had operated as suppliers to large European and American brands manufacturing goods requested by them. But in the late 90s the model had changed and Taiwanese firms had begun focusing on the management of the supply chains, on network orchestration. Taiwanese firms were successful in creating supply chains, even in being nodes of the structure. Today, the argument for cooperation can clearly be found in the special role Taiwan and Western European firms play in global supply chains. This is the reason why Taiwan is more important to the EU than what seems to be the case based on macroeconomic data and the sheer share, and size of international trade between the EU and Taiwan.

- Although Taiwan has only been the 25th export destination of goods, in recent years, export to Taiwan has grown faster than in any other trade relations. With respect to European exports to Taiwan, we find a 42% increase in the export of goods between 2008 and 2013 while European export to the world was only able to expand by 32% in the period considered.

- Taiwan’s significance as a mature, sophisticated market is growing too. As a result of the catching up process of the past several decades, today Taiwan has reached/overtaken the average income level of the core European economies. The purchasing power of the economy is growing, which, along with openness makes Taiwan an important
partner to the European countries. As a result of the expanding trade relations, European trade deficit has decreased in recent years, which is a clear indication of improving investment and trade opportunities for European firms.

The importance of common values must be underlined; democracies, free market economies can serve as appropriate frameworks of long-term stable economic relations. This soft argument combined with the hard arguments can lay the foundations for a comprehensive economic agreement between Taiwan and the European Union which would serve the interests of both parties.
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Nightmares and Dreams: The Eurozone Crisis and the Prospects of Hungary’s Eurozone Accession

The crisis of the eurozone has led the attention of economists to issues that were discussed two decades ago, but, at that time, strong political will (together with a relatively favourable overall economic situation) led to compromises, not in the letters, but mostly in the interpretation of the texts describing the conditionality of becoming (and, to a much less extent, of being) a member of the eurozone.

The reinforcement of the security mechanisms of the eurozone was a logical step, which was necessary to be completed very rapidly. It was also important for the mid-term stability of the eurozone. In order to make the eurozone an attractive and successful project, in the long run, even more emphasis should be given – beyond nominal convergence – to criteria describing the real economy of the members (or candidates for membership). Indicators based on such criteria may help avoid problems similar to those which occurred in some Member States (first of all, of course, in Greece) in the recent half-decade, and foresee potential problems, and avoid potentially harmful decisions made (only) because of political reasons.

In order to avoid (as much as possible) conflicts similar to the present Greek crisis management, the political aspects of the European integration process should be redesigned. One of the potential (theoretical) solutions could be the increase of the importance of supranational political decision-making bodies and institutions – of course, only as a result of thorough negotiations.

In the first years of its EU membership, Hungary had among its mid-term objectives to join the eurozone. However, serious problems regarding the fulfilment of the convergence criteria have led to a redesigned convergence
programme in September 2006 that contained no target date. At the time, it was a much more credible and realistic approach than the 2004 and 2005 extremely ambitious versions (and the target dates for the introduction of the euro set in them) of the convergence programme. The September 2006 version was even corrected positively in December 2006, and the targets were being met until the world financial and economic crisis seriously hit Hungary in the autumn of 2008.

The success of the fulfilment of the convergence programme (especially the substantial reduction of the public deficit) in the short period between 2006 and 2008 substantially contributed to the fact that Hungary could avoid default as the situation became very tight at the end of October 2008.

During the crisis, in Hungary, eurozone accession was not on the agenda, and it has not returned there after the crisis, either. The (elected in 2010, re-elected in 2014) right-wing government’s Europe-rhetoric concentrates on the “independence” of the country, in some periods even expressly talking about a “fight for freedom”. eurozone accession simply does not fit into such an approach. The crisis of the eurozone as well as the costs of the reinforcement of security mechanisms have further strengthened this approach. In the meantime, the National Bank of Hungary has followed a policy of lowering the basic interest rate; these (also due to external factors) successful steps have strengthened the feeling of being able to have an “independent” monetary policy. The debates on the future of Greece – including the debates on e.g. German dictates – also have strengthened this approach recently.

In the near future, no substantial change in this respect can be expected. In the longer run, however, the treatment (and the degree of success of the treatment) of the Greek crisis may have an effect on the Hungarian approach towards the question of joining the eurozone. A successful crisis management, with the consent of the majority of Greek citizens (which, at the moment, does not seem to be very likely) could in principle tune the present attitude of the Hungarian government towards a more positive one, while a more dramatic outcome – strong pressure of Western countries, first of all Germany, not accepted by the majority of the Greek population, persisting economic difficulties and social tensions – may provide additional support to the present approach.
As a result of the very deep political division within Hungarian society, the social perception of the euro is very different in different groups of the population. For many, the single European currency is still a symbol of stability, of avoiding risks (e.g. stemming from the fluctuation of the exchange rates), and of the strength of a big economic player (the eurozone, owing this first of all to the economic power and stability of Germany and France).

For others, the euro is a symbol of the reduction of a country’s sovereignty – the events in Greece and their media coverage have recently contributed to the strengthening of this approach. A recent (April 2015) Eurobarometer survey (Flash Eurobarometer 418, Introduction of the euro in the Member States that have not yet adopted the common currency, has clearly reflected this division.

Still, among the countries presented in the survey, the respondents from Hungary were relatively pro-euro. Beyond Romania (54%), Hungary (50%) is the only country in the survey where at least half of the respondents believed that the introduction of the euro in their country would have positive consequences (for their country). Despite a 4 percentage point decline compared to 2014, still 60% of the respondents from Hungary were in favour of the introduction of the euro.

Despite the relatively (and only relatively) pro-euro survey statistics, the introduction of the euro in Hungary looks to be an event in the far future – if ever. Different government statements in the recent years have put the earliest potential date of the introduction to 2018, then for even later 2020 or beyond – again: if ever. Despite the fact that Hungary – similarly to all other Member States joining the EU after the formulation of the Copenhagen criteria – has no opt-out for the introduction of the single currency, the non-fulfilment of the convergence criteria “legalizes” this approach; at least in this respect, the country has become similar to Sweden. The increasing awareness of the risks of an incautious widening of the eurozone (as a lesson learnt from the Greek experience) from the side of the core eurozone members makes the approach of the Hungarian government far more “manageable” even in the long run than it was the case before the Greek crisis. All in all, if no sudden, for the moment not foreseeable changes occur, eurozone accession remains distant for Hungary.