Preface

The dramatic events of 1989 starting in Hungary and Poland helped bring down the single most concrete – in every sense of the word – symbol of the division of the European continent: the Berlin Wall. This book pays tribute to this historic event by revisiting the political and economic transformation that has taken place in Central, Eastern and Southeastern Europe (CESEE) over the last 30 years. Even though, in 1989, Francis Fukuyama called the bold victory of economic and political liberalism the ‘end of history’, he later revised his judgement. Indeed, history has not ended yet, and – in contrast to Fukuyama – others such as Patrick J. Deneen have even stated the failure of liberalism in the meantime. Certainly, the future will have a few more tricks in store. Against this backdrop, this book explores not only driving factors of the successful transition to date but also key challenges that CESEE will be facing in the years and decades ahead.

Part I frames the discussion on three decades of political and economic transformation in CESEE from a historical perspective, mixing praise for the CESEE countries’ truly impressive transition and integration achievements with concern. Unfulfilled promises and unrealistic expectations about the speed and ease of transformation contributed to a social, economic and political backlash; a phenomenon unfortunately not unique to the CESEE region. Over time, many people have become disillusioned with the process of transition as economic modernization has failed to produce the expected social outcomes. Yet, at the same time, the anchor of European integration has proven to be able to build the ‘best Europe we have ever had’, delivering peace, liberty and prosperity. After all, the post-national Europe implied by the ‘Jean Monnet Process’ was a response to fascism, world wars and holocaust. To reach out to those who feel ‘lost in transition’, fostering convergence by spurring inclusive economic growth will remain a key factor.

Part II turns the attention to the role of monetary policy during transition as viewed from the perspective of three central bankers in the CESEE region. Following strong currency depreciation and hyperinflation in the 1990s, the Serbian case underlines the importance of restoring confidence in monetary policy and having an adequate fiscal framework in place for inflation targeting to work. Due to a strongly mismanaged economy in Yugoslavia in the late 1980s, Croatia first had to rein in hyperinflation and stabilize the economy in the early 1990s. A decade later, the country faced the challenge of having to

manage capital inflows to address resulting imbalances. The Czech experience recalls the early transition phase in which the currency had to undergo a significant devaluation. The subsequent exchange rate peg, adopted with a view to anchoring the economy, worked well initially, yet ultimately proved unsustainable given the impossible trinity of open capital markets, independent monetary policy and a fixed exchange rate. Having abandoned the fixed exchange rate under market pressure, the Czech National Bank then became one of the first central banks to introduce inflation targeting.

The impact of different economic policy approaches on the transition process is the key focus of Part III. History has proved that countries that undertook fast and decisive reforms were most successful in catching up to Western European income levels. Furthermore, in a severe crisis – such as the dismantling of communist rule in CESEE – newly incoming policymakers building on new ideas played an important role in developing and implementing comprehensive reform packages, ideally with adequate and timely international financial support. Crucial factors for successful continued transition include open markets, transparency, good governance, the establishment of property rights and rule of law. Here, the European Union (EU) can assert a positive influence on CESEE countries that are not yet part of the EU. Not least because of the lack of EU accession perspectives, one can observe that Russia's and Ukraine's economic recovery started later and lacked some central reform elements found in other CESEE countries. The main transformation challenges for Russia and Ukraine are the low quality of institutions and the decrease of foreign direct investment (FDI) inflows.

Further lessons from three decades of catching-up are presented in Part IV, which highlights above all the differences in the catching-up process between CESEE and in East Asia. While East Asian countries have built up and successfully managed domestic human capital and research and development (R&D) bases (industrial policy), CESEE economies have largely relied on FDI inflows and suffered from large-scale emigration, especially of the young and well-educated. While East Asia opted for gradual economic opening, CESEE mostly went through a rather fast liberalization of the capital account that led to a dominance of foreign banks in many countries of the region. While in East Asia the state often played a strong role in catching-up, in CESEE catching-up was driven by the EU accession process (the *acquis communautaire*) and (prospective) EU membership. Looking at the relations between CESEE and China, one can observe that CESEE offered China strategic entry points to the EU. CESEE's wish to cooperate with China may partly stem from disappointment from not catching up (more quickly) with advanced EU members.

Part V discusses the challenges for CESEE's near future, focusing on financial and monetary stability. Most CESEE countries experienced strong capital inflows, very dynamic credit growth rates and booming domestic consumption

in the years up to 2008, which led to the build-up of macroeconomic imbalances. The unwinding of these imbalances drove several countries into deep recessions when the 2008 crisis hit the region. Hence, effective micro- and macroprudential regulation is a key factor for safeguarding financial stability and avoiding very costly boom–bust cycles. Some of the CESEE countries belong to the relatively small group of countries that had used macroprudential policy tools already prior to the global financial crisis; these tools were indeed effective in containing credit growth and capital inflows in CESEE. However, the implemented macroprudential policies have apparently not yet been effective in dampening the strong recent property price increase in those countries of the region where house price inflation is no longer justified by fundamentals. House price growth might possibly be contained more effectively with borrower-based measures rather than capital-based measures. Turning from financial stability to monetary policy, 30 years after the onset of transition in CESEE, almost every type of monetary and exchange rate regime can be found in the region: from flexible exchange rates and inflation targeting to different types of managed exchange rates, euro area membership and the unilateral use of the euro. Analysing whether this diversity of regimes is a good outcome and how regimes are likely to evolve going forward is worthwhile, especially as regards the prospects, plusses and minuses for non-euro area CESEE countries to adopt the euro.

Finally, Part VI examines the impact of megatrends on the future of CESEE. Thirty years after the fall of the Iron Curtain, one may wonder where Europe stands and where the place of CESEE is in this new constellation, and in the new mandate of the EU institutions. For one, CESEE is strongly represented in the new European Commission which took office in late 2019. And the main topics of the new European Commission are closely related to CESEE. CESEE countries are among the digital forerunners and carbon reduction laggards alike. The search for meaningful action to address the challenges of population ageing, labour migration and brain drain will rely on the solidarity and responsibility of Member States no less than building a green European economy. In this context, however, one may argue that the Iron Curtain as a former East–West divide has now been replaced by a ‘Coal Curtain’ of Europe. This line on the map marks the divide of the EU, with the share of renewable energy in the CESEE EU countries being much smaller than that in Western EU countries. Another East–West divide is created by rapid population declines in many CESEE countries, versus population increases in Western EU countries. Population decline in the CESEE countries is due to collapsing fertility after 1989 and its slow recovery, lower life expectancy than in the West and strong outmigration. Looking ahead, migration pressures in and migration flows from CESEE – in particular in poorer countries – are expected to stay high, presenting a major future challenge for the CESEE countries. Other challenges to be

tackled include the relocation of global power from the West to China, nationalistic tendencies and consequently declining support of European integration.

Summing up, there is no doubt that CESEE will be faced with major challenges when looking 30 years ahead. Yet, when looking back on the past 30 years, there is no doubt, either, that the transformation itself has mostly been a success: per capita income levels have increased impressively, far-reaching reforms have been implemented swiftly and decisively, and macroeconomic and financial stabilization has been reached. The surest path for CESEE's success story of the past decades to continue will be ongoing cooperation in the spirit of the European Union's official motto, 'United in diversity'; a motto that should also be applied to countries beyond EU borders. We thus hope that this volume will not only contribute to the debate on the successes and shortcomings of this historic transformation, but also provide policymakers with insights helping CESEE manage the challenges that lie ahead successfully.

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