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Hungarian Steps toward European Union Membership

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1. The systemic change target

East-Central Europe comprises but several countries located on the Eastern side of the former Iron Curtain. This is a judgement on societal classification as much as an issue of geographical labelling. Russian territories belonging to Eastern Europe represent a level of civilization clearly distinct from that of Hungary, Poland or the Czech Republic. The latter have been demonstrating their cultural affinity with Western Europe for many centuries. Nor secular backward patterns of social action, economic behavior and the way of life are to be denied.

There are some similarities as well as peculiar features in the process of recent social transformation of different countries. Systemic changes in Hungary have attained a crucial point of no return. The old system has collapsed but the new one has not fully developed yet. As compared to Western Europe democracy has weaker historic roots and institutions. As compared to some other ex-socialist countries, high degree of ethnic homogeneity, of no value in itself, is an important asset when several neighboring states have disintegrated on the base of national differences.

Another asset is an historically different from the Soviet Communism model of the Hungarian society reformed step by step mainly after the introduction of a new economic mechanism in 1968. Much of the then existing institutional framework nominally continued to function as before but the role of some old structural elements was being reduced to external forms. Entrepreneurship started to evolve and personal freedom widened thus appealing to the peoples of other East European countries and meeting a rather hostile reception by their conservative leaders. Those reforms even if they were partly reversed and failed to reach a critical mass of change, helped open the economy and the mind to business culture and to freedom of exchange both within and without the country.

Other old elements continued to exert essential influence on the economic life. There was neither market system nor command system. What was that, then? An ambiguous practice with two incompatible main components and, in consequence, a specific tension of this way of functioning. There were two options in terms of easing the tension: to go forward to a qualitatively new system or back to command economy. Backward and progressive periods followed each other pending also on Russian power struggle. After the beginning of the Soviet implosion there was no more international support for the backward direction.

The third asset is continuity in legality, owing to which the process of introducing and strengthening democratic rules of government is characterized by relative peace andstability. Rule of law, separation of powers, individual freedom, human rights and property rights have already been established as constitutional and actual fundamental norms in Hungary. Political conflicts might have become dangerous if any social strains had manifested in anti-parliamentary forms of power-struggle. For the time being, in spite of some bickering among the national political elite Hungary is distinguished by a smooth transition process, relatively stable and calm atmosphere and the predictability of events. The nation could do with one and the same government for four years. It is true, a revival of archaic or anyway obsolete, even semi-feudal ways of behavior was present in the style of the government until 1994 when a convincing majority of electorate voted them out of power.

Market-oriented reforms having been unable to corroborate the state of affairs a more substantial change to another modus operandi, namely, the private profit-drive was necessary. Denafionalizafion of most assets has been an organic component of the economic transformation underway in recent years. A major part of small and medium businesses develop,however, independently of privatization. There exist more than 700.000 small entrepreneurs and this part of the system has been growing at an amazing speed to have become its most important accelerating component.

2. The liberalization target

Trade liberalization is going on in conformity with GATT rules on abolition of non-tariff restrictions. Currency is practically convertible for the enterprise sphere. The legal system includes a newly introduced set of laws aimed at harmonizing the Hungarian system with the EU standards. Acts of economic legislation appear to be the most important. Since January 1991 the Hungarian government has been setting prices only at about 10% of goods and services. Government control of prices concerns mainly public enterprises providing postal service, electricity, etc. Legal regulation is geared toward abolishing nonbusiness uncertainties for investors. New legislative acts (such as laws on investment funds, accounting, Central Bank, financial institutions, bankruptcy, etc.) are conceived so as to ensure safe and sound climate for foreign entry. Investments are guaranteed against nationalization. Foreign companies may repatriate in convertible currencies their profits. A value added tax and a business profit tax are the two key taxes on business activity in Hungary. Depending on the type of economic activity tax exemptions are offered. [26]

Because of its geographic location and a number of other reasons, modern way of life had influenced the country long before the systemic changes started. Hungarian consumers are aware of western and East-Asian manufactured goods, the reception of up-to-date products is favorable. This is not to ignore the impact of economic situation on consumer's choices.

Current macro-economic situation is not very attractive. The GDP has been decreasing in the Nineties.(About 30% of the GDP comes from manufacturing and mining, 45% from service and 20% from agriculture.) The transition from a command economy to a market economy was complicated by the debt service. This burden had come from the debtborrowed and inefficiently spent since the 70-ties. It is also true that ill-conceived programs, unwise and ill-administered economic measures taken in 1991-1994 have much contributed to the worsening of the situation at least in the fields of agriculture, public finances and indebtedness that went on growing in 1993-94. Abuses became paraphernalia of some fields of privatization. In 1993 saving propensity and foreign capital inflow also weakened.

In another complicating development the country has lost from one day to another about two thirds of East-European trading partners and markets for products, that could not be sold elsewhere. The supply of commodities and raw materials from these markets has dried up respectively. The impact of additional expenditures and losses caused by the war in neighboring former Yugoslavia is also worth mentioning.

In light of these events a degree of versatility of the economic-cultural potential was demonstrated by a shift in foreign trade that resulted in a fast actual market integration into Europe which now accounts for about 3/4 of Hungarian exports. The export boom didn't last for long and the terms of trade worsened but a foreign trade reorientation was completed in some two years. Hungarian economy has got to be adjusted to the EU standards in order to sell its products on Western markets. The protection of property rights, trademarks, patents in 2-3 years will reach West-European level. Technology transfer meets no legal or political impediments. But there seems to be too much of red tape. A sustained higher dynamism is linked up as well to stability issues reviewed in the following sections.

3. The stability target

In 1991-'92 Hungarian macro-policy could boast of some stability achievements and the nation was indeed doing relatively well in comparison with its neighborhood. But a two-digit inflation, a considerable recession and a dramatic trough in living standards was experienced. Consumer price index reached 35% in 1991 and oscillated around 23% in 1992, unemployment rate was roughly 13%, and the gross debt of the country reached 25 Bn. US$. (Statisztikai Havi Kozlemenyek, 1992,7. [23])

The Hungarian recession was no Keynesian one where effective demand ought to be increased so as to reduce incompletely utilized capacities and manpower reserves. In Hungary employment level had been maintained in an artificial way and against any indications of the international experience on the relation between employment and price level. Nor excess money supply gives enough ground to assess the inflation as a classical Friedmanite one. As reported by the National Bank of Hungary [21] while all economic indicators of output worsened, money supply increased from 1991 to 1992 by more than 25%.

Hungarian macro-equilibrium policy is likely to have embraced two opposite onesidednesses at once: an abused monetarist and an inflationary bias. Which indicates that the necessity to have a mixed approach does not mean that every mix is good. As shown bystatistical data the extremes were distributed not equally: while the excess money was supplied to the government the access of the business sphere to credits was restricted. (National Bank of Hungary. [21])

This way the inflation generated partly by deficit financing was complemented by a recession generated partly by credit allocation. Besides, the definition of monetary policy objectives was too wide in scope when stabilization should have been a dominating task.

There is empirical evidence on some economic improvements in 1991-92. It was during this period that the bulk of foreign trade shifted to Western Europe. [23, 1992,7.] International current payments were balanced. [21, August 1992] Inflow of foreign working capital was continuous. [ibid.] It slowed down afterwards, but the nation got a fairly good share of all investments in East- Europe. As an indicator of a relatively business-friendly environment this has come about partly owing to the fact mentioned above, namely, that Hungary began preparing systemic changes back in 1968 by introducing a new economic mechanism.

As far as bad news are concerned negative growth has to be mentioned. GDP decreased by 20% from 1989 to 1992. Industrial output decreased by about 1\4. [21.; March 1992.] The rate of unemployment was about 13% at the end of 1992 and it started to be slowly decreasing in the spring of 1993. In 1991 inflation and interest rates reached more than 35%, [ibid.] and the maximum tax rate on personal income was 50%. In connection with a more moderate rise of consumer prices (at about 23%) in 1992 the maximum tax rate was 40% and nominal interest rates were also lower than in the previous year. But state budget deficit was the highest ever recorded in Hungary. Pending on the methodology of calculation it was estimated at 6-8 percents of the GDP.

Commodity structure, technical, marketing and organizational level expressed in competitiveness and international performance remained to be the core weaknesses of the Hungarian economy. Central and local bureaucracy was as well a major hindrance to do efficient business.

At least four more factors created the environment of capital functioning and the macro-economic equilibrium situation. One of them was state redistribution of income. In Hungary more than 63% of the GDP was concentrated in various funds of the central government, state social security and municipal authorities. [Minister of Finances, 19.] That was more than the respective ratio of the most welfare oriented Western nation: Sweden (56%), where a reverse change with respect to the share of government spending began.

Another factor was the mounting pressure that the government compensate the diminishing real purchasing power of final consumers of national income. Indexation may have worked to the effect of further speeding up inflation itself because while the government wassiphoning inflated money into the budget the recipients of indexed benefits tended to siphon the same as previously amount of real value away from the budget. Inflation was, however an expression of a lasting general disequilibrium the spiralling impact ofindexation being a secondary cause.

The third factor was the state's role in borrowing money through the credit sphere at low interest rates. Extension of independence of the National Bank as well as tightening deficit financing would have been progressive steps even if they might have induced fiscal authorities to impose a heavier burden on tax-payers.

The fourth factor was the complex of foreign exchange and international finances. The integration of Hungary into the European economic space was going on. The full liberalization of current transactions attained more than 90% of annual imports that meant unrestricted foreign currency supply for imports. The speed of liberalization was somewhat exaggerated in view of the actual level of development of the country. The depreciation of the Hungarian currency was lagging behind the long-term worsening of its comparative purchasing power and the situation of a debtor country. The depreciation drive was mitigated by the inflow of foreign capital, net demand for Forints in neighbor countries and the fact that up to 1992 fall Hungarian exports were increasing.

In sum there existed a Hungarian Paradox comprising at least of the following components: a/output was receding, exports were growing; b/currency was appreciated, export share was increasing; c/ savings were accelerating during a two-digit inflation; d/nor negative real interests hindered savings' growth e/low real lending rates did not stimulate investments; f/ money supply was in excess, effective demand was contracting; g/ price level and unemployment rate were increasing together. From a rather general viewpoint it could be stated with certainty from the beginning that the paradox was transient and could not last long.

However, to point to the temporary character of it is no solution for this enigma, all the more that 'temporary' phenomena sometimes show an embarrassing permanence. A solution in this context means an explanation of causal chains of unexpected processes in their complexity. As it follows from

the discussion presented in above sections the causal complex breaks down to systemic and structural changes, stagflation, country-specific features, mismanagement and some miscellaneous components. To be more specific, component a/(" output was receding, exports were growing ") was able to come about due to the fact that other demand factors as investments (all the time) and consumption (in 1991) decreased at a higher speed than the GDP; 'b'/ (" currency was appreciated, export share was increasing ") existed because and while production outlays were being covered by export earnings what is no more the case. 'c'/and 'd'/(" savings were accelerating during a two-digit inflation, nor negative real interests hindered savings'growth ") may be explained partly by the appeal of an appreciated currency itself, partly by the fact that for small businesses it was safer to keep liquid assets in the form of personal savings. In addition, data on savings include accrued interest as well.
Component 'e'/(" low real lending rates did not stimulate investments ") took place because other conditions offset the impact of relatively low average real interest rates: 1. High marges mentioned above, 2. Influence of inflation in general and in respect of stocks' uncertain performance in. particular, 3. Positive recession expectations exceeding positive price expectations. The latter turned negative after 1991. Component 'f'/("money supply was in excess, effective demand was contracting") was a result of differences in money supply and interest rates for the respective borrowers (private or 'preferred' in this respect public ones), high taxes and appreciated currency. Component 'g' (" price level and unemployment rate were increasing together ") on one hand existed owing to the asynchronity of the related processes: the peak of inflation in middle 1991 and the peak of unemployment in the spring of 1993. On the other hand it does not require any explanation since it belongs to the essence of stagflation and not to the paradox under consideration. Paradoxical features of the economy existed inasmuch as the 'normal' way some aggregates behave was offset by other conditions of temporary nature. In view of the ceteris paribus rule of the economy there is nothing about them to be surprised at.
Propositions discussed above are focused on the anamnesis of the recent inflation the peak of which came about at the middle of 1991, afterwards price increases were slowing down to some extent.

4. The growth target. (Developments in 1993)

There were some signs of economic recovery, partly at the expense of economic equilibrium in 1993. There were less registered unemployed (which is not identical with an increasing employment rate) and the rate of inflation did not accelerate. Investment expansion began. Contraction of Eastern markets also stopped thus opening some rather restricted potential for growth.
In 1993 the growth of Western productive capital influx was going on but at a decreasing speed. Hungary was losing the preferred position due to which an important part of the working capital inflow into the region had been directed here. The total amounted to seven Billion $ of working capital invested in the years 1990-1993. After that net monetary debt had been slightly reducing and the balance of payments improving the latter drastically worsened in 1993 to have attained a deficit about 3.5 Bn. $. That was partly a result of decreasing agricultural production and exports. There remained also serious imbalances in the state budget.
Slowing inflation should have been a main priority for the economic policy. A moderately tight monetary policy and stabilization and austerity measures agreed with the IMF had allowed to check inflation. Along the lines of tightening monetary policy the minimum reserve requirements for banks had been raised in order to ensure the safety of the banking system. This policy was reversed in 1993. A mayor bank and debtor consolidation program began. These measures were contradictory and controversial because even if they might have contributed to growth renewal they loosened money supply.

The actual state of the economy on 31 December 1993 on the base of 1992 data is shown below (Magyar nemzeti Bank Havi Jelentés, [28])

I. Data on real processes
Output and prices:

Production factors:

II. National Bank of Hungary indicators

III. Banking sector indicators:

IV. Money supply, stock, rounded data

National accounting data on 1993 [29]

5. Lack of a sound therapy in 1994.

Date for 1994
(Source: Ministry of Finances: Åttekintés za 1994 évi és za 1995 év eleji gazdasági folyamatokról. Budapest, 1995 március.)

Corr. period of 1993=100
Investment outlays at curr. prices: 126.6
Industrial price index, domestic: 110.2
Consumer price index: 118.8
Retail trade turnover volume: 93.7
M2: 113.4

Rates in %
Aver.market interest rates on contracts maturing within one year:
loans: 29.7, deposits: 23.6
Bn. Hungarian Forints
Gross savings, households
Jan-Dec '93: 21.9; Jan-Dec '94: 394.2
Central government budget deficit
Jan-Dec '93: -1997.7; Jan-Dec '94: -321.7

Bn. $ US
Balance of payments, J-Dec '93: -3.5
J-Dec '94: -3.9
Working capital imports, J-Nov: cca. 1.2 (money)

GDP indices for five years (Népszabadság, 11 March 1995)

Last update for 1994 (Népszabadság, 28 March 1995)

I. Base: 1993

Volume indices

Growth rates in $ US
Exports: 20%
Imports: 16.1%

Welfare indicators, 1993=100

II. Deficits in Bn $ US
Balance of trade: 3.9
Balance of payments: 3.9

III. Central government budget deficit, Bn HUF
Current: 292 (without capital service)

IV. Unemployment
Registerd unemployed (31 December): 520 000

Capital imports were lagging behind the amount of current payments'defedit. Gross international dbt was increasing consequently. Savings, though accelerating in comparison with 1993 were lagging behind the amount of state budget deficit.

An early research into the related problems was sponsored by a generous Phare- ACE grant awarded to this author to carry out work on "A modus operandi for achieving macro-economic equilibrium on Hungarian commodity,money and capital markets." Performed in 1991 the study explored monetary imbalances, a high state redistribution ratio, crowding out effects, indexation abuses, insufficient and delayed devaluation moves, high taxes, loosening money supply. The suggestions of the study were not accepted by Hungarian decision-makers who, naturally, might have preferred some other options, but, unfortunately they failed to work out any sound diagnosis and therapy geared at moving the national economy on a path of reasonably balanced sustainable growth. Several major faults of macro-economic policy were standing for five years.

SUMMARY ON STEPS TOWARD FULL MEMBERSHIP:

1. Positive steps: systemic changes, democratic government, major shifts in production and ownership structure, market liberalization,smooth transition, international reorientation, harmonization with EU requirements, working capital imports, etc.
2. Lack of positive steps: unsolved monetary policy problems, continuous violation of some elementary macro-economic rules, poor incentives for competitive performance, a five-year delay in the reorganization of the social security system, major deficits in the balance of payments and public finances. Going on with bad performance on these items would indicate that in their respect Hungary would make steps not toward but away from the EU standards with implications pertaining to the perspective of a full membership as well.

SUMMARY ON 1994 DEVELOPMENTS

Growth recovery began back in 1993 after the European recession had been over and domestic activity touched a bottom line: the downward trend exhausted itself. Some imbalances were inevitable with this recovery. The outgoing government ignored a scenario for a dramatic worsening of the equilibrium situation. Nor the new one in power from March 1994 envisaged profound economic policy reforms for the first months of its existence. In fact it was waiting for a whole year before taking essential decisions on budget, trade and payments deficit problems.Another failure with an even more negative impact was that privatization practically stopped also for a year. (Data: See on next page)
On the positive side one can record that radical government decisions on economic policy and social security reforms are finally taken (As their first moment, the stability plan of March 12, 1995 ought to be mentioned). A sound diagnosis and therapy lacking in 1994 seem to have been present in 1995. That gives hope to expect further decisive steps to live up with requirements for full EU membership in macro-economic adjustment.

Date on Privatization
(source: Heti Privinfo, 7 March 1995)
On January 1, 1995. Bn. HUF

State-owned assets, book value: 1618.93
of wh.to be privatized: 1273.75

Privatized assets by their share in total assets of concerned firms:

100%:	258.27
more than 50%:	278.49
less than 50%:	107.17
Sum total:	643.94

Assets privatized to foreign owners:302.98
(Not equal to working capital imports)

% share of some OECD nations in the above sum:
Germany: 27, USA: 20, Austria: 14.04, Great-Britain: 7.46, France: 6.95, Netherlands: 5.29, Belgium: 4.38, Sweden:3.29, Switzerland: 2.57%.

Total income from privatization, Bn. HUF

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From the Association Agreements to Full Membership? The Dynamics of Relations Between the Central and Eastern European Countries and the European Union