Karoly Foldes:

East-Central Europe on the Eve of EU Enlargement

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1. Integration and systemic changes

Hungary, Poland, and the Czech Republic have chances to be among the next countries to access full EU membership within some years. Their recent efforts on the way from association to accession are aimed at applying integration measures pertaining to their economic and other performance, policy, regulation and institutions. It is surmised to be proper to present here a sketchy review of some similarities and a very few particulars of their foreign reorientation and internal transformation.

The recent westward integration drive of the subregion is a logical corollary of systemic changes begun back in 1989. By this transition the nations in question started to acquire an integration compatibility with their Euro-atlantic neighborhood. There are two levels of integration compatibility. The first one consists steps that since long ago should have been introduced from a general *economic rationality* viewpoint. The second level contains measures pertaining more specifically to EU regulations.

Steps toward the European Union assume a respective drive for EU enlargement that has recently been on agenda of the Intergovernmental Conference. [1] A sober and definitely reformist attitude both to deepening and widening the Community has to be adopted. Enlargement will involve costs and benefits both for the EU and its new members, but the comparative weakness of the latter calls for EU assistance. As a matter of fact the recent fifth expansion deals with a *zone* of small or medium sized countries *with less advanced economies* than the EU average. Previous expansions also included some like nations, but the recent one is the first to deal with several former East-bloc states. (German reunification was a special case.) Because of its scope and its diversity, it has to be preceded by more important changes than the previous ones.

In addition to and in connection with the deepening of the Union, EU will have to address the implications of the increased number of members. Still more flexibility is needed so as to *give enough time to the new member states to attain integration conditions gradually*. The actual accession may take place only in sequences. Bloc treatment is excluded in respect of the Visegrad co-operating neighborhood either. Their background and process of social transformation is characterized by some general as well as special features.

As a common historic feature, all have been demonstrating their socio-cultural affinity with the West for many centuries. Early in this millennium, or in Dante's time in spite of some Eastern-type phenomena they gradually diverged from the developmental models existing just over the divide line between civilizations, in Byzantine-orthodox and Islamic areas. This distinction was preserved even afterwards, when these countries have developed also differences from the West in their patterns of social action, economy, political systems and the way of life. After 1948 they fell under Soviet domination and, later, Soviet implosion was a *first condition and general background* of their transition.

Another resemblance pertains to the present state of affairs. Social transformation has attained a crucial point of no return, even if the new system has not fully developed yet. The situation is far from being an ideal one, but democracy is stabilized, market economy is operating. There is continuity in legality, owing to which the process of transition is characterized by relative peace and stability.

Economic and political freedom were won by democratic elections and in that sense *the end of the old regime was much better than its start.*

Rule of law, real separation of powers, individual freedom, human rights and property rights have already been established. They are at the root of the very existence, and meaning of any present and future governments, not excluding ones assuming a socialist tinge. Political conflicts are being fought over in parliamentary forms at the same time when, in some Balkan states changes have included explosion of violence and ethnic-religious hatred left a whole area with still smoldering ruins of social, economic and environmental disasters. In Central Europe the former Czech and Slovak Federation has disintegrated on the base of national differences smoothly. In these circumstances a recent high degree of ethnic homogeneity, of no value in itself, has been an important asset of the three central European countries on the eve of their EU membership.

The euro-atlantic and global implications of changes are demonstrated, *inter alia*, by the operation of non-European multinationals in the subregion, OECD membership of the Czech Republic, Hungary and Poland, and positive efforts of these countries to adhere to the North-Atlantic defense community.

There are too *trans-systemic* (not transition-specific) corellative links and similarities of this area with the rest of Europe: the evolving digitalization of life or a degree of welfare build-down are international attributes of a global transformation process. The same is true concerning the fight against drug abuse, terrorism, money laundering, nuclear trade, etc.

Economic conditions are the main concern both from the viewpoint of transformation and integration compatibility. Denationalization of most assets is an essential of the economic transformation. Industrial restructuring, evolving services, rising productivity are salient indicators of change. Growth is renewed. There have emerged millions of small entrepreneurs to have become a most important accelerating factor of development. Large international companies, even discounted for some negative consequences, greatly contributed to capital imports and economic growth.

Preparing for full membership goes hands in hands with a profound economic and social change i.e. a process which is in short and medium term *jeopardizing stability*. Prospective EU members have been receiving some financial transfers from the Community. As associates they have been getting PHARE benefits that, coordinated with EU assistance, IMF stand-by loans, World Bank benefits, EBRD investments are helping defray a part of transition costs and making a substantial contribution to the preparing of integration conditions. In spite of this the main onus of changes is born by the three countries themselves. An *unbearable burden* would endanger not only their economic and political stability, but the whole process of peaceful European development.

Macro-economic situation was by no means attractive over the 90s. The firms of the subregion lost from one day to another about two thirds of their East-European trading partners and markets for products, that could not be sold elsewhere. The supply of commodities and raw materials from these markets dried up respectively. The impact of war in former Yugoslavia was anything but beneficial, (especially for Hungary bordering with the territory of the tumultuous Southern Slavic area).

In light of these events, a degree of *versatility of the three nations' economic-cultural potential* was demonstrated by a shift (reorientation) of their foreign trade to Western Europe. The latter now accounts for about 2/3-3/4 of exports. The export boom didn't last for long and the terms of trade worsened but an actual trade integration into Europe was completed in two years.

2. Some national particuliars

At the beginning of changes, in 1990, the GDP per capita indicator, as compared to the Austrian level, was 30.4 for Poland, 37.8 for Hungary, and 50.4 for the Czech (and Slovak) Republic [2, p. 5.], which was an evidence of differences in their level of economic development. This gap remained standing in relation to Austria.

A special feature of Poland was that a *profound and lasting crisis* beginning in the late 70-ies preceded the systemic changes. In the other two countries the recession came later, but to reduce it to a "transformation crisis" (and nothing more) would be a simplification.

A distinct feature of Hungary is an historically different of the Soviet Communism model of its society in result of substantial reforms. With the introduction of a new economic mechanism in 1968 the economy reached a degree of adaptability to domestic needs and international markets. The reforms, even if they were partly reversed and failed to reach a critical mass of change, indeed helped to modernize and open the economy. In the 1980s the reforms already were unable to mitigate the decreasing of the economic performance

Some peculiarities of the three countries stemmed from *the respective extent of their previous openness*. Their "endowment" of international indebtedness was very much different. The Czech Republic boasting of the best economic indicators at the beginning of the transition was much less indebted than the other two nations. Poland had more debt and needed rescheduling yet in the 80-ies. The per capita indebtedness was the highest in Hungary, but the country managed to avoid rescheduling.

The privatization process was also different. In the Czech Republic large domestic financial institutions with the majority votes in the hands of state agencies or their holdings were the main agents of acquisition. Private capital was the main actor of privatization in Hungary.

Bold privatization and good business environment have been the main factors due to which Hungary attracted a fairly good share of working capital imports, the *highest per capita in the subregion*. The country could not avoid some ill-conceived and ill-administered economic measures in this field. Despite the country's impressive privatisation record and lead in attracting investment GDP rose at an estimated 2 per cent in 1995, (at about 1% in the following year) well below the 5-7 % in Poland and the Czech Republic. Inflation was slightly over 20 % in Poland and below 10 %. in the Czech Republic. The Hungarian rate was 28.2 % in 1995 [14] and remained high in 1996. More specifically some aspects of this nation's experience will be dealt in the next section.

3. The Hungarian experience

Already in 1990 major trade liberalization moves were made in conformity with WTO (then GATT) rules on abolition of non-tariff restrictions. A newly introduced set of laws was aimed at harmonizing the Hungarian system with international norms. Some of the most important acts of economic legislation were to guarantee the investments *against nationalization* and enable foreign companies to *repatriate* in convertible currencies their capital and profits. This legislative direction was continued over the Nineties. [3]

As far as bad news are concerned, the GDP was decreasing for 5 years. Ill-conceived policies have much contributed to the worsening of the situation at least in the fields of agriculture, public finances and indebtedness that went on growing, up to 1996.

In 1991-1992 Hungarian macro-policy could still boast of some stability improvements and in this respect the nation was indeed doing relatively well in comparison with some of its neighborhood. It was during this period that the bulk of foreign trade shifted to Western Europe. [4, 1992,7.] International current payments were balanced, inflow of foreign working capital was continuous.

But GDP decreased by 20% from 1989 to 1992, industrial output decreased by about 1\4 and the rate of unemployment reached about 13% [5, March 1992]. In 1991 inflation and interest rates reached more than 35%, and the maximum tax rate on personal income was 50%. In connection with a slower rise of consumer prices (at about 23%) in 1992 the tax ceiling was 40% and nominal interest rates were also lowered. But *state deficit* was the highest ever recorded in Hungary. Pending on the methodology of calculation it was estimated at 6-8 percents of the GDP. [4, 1992, N 12] As all indicators of output worsened, money supply increased in 1992 by 25% [5]. While the excess money was supplied to the government the access of the business sphere to credits was restricted [5].

More than 63% of the GDP was concentrated in various funds of the central government, state social security and municipal authorities [6]. The government failed to begin reforms in this field. Still for five more years this indicator remained high.

The speed of liberalization was somewhat exaggerated in view of the actual level of development of the country while the depreciation of the Hungarian currency was insufficient.

There were some signs of economic recovery, partly at the expense of economic equilibrium in 1993. The balance of payments drastically worsened in 1993 to attain 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 [7, N 4.]. Inflation was checked at 22.5 % as compared with the previous year's 23 %.

Along with transition processes a profound *degradation in average living standards* was underway. The fact itself was tolerated conditionally by the public within a perspective of economic growth in not too distant future.

A change of administration was to take place about the middle of 1994. Data for the first half of 1994 shew continuing growth and continuing disequilibrium. [8]

For the first 5 months on the base of the same period of 1993 industrial output volume reached 108 , investments, vol. 150. Gross international debt was increasing and so was state budget deficit. These imbalances did not stop under the new government. Disequilibrium culminated at the end of 1994. The deficit of the balance of payments amounted to about 4 Bn $ US and the deficit of the state budget to 340 Bn.HUF.

The same trends continued on in the first quarter of 1995. They were stopped in result of sweeping austerity measures and a sharp turn in the economic policy of the government [9].

The quantitative stabilisation targets included a cut in the balance of payments deficit to 2.5 Bn. $ US (by 1.5 Bn.), a cut of the state budget deficit to 200 Bn. HUF (by 140 Bn. HUF), a cut in the number of state employees by 15 %. and aimed at a 27% rate of inflation. [10]

Stabilization tools included currency depreciation of 9% at once and continuing on a sliding scale (appr. 15% on a yearly base.)

A temporary 8% import tariff supplement was introduced. Car consumer tax increased and reserve requirements for banks were raised. *Credit demand of the total public sector was to be limited* to the extent that could be covered mostly by household savings.

Comparative data on 1994 and 1995 [12] show that in result of austerity measures while in 1994 export sales reached 83% of the 1985 level, in 1995 they reached 99.3%, i.e. practically equalled the latter. But employment went on shrinking. On the base of 1990, from 1994 to 1995, consumer prices changed from 241.6 to 309.7. State deficit was reduced by about 40% in 1995. A major foreign capital influx came in December 1995. Net debt at the end of 1995 amounted to 16.8 Bn $ US of which the state debt was only 11 Bn. $ US [13].

In 1995 reducing the general government budget deficit was given high priority in the economic strategy of the government. A reduction in real wages (appr. 12 %) was contended by the government to have contributed into income reallocation to savings and improvement of competitiveness of Hungarian products. But the *reduction of real wages was overdone*, it hindered growth and collecting more state revenues. The ratio of net external debt to foreign currency revenues was indeed reduced.

A combination of high state debt, high interest rates and inflation, as well as high taxes have depressed economic growth. It may be added, that a major decline in the public sector deficit was up to to the end of 1996 hindered by growing interest payment liabilities of the budget.

In 1996 the stabilisation policy was sustained, large foreign capital inflows came, but the economic growth was marginal, about 1 %. Inflation was slower than in 1995, but remained at a high, 23,6% level.

A whole system of tools is necessary to apply so that economic growth gradually accelerate and reach the annual EU countries' average. By way of just mentioning the following problems may be enumerated.

The issue of preferences in agricultural market accession is very complicated. The possibility of social unrest is present in this sector.

Indicators of inflation and deficit of payments exceed the EU Maastricht threshold and Hungary is not yet able to lastingly live up to all these requirements.

Full EU membership requires the adoption of some more harmonisation changes in addition to those implemented already.

There is a need for substantial narrowing of state benefits. While Hungary's GDP per capita is a fifth of the OECD average, the share of GDP it spends on welfare is 1.4 times higher [14]. Around a third of state spending is channelled through the countrywide pension and health funds and central government must finance their deficits [15].

Monetary equilibrium must be sustained neither as a simple result of decision-making, nor as a pure consequence of self-clearing market workings, but rather as a trend stemming from the *interaction of business with monetary policy*. Within some years the country has to achieve full liberalization of capital movements.

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Summing up, it has to be recognised that integration is not only to provide new prospects but also require *different patterns of behavior* from all the business and public actors. It comprises a gradual advancement from low competitiveness and poor international performance to a developed market economy.

Hungarian minuses in this respect were concentrated in earlier years when changes were achieved at the expense of negative growth, increasing unemployment and monetary disequilibria. Now there exist some achievements in restructuring, stabilisation, privatization and marketisation. The economy is business-friendly, currency is convertible. , foreign working capitals are coming into the country. These factors are contributing to achieving the economic conditions for EU membership.

4/ References

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