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HUNGARY AND THE EUROPEAN COMMUNITY: PROBLEMS AND PROSPECTS

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Paper presented at the European Community Studies Association meetings, George Mason University, May 22-24, 1991.

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Introduction

Among the major reforms Hungary is currently undertaking is the pursuit of more open economic relations with Western industrialized nations. The furthest expression of Hungary's desire for economic links with the West is its desire to join the European Community (EC). This paper will examine some of the problems faced by Hungary as it pursues political and economic integration with the EC.

The first section identifies the procedures an applicant for EC membership must follow, identifying some advantages and disadvantages of enlargement from the point of view of existing EC members. There follows a description of the recent changes in and current status of the Hungarian economy. The pattern of Hungarian-EC trade and negotiations regarding association membership over the past two decades is discussed in section three, while the advantages and disadvantages of Hungarian membership in the EC from the viewpoint of both Hungary and the EC are identified in the following section. Finally, a likely future scenario is presented, including conditions Hungary has to meet before it can realistically expect to become an EC member and the length of time it is likely to take Hungary to meet these conditions.

Procedures for Joining the EC

According to the preamble to the Treaty of Rome the founding members of the EC called upon "the other peoples of Europe who share their ideal" (of democratic political and economic institutions) to join the EC. The founders recognized that trade policies have lasting political consequences, and they were anxious to lessen political tension throughout Europe. Article 237 states that "[a]ny European State may apply to become a member of the Community . . . The conditions of admission and the adjustments to this Treaty necessitated thereby shall be the subject of an agreement between the Member States and the applicant State."[1] Article 238 further states that "[t]he Community may conclude with a third State, a union of States or an international organization agreements establishing an association involving reciprocal

[1] *Treaties Establishing the European Communities* (Luxembourg: Office for Official Publications of the European Communities, 1987), p. 315.

rights and obligations, common action and special procedures.

Any nation seeking EC membership must begin by submitting an official request from its political authorities to the EC Council. At this point the Commission studies and evaluates the request before it renders a detailed opinion regarding the rules and necessary prerequisites (e.g., internal structural reforms) for the prospective nation to satisfy before the Commission believes the applicant should be granted membership. This opinion is sent to the Council, which decides whether further negotiations between the EC and applicant nation's authorities would be feasible. In particular the Council determines if the prospective member shares the ideals of the original six members as stated in the Treaty of Rome. These ideals include a commitment to democratic political and economic institutions, and the willingness of the applicant to give up some sovereignty and accept common rules proposed by the EC supranational authorities. For example, the applicant must accept the common policy of free trade within the EC, the EC's competition and commercial policies, common legal system, common product and service standards, common policy of pricing agricultural products and agricultural budgeting, freedom of movement for factors of production as well as goods and services, and common measures pertaining to trade involving coal, steel, and the production of atomic energy. Other considerations are the cultural origin of the prospective member, its respect for human rights, and its level of economic development. An additional, significant criterion is an assessment of the likely costs and benefits to EC members from accepting the applicant nation.

If at this point Council believes further discussion is warranted, lengthy negotiations begin concerning conditions (and timetable) for entry. After these negotiations are completed, accession treaties are prepared and signed by the negotiators. National parliaments of each member and the applicant nation must approve the terms of the accession treaties. If this occurs, the new member officially becomes part of the EC on the agreed date.

EC members place heavy emphasis upon the relative political and economic advantages and disadvantages of an enlarged Community as their basis for approving a new application. Advantages include a greater political bond among members which can serve to lessen European tension as well as to enhance the EC's bargaining power during international trade negotiation, and economic benefits such as the dynamic effects realized

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[2] *Ibid.*

by participants in a larger market, including trade creation and gains from specialization of labor.

Estimates of the effect of integration on overall trade and growth of EC members prior to 1990 have been favorable. Not only has considerable trade creation ensued from further integration, but the contribution to the rate of economic growth attributable to integration has been estimated to be about 40% of total EC growth over the 1961-1972 period, and 30% between 1974 and 1981.[3] It should be noted that enlargement and worldwide protectionism also were contributing factors to the 1974-1981 growth, for each stimulated member nations' exports (especially within the EC). Finally, the growth of EC exports over the 1978-1986 period exceeded import growth (215.5% versus 205.6%) while the EC trade balance improved from a deficit of 32.4 million ECU in 1979 to a 10.9 million ECU surplus in 1986.[4]

Overall, the EC members' experience with the economic effects of integration has been significant and, for most members, positive. It has been estimated that the 1972 GDP of the EC was 2.2% higher than it would have been without integration, while the comparable figure for 1981 was 5.9%.[5] In addition, estimates have been made of the additional costs born by EC business firms due to the absence of an internal market. These additional costs, which are due to complex customs barriers, protectionist procurement policies, divergent product standards, and the inability of small firms to achieve economies of scale have been estimated to add about 15% to total costs.[6] Meanwhile, the benefits, both real and potential, to be derived from further monetary and economic

[3] Studies indicate that trade creation outweighed trade diversion by more than 5 to 1 (about $10 billion trade creation compared to under $2 billion trade diversion) for the original six EC members over the 1969-1970 period. Following enlargement to 9 members, it has been estimated that trade creation increased by $28 billion versus $5 billion for trade diversion over the 1977-1978 period. Note that all figures are in current dollars. For further discussion see Mordechai E. Kreinin, *International Economics 5th ed.* (New York: Harcourt Brace Jovanovich, 1987), p. 320-321. Concerning integration's contribution to growth see A.J. Marques Mendes, "The Contribution of the European Community to Economic Growth," *Journal of Common Market Studies* Volume XXIV Number 4 June, 1986, pp. 266-270.

[4] *Eurostat, Basic Statistics of the Community, 25th ed.* (Luxembourg: Office for Official Publications of the European Communities, 1988), pp. 257-277.

[5] Mendes, "Contribution of the European Community," p. 268.

[6] Jeffrey Harrop, *The Political Economy of Integration in the European Community* (Hants, England: Edward Elgar, 1989, pp. 55, 56. Small firms face administrative costs and regulations when seeking to meet cross-national technical standards or to merge with firms whose owners reside within another EC member nation.

integration have been illustrated by the favorable performance of the European Monetary System and studies such as the Cecchini Report.[7]

From the point of view of existing EC members, however, there are numerous disadvantages, whether real or perceived, to enlargement. Each of these problems must be resolved during negotiations to the satisfaction of each member before new applicants can expect approval of their membership application. Five particular disadvantages can be identified.

First, enlargement requires adjusting political institutions. For example, the size and relative voting power of each nation changes (e.g., the Parliament increased from 476 to 518 members after Spain and Portugal became members). Second, enlargement results in greater political, social, and economic divergence among members. The per capita income of Greece and Portugal is far below the EC average. There are different rules pertaining to working conditions and pay for women in the Mediterranean member nations as compared to comparable conditions in other EC member nations.

Third, increased membership means a larger agricultural sector. In the case of the Mediterranean enlargement the potential for higher Common Agricultural Policy (CAP) expenditures was significant given the large increase in farmland and the ability of the Mediterranean countries to produce large volumes of products heavily subsidized under the CAP (e.g., Spain - olive oil). Most of this increased cost would be born by wealthier EC members. EC farmers fear a loss of income following enlargement due to competition from new members whose products cost less (e.g., citrus fruits grown growth in Greece, Portugal, and Spain).

The fourth disadvantage perceived by wealthier members with lower unemployment rates is the threat of large migration of labor from poorer new members whose unemployment is higher and whose wages, working conditions, and benefits from social welfare programs are well below the EC average. Finally, members fear that allowing poorer nations to join the EC will result in additional financial burdens. The EC commitment to fund redistribution policies out of "own resources" obligates all members to contribute to the EC budget. Existing EC members with domestic economic problems may be unwilling to finance redistribution programs which will primarily benefit new member nations. In addition, EC financial assistance for modernization and restructuring their economy is available

[7] Paulo Cecchini, *The European Challenge: 1992 - The Benefits of a Single Market* (Hants, England: Wildwood House, 1988), p. 97.

to new members in order that they may begin adopting EC policies before they officially become members. For example, Portugal received funds prior to entering the EC in 1986 for structural reforms to assist its industries towards becoming competitive with other EC industries.

Revolutionary Hungarian Changes and the Growing Necessity of Hungarian Association with the EC

In 1989 revolutionary economic and social changes took place in Hungary and in all other Central and East European countries. The state socialist economic and social system had collapsed, proving its complete incapacity for providing further economic and social development. Elections took place and parliamentary democracies replaced the former political structure. In 1990 the new Hungarian government started to lead a great program of changing the old system to a modern democratic "market economy." Some of its primary objectives included:

1. Privatization of state-owned enterprises.
2. Changing the legal system to provide for more human rights, including greater economic and social freedom.
3. Liberalization of prices, wages, foreign trade, and foreign exchange in respect to foreign trade.
4. Making the forint convertible.
5. Introduction of a modern private entrepreneurial system.
6. Introduction of a new tax system harmonized with the developed industrial states.
7. Joining the EC and abolishing the state-managed foreign trade system (COMECON), particularly the prevailing trade agreements with the Soviet Union.
8. Restoring a proper business climate for foreign capital investors.

With the quick collapse of the Soviet economy and trade with other COMECON members in the past two years, it has become clear to the Hungarian leadership that it will be necessary to associate with the EC within the near future. Otherwise, the Hungarian economy remains isolated from the European economic environment. Not only has there been a collapse of trade relations among East European nations, but this condition is not likely to be alleviated through systemic changes in any of these economies during the next 2-3 years. Consequently, Hungary needs help in transforming its economic and social system.

In the final period of the Kadarian state socialist rule (1985-1988) the Hungarian economy started to decline at an accelerating rate. The actual systemic reforms introduced since early 1990 (e.g., privatization, reduction of subsidies, freeing prices, devaluating the forint, eliminating the state's foreign trade monopoly) not only have been unable until now to reverse the economic decline, but not surprisingly have aggravated the economy's performance. Tables 1-2 indicate the poor state of Hungary's economy and the adverse trends of the past few years.

TABLE 1: STRUCTURE OF HUNGARIAN GDP, 1990

GDP	\$3500 per capita (Hungarian estimate) \$2400 per capita (IMF estimate)
Private Consumption	21.0[1]
Public Consumption	4.0
Investment[2]	6.5
Investment in reserves	0.5
Balance of trade	1.0
Debt service	2.0
Total	35.0

1 - In dollars (billion)
2 - private and public
Source: IMF estimates, 1991.

TABLE 2

MAIN HUNGARIAN ECONOMIC INDICATORS, 1988-1991[1]

	1988	1989	1990	1991[2]
Industrial Production	100	99	91.5	90
Industrial Employment	100	98.3	91.5	88.6
Unemployment				
Number (000)	NA	NA	88	150
Percentage of LF	NA	NA	2.2	2.8
GDP	99.8	99.8	98.2	96.5
Investment	95	116	97.4	96.2
Consumer Price Index	112	115	129	125-130
Money Income	110	116	124	126
Foreign Trade	100	114.4	100	102

1- Previous year = 100
2 - January and February, 1991.

Source: Hungarian Statistical Yearbooks, 1988, 1989; Estimates of National Statistical Office, 1990/1991.

These tables illustrate several points. For example, by reducing subsidies and liberalizing other aspects of the economy the inflationary process accelerated, and in 1991 it is expected to reach about 40%. Hungarian government estimates are that it will decline to 10%-15% during the 1992-1995 period. When strict monetary policy was introduced, interest rates (for savings deposits) rose to 35%. Real wages have declined, resulting in a rapid decline of the marginal propensity to save. Since the end of COMECON, payments to trading partners must be in hard currency. As a result, there is a rapid reduction in Hungary's trade with the other East European nations, although there has been a minor increase in trade with OECD nations. One growing problem is the inability of Hungary's East European neighbors to pay Hungary in hard currency for previously contracted exports, resulting in financial hardships for Hungary.

The end of COMECON has meant that the SOEs which formerly produced for COMECON under bilateral trade agreements have had to restructure their production and foreign trade and to expand trade with OECD nations. However, the lack of modernized production facilities inhibits this process considerably. In addition, Hungary has seriously diminished subsidies to SOEs in 1989-1990. Consequently, many SOEs are unable to meet their expenses and face bankruptcy. Failure of SOEs is is reflected by the decrease in industrial production, growing inflation, and increasing unemployment (see Table 2). It appears that the primary resolution to the macroeconomic stabilization problem would be an increase in Hungarian exports to OECD nations after fundamental systemic changes have been introduced. Therefore, establishing closer relations with the EC is becoming increasingly important to Hungary as it seeks to achieve macroeconomic stabilization while reforming its economy.

Hungary-EC Trade Relations

The first official contact between the EC and nations which formerly belonged to COMECON came in 1973, one year after the Soviet Union officially recognized the EC as a political and economic entity. Between 1974 and 1988 the EC sought to work out "unilateral or autonomous commercial policy measures"[8] with individual East European nations, attempting to "strengthen the economic and political independence of the smaller Central and Eastern European countries in relation to the Soviet Union."[9] During this period Hungary joined the General Agreement on Tariffs and Trade (GATT), an important step for influencing subsequent Hungarian-EC trade relations. However, while the EC pledged that its members' discriminatory quotas against Hungarian exports would be eliminated (as required by GATT), the EC insisted that Hungary sign a bilateral trade agreement. This agreement effectively sanctioned the continuation of discriminatory EC trade practices against Hungary, a significant problem for Hungary, since over 450 of its products faced quantitative restrictions. Many of Hungary's most important exports were affected, including meat, produce (particularly heavy duties were levied against its agricultural products), beverage, tobacco, textile, chemical, iron, and steel products.[10] One analyst argues that the EC, while agreeing to Hungary's accession to GATT, "did not want Hungary to reap full GATT article I benefits. In particular, the EC wanted to maintain quantitative import restraints on Hungarian goods as a safeguard to assure that member states were also benefited by Hungary's accession to the GATT."[11]

The EC first approached Hungary about a trade agreement in 1983, a move welcomed by Hungary since it was continually seeking the elimination of the quantitative restrictions its exports faced under GATT. In June, 1986, a resolution passed by the EC Parliament established objectives for a trade and economic cooperation agreement with Hungary to serve as the basis for continuing negotiations. Included in the EC's resolution was a new proposal concerning tariff concessions on both industrial and agricultural products, elimination of the quantitative restrictions on imports from Hungary, industrial and technical cooperation, and the establishment of diplomatic relations.[12]

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[8] Moresceau, Marc, *The Political and Legal Framework of Trade Relations Between the European Community and Eastern Europe* (Dordrecht: Kluwer Academic Publishers, 1989), p. 3

[9] Hrbek, Rudolph, "The EC and the Changes in Central and Eastern Europe," *Intereconomics* May/June, 1990, p. 133.

[10] Hamori, J. and Andras Inotai, eds. *Hungary and the European Communities: Facts, Trends, Prospects* (Budapest: Hungarian Scientific Council for World Economy, 1987), pp. 55-64.

[11] deKieffe, Donald E., "European Community/Hungary Relations," *Case Western Reserve Journal of International Law*, Volume 21:55 1989, , pp. 59-60.

[12] Maresceau, *The Political and Legal Framework*, pp. 66-67.

In June, 1988 the Joint Declaration on the Establishment of Official Relations between the EC and COMECON was signed to encourage political and economic reform in Hungary. This declaration established the foundations for "bilateral agreements between the EC and individual COMECON members on trade and economic cooperation."[13] Hungary signed an agreement with the EC in September, 1988, aiming to expand mutual trade and economic cooperation - particularly in regard to increasing its access to resource supplies from the EC while opening new markets for Hungary and encouraging joint ventures and other forms of industrial cooperation between Hungarian and EC firms. One main feature of the agreement was that Hungary would receive most-favored nation status in accordance with the GATT regulations., with the exception that products covered by the ECSC treaty were excluded. The year 1995 was established as the target date by which all quantitative restrictions against Hungarian exports were to be eliminated.[14] The agreement also provided for tariff reductions, economic cooperation in the fields of energy, financial services, environmental protection, and occupational and management training. In return Hungary agreed "not to apply discriminatory measures and procedures in areas such as business facilities, import licensing, administration of global quotas for consumer goods, and the awarding of contracts."[15] This agreement was superseded in 1990 by a new proposal designed to assist both Poland and Hungary.

In recognition of the needed modernization and their unprecedented reform efforts the OECD nations decided to support Hungary's (and Poland's) reform programs. In mid 1989 the Group of 24 nations (G-24) offered financial and technical support for professional training and promoting investment. Known as PHARE, assistance for the restructuring of the economy, the program was designed to eliminate all specific quantitative restrictions on imports from Hungary scheduled to be dismantled by 1995 and to give Hungary greater agricultural concessions. In addition, the agreement pledged financial support from the G-24 nations for rebuilding infrastructure, professional training, investment promotion, and environmental protection. Under PHARE, Hungary also would be granted additional market access for textile, clothing, and steel products which increased the export potential for Hungary (by having its

[13] Hrbek, "The EC and the Changes in Central and Eastern Europe," p. 132.

[14] In fact, these restriction were eliminated by the end of 1990 as part of the PHARE program (see below).

[15] Maresceau, *The Political and Legal Framework,* p. 7

quota enlarged) by about 13%. The amounts allocated for Hungarian (and Polish) reform efforts were 300 million ECU for 1990. Trade with the EC has been growing in importance to Hungary over the past few decades. Presently the EC is Hungary's second largest trading partner, accounting for over one third of Hungary's exports and imports (see Table 3). The largest single EC customer has been Germany, which purchases about half of Hungary's exports to the EC and is the source of about half of Hungary's imports from the EC.

Important Hungarian exports to the EC include organic chemicals, medical and pharmaceutical products, textiles, iron and steel, electrical machinery, clothing, live animals, beverages and tobacco, and animal and vegetable oils. There has been a trend towards greater diversification of these exports in terms of an increasing share of manufactured goods. During the last decade, however, Hungary's competitiveness has diminished of such products due to production inefficiencies in Hungary as well as rising agricultural protectionism in the EC. Between 1970 and 1990 there was a decline in Hungarian agricultural exports to the EC, although chemical and raw material exports increased proportionately.

TABLE 3 HUNGARIAN EXPORTS-IMPORTS IN 1989-1990[1]

	Exports[2]				Imports[2]			
	1989		1990		1989		1990	
	$	%	$	%	$	%	$	%
EC	2390	24.9	3090	32.2	2450	27.8	2680	31.0
EFTA	1020	10.6	1140	11.9	1220	13.8	1320	15.3
COMECON[2]	5600	58.3	4600	48.0	5000	56.7	4000	46.2
UDCs	590	6.2	758	7.9	150	1.7	650	7.5
TOTAL	9600	100	9588	100	8820	100	8650	100

1- These data concerning Hungarian trade do not indicate the actual size of Hungarian-EC foreign trade, for there are not yet any real or total measures of the volume of trade for the newly emerging small private businesses.

2 - in million dollars for 1990; for 1989 figures are calculated for transfer rubles.

Source: *Hungarian Foreign Trade Statistics* (Budapest: Ministry of International Economic Relations, 1991).

Prior to 1990 Hungary experienced a growing deficit in its balance of trade with the EC. Hungarian exports often lacked competitiveness, and the CAP imposed a limit on imports of Hungarian food products, especially live cattle. In addition, since a small percentage of Hungarian exports to the EC are highly processed goods while a high percentage of Hungarian imports from the EC are processed manufactured goods, the terms of trade have deteriorated as far as Hungary has been concerned. However, in 1990, Hungary realized a trade surplus with the EC for the first time.

Hungarian-EC Negotiations Concerning Associate Membership Status

The European Council in December of 1989 decided to examine the issue of Associate Membership in the EC for East European nations "which successfully and purposefully followed their chosen path of thorough economic and political reform."[16] The EC was committed to completing negotiations with Hungary if the "basic conditions with regard to democratic principles and transition towards a market economy were being met."[17] The view of the Commission was that, consistent with the provisions specified in Article 238 of the Treaty of Rome, an association agreement with Hungary could include provisions pertaining to freer trade, economic and commercial cooperation, innovative investment programs, technical assistance and financial support, joint ventures for rebuilding infrastructure and modernizing industry, and discussions regarding democratizing Hungary's political institutional framework.[18]

Hungary approached the EC with its views on the substance of such an agreement in July, 1990, with the EC demonstrating its commitment to further integrating with Hungary by opening a Delegation in Budapest at this time. Exploratory talks began in September, and on the basis of these talks the Commission asked Council to approve specific negotiating directives for Hungarian associate membership by the end of 1991.

In 1990 the Commission and Hungarian authorities started debates about deepening political and economic cooperation. Measures were advocated that would encourage and promote further economic reform in Hungary through providing closer political and economic relations than existed between the EC and any other nonmember nation. The Commission was authorized to monitor the progress of Hungarian reform and to lend Hungary funds in order to enable it to overcome its structural adjustment problems. The sum agreed upon in February, 1990 was 870 million ECU for

[16] Hrbek, "The EC and the Changes in Central and Eastern Europe," p. 135.

[17] EC-Eastern Europe ICC Brief, p. 8.

[18] Ibid., p. 7.

a medium term loan, and subsequently another 1 billion ECU was allocated for assisting Hungary (and Poland) in 1992. Some of the particular targets of these funds are to modernize the infrastructure for foreign trade in Hungary, teach Hungary material and handling and packaging methods, develop and reform Hungary's vocational education, and encourage local social welfare projects through provision of training and technical assistance as well as finance.

For additional financial support the European Investment Bank was authorized to lend over 1 billion ECU to Hungary. Recognizing that funds in this institution were not sufficient for the massive reform measures needed throughout Eastern Europe, a European Bank for Reconstruction and Development was established. This bank, which formally opened April 15, 1991, was created to "promote productive and competitive investments in the Central and Eastern European countries, to facilitate the transition towards a market based economy and to accelerate the required structural adjustments. The Bank's main tasks would be to develop the competitive productive sector,"[19] especially promotion of private entrepreneurial activity. From the contributions of OECD and East European nations, the bank now has over $13 billion in capital with which to grant loans to assist the reform process throughout Eastern Europe.

Until the end of May, 1991, the official Hungarian-EC debate revolved around the following issues. The EC did not consider the development of Hungary to be sufficiently mature for granting full membership. In terms of the relative underdevelopment of Hungary, the nation has to resolve many problems while introducing systemic changes, including abolishing state dominance in economic activities, ending subsidies, and thereby the EC proposes an agreement be reached regarding associate membership. This agreement would contain a gradual and mutual reduction of some customs duties, elimination of the quantitative restrictions, among other provisions. The EC does not consider the offer of associate membership to be a guarantee of Hungary subsequently becoming a full member. While Hungary would like to attain full membership by the end of this century, some Hungarioans believe the EC does not intend to offer them associate member status on favorable terms (to Hungary), let alone full membership.

Other issues of concern to both sides include the number of stages and pace by which both sides will reduce customs and other restrictions; whether Hungary can attain some reductions in the customs charges of its

[19] EC-Eastern European Relations" ICC Background Brief (Luxembourg: Commission of the European Communities, December 7, 1990), p. 13.

agricultural exports as well as abolition of the quantitative restrictions it faces; whether the textile and steel export quotes imposed on Hungary will be reduced; whether an agreement can be reached concerning the free movement of labor and capital; how to adjust the social security system of Hungary to conform to the EC norms; the extent of financial cooperation to be provided by EC to Hungary, within the framework of PHARE (see below).

There is a general commitment by both sides in reaching an agreement by the end of 1991 which prescribes the mutual and gradual reduction of trade restrictions, but divergent views persist on key issues. In the industrial sector the weak Hungarian competitiveness precludes Hungary from accepting immediately free trade of industrial products. Meanwhile, from the EC's point of view the inhibiting aspect of reaching an agreement is the agricultural issue, where overproduction is the main concern. Hungary is concerned that the structure of its economy is not supplementary to the EC's needs. Overall, the Hungarian approach to becoming an associate member of the EC must be to adopt a gradual approach, but even if Hungary makes a limited agreement it will give Hungary some definite benefits.[20] Tables 4-6 illustrates the extent Hungarian relative underdevelopment, reinforcing the need for Hungary to proceed slowly to full member status.

[20] For further discussion see Dienes-Oehm Egon: Magyarorszag es a bozossegi tagsog.

TABLE 4
NUMBER OF UNIVERSITY GRADUATES PER 1000 MEMBERS OF THE POPULATION IN 1988

Country	Number of Graduates
Belgium	52.0
Denmark	36.9
France	49.9
Greece	27.5
Netherlands	40.6
Germany (West)	37.7
Italy	15.7
Portugal	13.4
Spain	26.0
Hungary	22.7

Source: *Statistics Yearbook, 1989* (Paris: UNESCO, 1989)

TABLE 5
OWNERSHIP OF TELEPHONES, RADIOS, TELEVISIONS, AUTOMOBILES IN 1988 PER 1000 MEMBERS OF THE POPULATION

Country	Telephones	Radios	Televisions	Automobiles
Belgium	476	465	320	366
Denmark	828	451	386	311
France	600	893	333	395
Greece	356	411	175	144
Netherlands	642	NA	325	356
U.K.	524	1145	347	349
Germany W.	659	385	385	470
Italy	664	266	257	392
Portugal	NA	212	159	202
Spain	399	295	368	278
Hungary	152	586	276	156

Source: *Statistics Yearbook, 1989* (Paris: UNESCO, 1989

TABLE 6
OCCUPATIONAL STRUCTURE OF SELECTED EUROPEAN COUNTRIES
(% of all occupied people)

Country	Manufacturing	Services
Belgium	57.7	42.3
Denmark	55.5	44.5
France	60.4	39.6
Greece	78.9	21.1
Netherlands	55.9	44.1
United Kingdom	59.3	41.7
Germany (West)	65.8	34.2
Italy	69.1	30.9
Spain	73.4	26.6
Hungary	78.0	22.0

Source: *Yearbook of Labor Statistics* (Geneva: ILO, 1988).

Given the occupational structure of the EC compared to Hungary, only in Spain and Greece are there a structure similar to Hungary's. Compared to the EC, the percentage of university graduates is quite small in Hungary. This indicates that Hungary is relatively undeveloped in terms of human capital as it embarks on its reform process. In addition, the undeveloped economic structure in Hungary is reflected by the relatively small ownership of telephones, radios, television sets, and automobiles in Hungary. Overall, from these figures it is clear that Hungary cannot adjust itself quickly to the EC and therefore can be associated gradually over a long (10 years) period during which time the nation will restructure and modernize its economy.

Advantages to Hungary of Membership in the EC

From Hungary's point of view becoming an associate member of the EC would give the nation almost full access to customs union, allow it privileged access for its industrial products, reduce to a certain degree the barriers its agricultural exports currently face, and make it eligible for subsidized loans, grants and special workers rights now available to EC member nations. In addition to gaining more political recognition associate membership would enable Hungary to become a part of Europe's dynamic political and economic changes, many of which originate within the EC. Rather than falling further behind economically, Hungary would "become more involved with the world economy . . . experience a social and economic modernization . . . and avoid the hazards of marginalization."[21]

Another benefit is that associate membership would enable Hungary to avoid any discriminatory practices except regarding agricultural trade imposed on nonmember nations as well as the impact of trade diversion and a deterioration in Hungary's terms of trade when important trading partners become EC members. Such was the case with the Mediterranean enlargement, which adversely affected Hungarian exports, especially agricultural products ,following the implementation of the CAP. Hungary fears similar losses following German reunification and anticipates further losses if Austria, another important trading partner, joins the EC.

[21] Inotai, Andras "The Single European Market 1992: Chances and Tasks for Hungary" *Trends in World Economy* (Budapest: Hungarian Scientific Council for World Economy, 1989), p. 33. Inotai argues that while a radical transformation of the "socio-psychic foundation" of Hungary is required, extolling the successes to be derived from EC membership, and the institutional reform it requires, is "an essential precondition for the dynamization of the economy." Hungary should not miss this chance to enjoy the dynamic benefits of integration with the EC, or it risks "fall[ing] far behind on a historical scale." pp. 34-36.

EC membership would enable Hungary to maintain its trading relations with previous important trading partners while avoiding obstacles to trade such as higher tariffs and quotas, licensing procedures, standards and technical regulations, and packaging and labeling requirements.

EC associate membership would also stimulate much needed reform and privatization of the obsolete state-owned enterprises, thereby prohibiting bureaucrats from protecting their control over resources. Integration with the EC "imposes an external discipline not only on individual companies but also on macroeconomic management."[22] Rapid structural shifts within Hungary would be necessary in the name of economic efficiency. Membership would result in "breaking the deadlock on microeconomic reforms." [23] As specialization of production was promoted, some resources would be liberated, others mobilized in the face of external competitive pressure. Among those likely to be affected dramatically are small traders, public trade monopolies, and most service industries - particularly those involved with retail trade, construction, transport, and finance.[24] On the other hand, Hungary would have easy access to shared research and development studies sponsored by the EC.

Associate membership obviously gives Hungary easier access to EC market, especially for its agricultural products. It has been argued that the agricultural potential for such exports to the EC "is one of the most important outlets for Hungarian agricultural exports," and could account for well over one fourth of such exports for Hungary (while the EC's imports of Hungary's agricultural products accounts for less than 1% of all EC agricultural imports).[25] This would stimulate the growth of Hungarian exports, thereby increasing the nation's purchasing power to obtain imports from the EC.

Until 1988 Hungary's main foreign trade partner was the Soviet Union, representing 30% of Hungarian exports and imports. The proportion of Hungary's trade with COMECON was 60%. By the end of the 1980s the proportion of Hungary's trade with all COMECON nations was declining rapidly, while Hungarian trade with EFTA and EC countries grew almost enough (about 60%) to offset the loss of trade with East European nations (see Table 3). However, while the Hungarian income from customs duties

[22] Hieronymi, Otto, *Economic Policies for the New Hungary: Proposals for a Current Approach* Columbus, OH.: Battelle Press, 1990), pp. 98,99.

[23] Weiser, T. and E. Kitzmantel, "Austria and the European Community," *Journal of Common Market Studies* Volume XXVIII Number 4 June, 1990, p. 449.

[24] *Ibid.*, p. 447.

[25] Hamori and Inotai, *Hungary and the European Communities*, p. 40.

is about $250 million per year from EC exports to Hungary, EC customs and agricultural levy fees imposed on Hungarian exports into the EC account for almost $500 million according to some nonofficial estimates. This increased cost is another reason Hungary is interested in membership with the EC, with the stipulation that Hungarian agricultural exports would face lower levies than currently exist. Concerning nonagricultural products, the customs duties collected by both parties is almost equal today. Hungary collects more duties as a percentage of its trade in nonagricultural products with the EC, but has a lower volume of trade relative to EC nonagricultural exports to Hungary.

Due to the greater mobility of labor and direct foreign investment following associate Hungarian membership in the EC, the wage gap between Hungarian and EC workers hopefully should be reduced - a positive effect (from Hungary's viewpoint) of the promotion of an international division of labor. Associate membership would also make it easier for Hungary to attract direct foreign investment and labor, thereby overcoming its persistent shortages of skilled managers, foreign exchange, and credit. There is considerable potential for such investment (once infrastructure has been modernized), for as of early 1990 the percentage of Hungarian industry owned by foreigners was only about 2%. Such investment will development entrepreneurial activity and a business culture throughout Hungary, transfer and diffuse technology and management know-how, and help restructure noncompetitive enterprises.[26] There is reason to believe such investment would be forthcoming for in terms of direct foreign investment by the EC throughout Eastern Europe, Hungary receives about half.[27]

One final benefit is that Hungary could cooperate with other EC members in activities providing assistance to underdeveloped countries. From this Hungary could benefit from expanding its knowledge of marketing. In addition, these activities would enable Hungary to make personal contacts and perhaps to extend the markets for its exports

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[26] Blue Ribbon Commission, *Action Program for 'Hungary in Transformation to Freedom and Prosperity'*, (Indianapolis: Hudson Institute, April, 1990), p. 48.

[27] Philip Revzin, "East-West Ties Are Fraying at the Edges," *The Wall Street Journal* February 22, 1991, p. A 8. Unfortunately, the volume of investment has been modest (about $500 million in 1990 - less than 2% of Hungary's capital needs). One problem inhibiting a greater volume of such investment is the poor infrastructure throughout Hungary, which prompted the G-24 nations to include funds for modernization of infrastructure in the PHARE provisions.

throughout the Third World.[28]

Overall, Hungary stands to enjoy numerous direct and indirect benefits from the EC. As a relatively small economy in which foreign trade is playing an increasingly important role, an export promotion policy, partly stimulated by greater direct foreign investment and qualitative improvement in Hungary's output and marketing methods, can best be pursued as an associate member of the EC.[29] There are, however, some very serious costs of membership that make full membership less attractive. Less important costs are associated with needed changes in customs administration and the statistical gathering system, but heavy social costs will emerge with privatization, restructuring of export sector, development of infrastructure. These costs are partly due to the systemic changes as well. One cost will be the dramatic impact on Hungary's industry, which currently is unable to produce competitive products. Mr. Kadar recently "concede[d] that if Hungary adopted all EC free-trade rules, 50% of our [Hungarian] industry would collapse overnight."[30] Hungary would face considerable legal obligations and the need to lower production costs and prices due to much greater competitive forces, among other problems. Some argue that in order to minimize such costs during a transition period Hungary should, prior to becoming a full member, engage in "trade suppression" by asking the EC for special concessions. In addition to financial support for restructuring, Hungary could request permission to maintain protective barriers (such as quantitative import restrictions) against EC imports for certain of Hungary's "sensitive products."[31]

From the EC point of view the costs of Hungarian membership could be relatively modest, considering that the size and composition of Hungarian production is similar to that of Portugal's and that Hungary is a "marginal supplier" of agricultural products to the EC.[32] The burden would fall most

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[28] Hamori and Inotai, *Hungary and the European Communities,* p. 14.

[29] The Blue Ribbon Commission recommends that in pursuing an "export-oriented development strategy" Hungary needs to engage in "liberalizing imports, ensuring the adequacy of trade-financing institutions; developing market information services, marketing capabilities, and training programs to enhance competitiveness on international markets . . . " Blue Ribbon Commission, *Action Program,* pp. 44, 45.

[30] Revzin, "East-West Ties," p. A 8.

[31] Robert C. Hine,"Customs Union Enlargement and Adjustment: Spain's Accession to the European Community," *Journal of Common Market Studies* Volume XXVIII Number 1, September, 1989, pp. 6,7.

[32] Hamori and Inotai, *Hungary and the European Communities,* p. 13.

heavily on the CAP and Regional Policy, with the need for subsidies and funds for development not insignificant. EC producers of particular products would also bear the burden from those goods Hungary can produce more cheaply. These include textile yarn and fabrics, some organic chemicals, and many agricultural products and live animals.[33]

There appear to be many potential benefits to the EC from Hungarian membership, although a thorough quantitative project of the costs and the following benefits has not yet been provided. Hungary's market is open, easily accessible for EC firms, and lies along an important trade route (the Danube) between northern and central Europe and Greece. The EC is interested in profitable investment opportunities in Hungary, attracted by the sale of state-owned enterprises, cheap, well-educated labor, and the demand in Hungary for quality consumer goods,services, and housing. The possibilities for joint ventures and licensing agreements are real in a country with a stable government committed to economic and political reform and a favorable business and investment climate. Hungary has a "high per capita foreign trade turnover,"[34] and a strong commitment to expanding trade with the EC. The nation has a history of cultural and economic ties to the EC (and EFTA), mainly to Germany and Austria. At present it has established more enterprises within the EC than has any other Eastern European nation, with the exception of the Soviet Union.

As we are informed, neither Hungarian nor EC analysts has prepared any estimations of the costs and benefits of Hungary becoming an associate member of the EC. The lost custom revenues and increases in custom fees can be estimated, but the costs of the needed systemic changes, infrastructure investment, and export sector's innovations are difficult to calculate. That is, it is very difficult to distinguish within the costs and benefits those directly related to Hungary associating with the EC and with Hungary's reforming its economy.

The debate between Hungary and the EC are not based on concrete analysis concerning advantages and disadvantages to either side. The costs of modernization of Hungarian industry is estimated to cost about $20-$30 billion, while the anticipated foreign capital inflows in the 1990s will not exceed $10-$15 billion. Thus, the probability of Hungary modernizing will depend upon the nation's ability to generate sufficient investment funds internally.

[33] *Ibid*, pp. 27-28.

[34] Currently the value of Hungarian imports plus exports exceeds 50% of GNP.

The Future: Conditions Hungary Must Satisfy, Likely Timetable, and EC Reservations about Hungarian Membership

There are many conditions which Hungary must satisfy before they can expect to be approved as a member of the EC. While the question of full membership is not pressing at this time, Hungary would like to attain this goal by the end of this century by developing its economy through associate membership in the EC. The current aim, therefore, is associate membership, and even before Hungary can achieve this goal there are serious conditions it must meet. In the short term the legal system has to be changed according to EC standards. There must be a radical change in ownership and control of enterprises in order to attain the dominance (greater than 50% versus the present 7% level) of the private sector. Large state subsidies to state-owned enterprises must be reduced, and those that are continually losing funds must be eliminated. Such a policy would release considerable funds, for between 1970 and 1990 about 12% of the state's budget was for subsidizing nonprofitable enterprises. Those who become unemployed during the transformation process (which may reach about 7%-10% by the end of 1992 if privatization proceeds as planned) must be supported by the state or reabsorbed into the economy (or high EC Social Policy costs will ensue). The work ethic must improve, particularly among those employed by the state.

The role of the state and its means of economic policy have to be reformed according to the needs and practices of EC nations. There must be effective monetary and fiscal policies, tax policies, budget policies (similar to budget practices of OECD nations), and Hungary must be willing to coordinate all of these policies with the EC. The monopolistic rights of the state have to be defined by rules similar to the international practice of EC members. State intervention in economic matters must be reduced dramatically.

The forint has to become freely convertible. However, high inflation (currently about 30%) must be brought under control before the forint can be expected to stabilize, thereby enabling Hungary to work within the European Monetary System. This will be easier to accomplish if Hungary achieves favorable rates of economic growth, and successfully implements structural change. Hungary must reduce its indebtedness, currently over $27 billion and the highest per capita in Europe. Debt service needs are about 8% of GNP, inhibiting the state from restructuring the economy in terms of funding investment for modernization of infrastructure and industry, among other needs. Simultaneously, the international balance of payments has to be improved significantly, for this would enable Hungary to cover its debt service obligations while diminishing its high indebtedness (Hungary must meet its international obligations as imposed by the IMF), thereby improving its investment capacities. The propensity to save must increase, for currentlythe level of domestic savings is very low. As a result, savings have not been a main source of funds for privatization, and the country must be able to finance investment to stimulate economic growth.

Within 3-5 years Hungary has to realize economic conditions that will enable it to follow the common rights and regulations and practices of the EC. The usual means of economic policy in Hungary must conform to EC norms and practices. The extent of state ownership of enterprises cannot exceed 50% (measured in terms of the value of output). There must be freedom of movement of goods and services, labor, and capital. Hungary must abide by the conditions for free competition and the customs union as specified in EC treaties.

In order for Hungary to be fully integrated with the EC it must be prepared to abolish all formal barriers to trade and mobility of resources, establish a coherent productive system capable of stable production and distribution of competitive (in terms of quality and price) goods and services.[35] Before its economy will be able to compete with the EC nations there must be strong linkages between sectors, and "the establishment of complete vertical chains from R&D, over the production of means of production, to production of sophisticated final products."[36] The extent of foreign control over Hungary's natural resources, industries, trade and financial institutions should not be too great. According to one view, Hungary will be in position to integrate when it attains a relative high degree of national self sufficiency (that is, imports are not more than 30% of GNP) and it can rely on domestic producers (rather than relying upon external sources) for many of its investment and production needs.

Regarding a likely timetable, Hungary must set realistic, practical objectives and adopt a gradualist approach. It may be 3-5 years or longer before the privatization process reaches the point at which at least 50%

[35] Jan Otto Andersson, "Economic Integration from an EFTA-Country EC Point of View, paper presented at the European Association for Evolutionary Political Economy meetings, Keswick, U.K., September 20-22, 1989, p. 4.

[36] Ibid., p. 5.

of the enterprises are privately owned, even with anticipated deeper participation of foreign capital inflows into Hungary. There must also be 5 or 6 years of favorable economic performance by the Hungarian economy before it will be able to compete more favorably within the EC. While there has not been sufficient cost-benefit analyses of Hungarian membership into the EC, there is a real danger that associate membership under the present EC proposal would hurt Hungarian industry without compensating gains from the agricultural sector. The non-official view is that Hungary can only be ready for full membership in 10-15 years only under the best future internal and external conditions.

There are some reasons for optimism regarding Hungary's capability for adjusting to the new economic environment. The expansion of small, private businesses has been rapid. There are signs of political mutual willingness for the founding of a new type of economic free trade zone among the former COMECON countries. The Hungarian economy responded well to the loss of COMECON trade, as it was in great part restructured to the Western markets. There was a balance of trade surplus in 1990 in excess of $1 billion, while in the first quarter of 1991 the surplus has been about $300 million. Social support for the state has been maintained even though during 1990 wages and salaries have decreased about 5%-6% in real terms. There are indications that inflation, which rose to 30% in 1991 due to state elimination of subventions, introduction of a new tax system, and raising the prices of energy products would be lowered in 1992 to about 15%, and that in 1993 inflation would stabilize at about 10%. Overall, Hungary's exports to EC markets have been growing while barriers are being removed. Technology transfer has become much easier.

SUMMARY

While the EC has reservations about admitting Hungary as a full member in the near future, it agrees that within this decade the conditions of this occurring could be attainable. The EC and Hungary have agreed to fix the aim of concluding an agreement concerning Hungarian associate membership by the end of 1991. While the EC recognizes Hungary's desire for full membership, it is not linking such membership to the granting of associate member status. In the next few years the EC is faced with completing the internal market, then considering the applications of Turkey, Austria, Cyprus, Malta, and Sweden (and perhaps Finland and Norway). In each case enlargement creates more political and economic problems for the EC, and once each of these nations is accepted the EC needs time to harmonize its internal structure. In addition, wealthier EC members will be inclined to resist redistributing their wealth to poorer applicant nations such as Hungary.

At present there are continuous meetings between Hungarian and EC officials about the Hungarian application to the EC. It is clear that Hungary is not likely to be able to meet the aforementioned conditions in the near future, so one should not expect that Hungary's application for full membership in the near future. The EC appears to agree with this contention, for their "integration" proposal concerning Hungary does not contain today more than elaboration of some kind of "Contract of Association." Meanwhile, Hungary will press to get an enlargement of free trade with the EC in the industrial domain, with improved customs conditions for Hungarian industrial exports to the EC. However, the EC wants to maintain the barriers for the Hungarian steel and textile exports to the EC. They intend to maintain the barriers for Hungarian agricultural exports, encouraging Hungary to open its internal market to the EC industrial exports and capital flows. According to the present Hungarian impressions, the EC wants to remain closed to outsiders by not permitting the process for accession of Hungary, Czechoslovakia, and Poland to begin. Instead, the EC intends to improve the conditions of foreign trade between itself and these East European countries without granting them too many privileges, especially full membership.

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