UNIVERSITY OF ALBERTA

Hungary: Transformation and Re-Integration into Europe, 1989-1995

by

Oona Esther Gyöngyike Schreiner ©

A thesis submitted to the
Faculty of Graduate Studies and Research
in partial fulfillment of the requirements for
the degree of Master of Arts

in

Slavic and East European Area Studies
Department of Slavic and East European Studies

Edmonton, Alberta
Spring 1996

ISBN 0-612-10683-7

University of Alberta

Library Release Form

Name of Author: Oona Esther Gyöngyike Schreiner

Title of Thesis: Hungary: Transformation and Re-Integration into Europe, 1989-1995

Degree: Master of Arts

Year this Degree Granted: 1996

Oona Schreiner

(Student's signature)

3435 - 86 St.

(Student's permanent address)

Edmonton, AB.

T6K 0H5

Date: April 18th, 1996

University of Alberta

Faculty of Graduate Studies and Research

The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies and Research for acceptance, a thesis entitled **Hungary: Transformation and Re-Integration into Europe, 1989-1995** submitted by **Oona Esther Gyöngyike Schreiner** in partial fulfillment of the requirements for the degree of **Master of Arts in Slavic and East European Area Studies**.

Supervisor - Dr. T. Yedlin

Dr. R.R. Gilsdorf

Peter Rolland

Dr. P. Rolland

Date: April, 9 1996

I would like to dedicate this thesis to my parents, Gyöngyi and Mátyás, who instilled in me a sense of my Hungarian heritage by teaching me the language and culture of Hungary, which was the motivation for writing this paper. I wish to thank them for the support they provided me throughout my years of study, for their advice and wisdom, and for encouraging me to work towards achieving my goals.

ABSTRACT

The purpose of this thesis is to examine the attempts by Hungary to transform itself from a centrally-planned, socialist dictatorship to a market-oriented, democratic state after the fall of the Iron Curtain in 1989. This process of transformation requires fundamental changes in Hungary's political, economic, foreign and social policies. These changes were initiated by the first post-Communist government elected in 1990 led by József Antall, and are continuing today under the direction of the socialist government elected in 1994, led by Gyula Horn.

A vital part of Hungary's transformation process is the assistance it receives from the West in the form of technology, expertise and monetary aid. Without this assistance, Hungary could never realise its goal of rejoining Europe and integrating itself into the European Union (EU). Although an Association Agreement has been signed between Hungary and the EU, full membership in the latter organisation will not be realised in this century, as Hungary must first coordinate all its policies and institutions with those of the EU, as well as modernise its infrastructure and bring its economy out of its current recession. Foreign direct investment is playing a large role in the modernisation of infrastructure and in technology-transfer, as multi-national companies are investing in Hungary's future in preparation for its foreseeable integration into the European Union.

ACKNOWLEDGMENT

I would like to thank Dr. Tova Yedlin for her insight and guidance during the preparation of this thesis and during my Master's degree studies in the programme of East European Studies. I would also like to extend thanks to all the professors and secretaries in the department of Slavic and East European Studies who have taught me and given me encouragement throughout my Bachelor's and Master's degrees.

TABLE OF CONTENTS

		Page
Introduction		1
Chapter One	Communism in Hungary, 1945 - 1989	5
	The Second World War	5
	Liberation and Subjugation	6
	Why did the Communists succeed?	8
	Stalin - The Sovietization of Hungary	10
	Revolution	15
	Restoration and Reform	17
	The New Economic Mechanism	20
	Reversing the Course of Reform	22
	The Second Decade of Reform	25
	Perestroika in Hungary	28
Chapter Two	The Transformation Process	31
	A. Why did the Soviet economic system collapse?	31
	B. Transformation of the Hungarian Political System	33
	C. Hungary's Economic Transformation	37
	The State of the Hungarian Economy	38
	Marketisation	42
	Privatisation	45
	Trade Liberalisation	48
	D. Transformation in Hungary's Foreign Policy	50
	E. Transformation of Hungary's Society	53
	F. The First Four Years of Transformation	58
	Political Transformation	58
	Economic Transformation	59
	Social Transformation	60
	General Assessment	61
	G. Socialism Re-Born	62

Chapter Three	Re-Europeanisation and Re-Integration	69
	A. Europe After World War Two	70
	The European Community	70
	EFTA	71
	Hungary and the CMEA	71
	EC-Hungary Relations under the CMEA	73
	EC-Hungary Relations in Transition	75
	B. The Integration and Unification of Europe	78
	The European Union	79
	The Visegrád Four and CEFTA	81
	The European Economic Area	87
	EU Integration or Enlargement?	88
	Are there alternatives to EU membership for Hungary?	93
	C. The Europe "Association" Agreement between Hungary and the EU	95
	The Benefits of EU Association	96
	The Disadvantages of EU Association	99
	Trade and the Association Agreement	100
	D. The New European Architecture	102
Chapter Four	Business and Investment	106
	A. Communist Reforms Invite Capitalism	106
	B. New Legislation	107
	C. Hungary's Investment and Business Climate	109
	D. Hungary's Future with the EU	112
	E. Canadian Investment in Hungary	114
	F. Hungarian Investors in the East	116
Conclusion		119
Bibliography		121
Appendices		125

LIST OF TABLES

Table		Page
1	Parliamentary elections for March 25 and April 8, 1990.	34
2	Percentage of Hungarians satisfied with the coalition government between March 1991 and June 1993.	59

LIST OF ABBREVIATIONS

AFD	Alliance of Free Democrats
AYD	Alliance of Young Democrats
CDPP	Christian Democratic People's Party
CEE	Central and Eastern Europe(an)
CEFTA	Central European Free Trade Agreement
CFE	Treaty on Conventional Armed Forces in Europe
CMEA/Comecon	Council for Mutual Economic Assistance
CPSU	Communist Party of the Soviet Union
CSBM	confidence- and security-building measures
CSCE	Conference on Security and Co-operation in Europe
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EEA	European Economic Area
EEC	European Economic Community (-ies)
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
EU	European Union
Euratom	European Atomic Energy Community
FDI	Foreign Direct Investment
GATT	Generalised Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	General System of Preferences
HCP	Hungarian Communist Party
HDF	Hungarian Democratic Forum
HSP	Hungarian Socialist Party
HSWP	Hungarian Socialist Workers' Party
HWP	Hungarian Workers' Party
IMF	International Monetary Fund
ISP	Independent Smallholders Party
MFN	Most Favoured Nation
NATO	North Atlantic Treaty Organisation
NORDEC	Nordic Economic Co-operation
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation on Security and Co-operation in Europe (see CSCE)
PHARE	Poland, Hungary Assistance for Reconstruction of the Economy
SPA	State Property Agency
UNO	United Nations Organisation
WEU	Western European Union
WTO	Warsaw Treaty Organisation

Introduction

The decade of the 1990s has seen amazing technological advances in the field of communications which has led to the globalisation of every aspect of business, capital markets, and the economies of individual countries, in general. Countries can no longer afford to seal themselves off from the economies of the rest of the world, and risk not being integrated into the developing global economy. In 1996, Hungary entered its seventh year of transformation since it took part in the unexpected peaceful "revolutions" of 1989 which announced the intent of Central and Eastern Europeans to end their seclusion from the West, permanently altering the global economic and political environment.

The historic events which have taken place since the 1989 transition from communism towards capitalism have been the subject of numerous published works over the past six years, however, few have taken the form of an up-to-date, comprehensive study encompassing the economic, political and social developments that Hungary has been undergoing in order to attain its goal of re-joining Europe. The purpose of this paper is to discuss Hungarian attempts to transform that country into a modern, Western, European nation which will be able to compete globally in the fields of business, industry, communications, science and technology, banking and finance, as well as in the realm of culture and the arts. The chosen path to Hungary's re-Europeanisation[1] is through integration into the European Union, and thus, the global market place.

In order to understand the unexpected turn of events in 1989, it is important to have some knowledge of the history of the Hungarian nation--a tiny country situated in the very heart of Europe with a population of only 10 million people. Its four-decade long domination by the Soviet Union, and the successes and failures of the political and

[1] A term denoting the process of re-assimilation by way of economic and political transformation which must be accomplished before Hungary will be considered a nation of Europe as epitomised by the member states of the European Union and EFTA.

economic reforms which took place before 1990 will be discussed in Chapter One. It is important to emphasise that during this time, a tangible element of polarisation developed between East and West, socialist state and capitalist state, as the two sides exhibited distinct ideological, political and economic differences. Moreover, a significant degree of economic disparity between the two trading blocs of the Council for Mutual Economic Assistance and the European Community developed, revealing in gaping economic backwardness in Central and Eastern Europe.

The conscious decision of the Hungarian government to reverse this trend will be reviewed in the second chapter, outlining the numerous changes in Hungarian political, economic and foreign policy, and in the social attitudes and mood of the populace over the course of the transformation since 1989. All of these changes are important in order to prepare Hungary for acceptance and re-integration into Europe. The achievements and setbacks experienced by the first government, and the hopes instilled in the present socialist government will also be reviewed.

The actual question of re-Europeanisation and integration into the European Union is dealt with in the third chapter. The re-integration of Hungary and the other countries of Central and Eastern Europe into the world economy is vital for the continued growth of their fledgling market economies and democracies. Only close and continuous contact with the West--and the European Union in particular--will be able to bring about the modernisation that is necessary for these countries' forward development. Re-integration is a very complicated process. The benefits and drawbacks of integration for Hungary will be examined in this chapter, as well as the preparatory measures which have already been taken by both Hungary and the European Union--for example, the signing of the Europe "Association" Agreement--and any possible alternatives to Union integration which may exist.

Hungary's business sector will be briefly looked at in the final chapter. Since the 1989 transition from a socialist system, Hungary has been the beneficiary of the majority of all foreign direct investment in the Central and Eastern European region. This is mainly due to the fact that in the 1970s and 1980s Hungary was more open to Western economic ideas, thereby creating a more stable environment for capitalist investors. The capital which has poured into the country has greatly aided Hungary's transformation process, and has provided Hungarians with one of the highest standards of living in Central and Eastern Europe. Although Hungary is still looked upon very favourably by foreign investors, capital is now being directed away from Hungary towards the other countries of Central and Eastern Europe, a trend tied to the maturation of Hungary's investment climate in relation to that of the other countries in the region. Changes in government policy and new legislation will also be discussed in the last chapter.

Having studied one year at the Budapest University of Economic Sciences (1993-94), the author was able to research primary sources such as the following Hungarian and European journals: Business Central Europe, Eastern European Economics, EIU European Trends, Hungarian Economic Review, HVG (Heti Világgazdaság) "Weekly World Economics", Invest in Hungary, RFE/RL Research Report. Moreover, first hand knowledge was gained from university professors, research papers and textbooks, such as Budapest Papers on Democratic Transition, Transformation and Integration in Central Europe, Occasional Paper Series: The European Community and Central European Integration: the Hungarian Case; and from researchers of other institutes, such as the Commission of the European Communities Delegation in Budapest which provided the author with European Community/Union documentation and the original text of the Association Agreement between Hungary and the European Union. Moreover, the author spent one year (1994-95) managing the Canadian Chamber of Commerce in Hungary, working closely with both the Canadian and Hungarian business communities, and the Canadian Embassy in Budapest, a position which provided access to such documentation as CanadExport, Hungary: The First Choice for Business in Central-Eastern Europe, and Investment and Business Guide to Hungary - 1992.

In addition to the above-mentioned primary sources, most of the secondary sources were acquired in Canada. The majority of historical information for Chapter One was provided by the following books: Hans-George Heinrich's Hungary: Politics, Economics and Society (1986), Bennett Kovrig's Communism in Hungary: From Kun to Kádár (1979), and Gábor Révész's Perestroika in Eastern Europe: Hungary's Economic Transformation (1990). Important secondary sources for Chapter Two and Chapter Three consisted of Batt, Lewis and White's Developments in East European Politics (1993), Richard Baldwin's Towards an Integrated Europe (1994), Henning, Hochreiter and Hufbauer's Reviving the European Union (1994), Thomas Pedersen's European Union and the EFTA Countries: Enlargement and Integration (1994), and Gregory Treverton's The Shape of the New Europe (1992).

It is the hope of the author that this paper will provide its readers with a more comprehensive grasp of the changes which have occurred since 1989, and will allow a better understanding of the difficulties which still lay ahead for Hungary and the countries of Central and Eastern Europe. This is a very exciting time in history, not just for Central and Eastern Europe, but for the entire world. The opening up of the formerly closed East Bloc countries is benefiting not only the peoples who live in this region, but also those who study its history, who visit its monuments and natural attractions, and who invest in its future. For over four decades the world was divided into two hostile camps, and now the time has come to unite and live together peacefully in a new global environment, and to learn from each other's unique differences.

CHAPTER ONE
Communism in Hungary (1945-1989)

In order to better understand the difficulties that Hungary is presently experiencing during its transformation from a socialist dictatorship to a system of capitalist democracy, it is important to have some knowledge of the history of the people living in Hungary today. The Hungarians have a rich one thousand and one hundred year old heritage during which the ancestral tribes fought their way from Asia westward across Europe until they were defeated by the Germans in the tenth century. These nomadic warriors then settled in the Carpathian Basin, embraced the religion of Christianity, and eventually became dominated by various empires--the Mongols, the Turks, the Austrians. After centuries of foreign domination, Hungary regained its sovereignty in 1867 when it became an equal ruler in the Austro-Hungarian Empire. The First and Second World Wars devastated the country and its people, and Hungary once again came under the domination of an empire from the East known as the Soviet Union. For four decades, almost completely sealed off from the West, the people of this tiny country withstood pressures to be Sovietised, and succeeded in once again joining the European family.

The Second World War

Hungary's modern misfortunes began with the ill-fated choice of supporting Adolf Hitler and Germany during World War Two. Although Hungary's aggression was minimal in comparison to Germany's, it was on the losing side in 1945 and at the mercy of the Great Powers. In October 1944, Sir Winston Churchill met Joseph Stalin in Moscow where he presented the latter with a proposal outlining the respective shares of influence the superpowers would have in certain liberated countries in terms of percentages: 10-90% over Greece, in favour of Britain; 50-50% over Yugoslavia and

Hungary; and, in favour of the Soviet Union, 75-25% over Bulgaria, and 90-10% over Romania.[1] These carefully calculated percentages were an exercise in futility, however.

At the Yalta Conference in February 1945, the Americans came to the conclusion that American and Soviet policies "may not be in harmony if the Soviet Union uses its position as the power in actual control of the execution of the armistice to intervene in Hungarian domestic affairs, to dominate Hungary, or to pursue a severe policy on the reparation question which would cripple the Hungarian economy." Nevertheless, the United States "would not, of course, take the position of supporting Hungary against the Soviet Union."[2] By the time of the Potsdam Conference in July 1945, it became clear that the Soviet Union was making no effort to honour the Yalta Agreements. Stalin informally commented that freely elected governments in the liberated countries would be *anti-Soviet* (therefore, not subservient), "and that we cannot allow". He did, however, profess that he had no intention of sovietizing the liberated countries.[3] Thus Berlin's imperialism made way for Moscow's. Hungary, and the other countries of Central and Eastern Europe, once again became pawns in the political games of the Great Powers.

Liberation and Subjugation

The people of Hungary had gone through terrible trials during the last months of the war, and were now attempting to rebuild their homes and their lives. They were more interested in domestic affairs as opposed to fighting for regaining the Hungarian territories lost after WWI. Modernisation and reconstruction were now the goals of the people, and the prevailing popular mood favoured major economic, political and social reforms. Nonetheless, many still feared the revolutionary impact of Soviet influence. The population identified communism with the Soviet Union, and the latter with Pan-

---

[1]Bennett Kovrig, Communism in Hungary, 154.
[2]Ibid., citing United States Department of State, Foreign Relations of the United States, 1945: The Conference of Malta and Yalta, 242-45.
[3]Ibid., citing Philip E. Mosely, Face to Face with Russia, 23.

Slavism; and the anti-Hungarian designs of the successor states (Czechoslovakia, Romania and Yugoslavia) were deeply enrooted in the national Hungarian consciousness. Subsequently, even twenty-six years after the fall of Béla Kun's communist government of 1919, Hungary's cultural and political ethos was less receptive than that of the other Central and Eastern European *Slavic* countries to the values that Stalin intended to implant in his newly acquired "buffer zone" against Western imperialism.

Accordingly, Stalin proceeded with more caution in fostering a compatible regime in Hungary, thus the Hungarian Communist Party's (HCP) leaders developed a strategy by which they would gain support in stages. The first step came in January 1945, in the form of a much-heralded land reform carried out on the initiative of the communist Minister of Agriculture, Imre Nagy. This reform eliminated the large estates, after which the rich peasant or smallholder took the place of the estate lord in the rural hierarchy. Next, in October-November 1945, came the first relatively democratic and free elections ever held in Hungary. The communists suffered an overwhelming defeat despite their solid programme of reform; large support-base in the proletariat and radical intelligentsia; control of the Trade Union Council, and civil and political police forces; and Soviet assistance. The clear winner of the elections was the Smallholders' Party which had a good majority of 57% of the votes and 245 Diet mandates out of a possible 409.[4] These elections made it clear that the communist party--despite its material assets and the popularity it gained from Imre Nagy's land reforms--would never gain power in Hungary through democratic and legal means. Doubtless the communists had foreseen this, for prior to the elections they had made agreements with all the parties of the provisional government stating that a coalition would be maintained regardless of the outcome of the November elections, and they insisted on being granted the key portfolio of the interior--which in the end facilitated their takeover of the country.

---

[4]Hans-George Heinrich, Hungary: Politics, Economics and Society, 27.

With this formidable weapon at its disposal, the HCP used a policy of gradual attrition (what Rákosi called "salami tactics")[5] to eliminate its rivals, clearing the way for a communist victory during the fraudulent September 1947 elections. Even so, the communist led coalition only gained 60.8% of the votes,[6] but by this point, the communists were the ruling power within the coalition, and therefore, within the government. The results signalled the end of Rákosi's experiment in semi-democracy, and the final step towards Hungary's complete incorporation into the Soviet sphere of power. All private industry and banks were nationalised and, in June 1948, the left wing of the Social Democratic Party was absorbed into the newly renamed Hungarian Workers' Party (HWP). Although the new *people's democracy* briefly gave the semblance of some form of pluralism and patronage of private farming, soon free enterprise and liberal democracy were effectively eradicated. Using first persuasion, then manipulation, then outright terror, with Soviet financial support and the assistance of the ever-present Soviet Red Army, the communists disregarded the preference of the people's majority for orderly transition to a democratic republic and seized power through a dictatorship.

<u>Why Did the Communists Succeed?</u>

The Hungarian people were proud of their ties to the modern, cultured and "democratic" systems of Western Europe, due to Hungary's status as an equal ruler within the Austro-Hungarian monarchy. There was a strong dislike between Hungary and its Slavic neighbours (with the exception of Poland, with which Hungary has always had a special friendship), and the Hungarian people feared the oppressive Pan-Slavism which threatened to engulf them. The ideology of communism--with its rejection of capitalism and democracy--was alien and alarming to most Hungarians, yet it was the system that prevailed. Why?

---

[5]Ibid., 28.
[6]Ibid., 29.

The transition periods after each world war were times of severe crises which were not only economic and political in nature, but also social, moral, psychological and ethnic. These were times of structural crisis, or of a complete collapse of the former system. Both times, the Hungarians had to rebuild their country, almost from the foundation up. During both periods Hungary had temporary status as an independent republic, but international power struggles intervened in any attempts to consolidate a truly Hungarian democratic system.

Even though both transition periods saw the birth of temporary pluralistic democracy through the proliferation of parties, the multi-party system eventually led to one-party rule because the prevailing parties had strong internal unity, whereas opposition parties were weakened by factionalism. Social factors were also at play during these times. Before 1945, Hungary was underdeveloped and 60% of its population lived off the land, however, land distribution was very unequal. 30% of the lands were owned by only 0.2% of the aristocratic landowners, whereas 94% of the peasant landowners owned another 31% of territory.[7] There was no sizeable bourgeoisie or entrepreneurial class to speak of, and the ownership of the majority of business and industry was concentrated in the hands of a few wealthy dynasties. This social background conveniently lent itself to an anti-democratic, authoritarian-type political system, making the takeover by the communists in 1948--and by the conservative regime of Admiral Miklós Horthy in 1921--ever so easy.

Undoubtedly, the factor which most negatively influenced the development of a democratic system in Hungary during the transition periods was the antagonism of the Western European powers towards Hungary at the close of the two wars. After WWI, the West refused trade relations with Hungary, forcing the latter to seek out Germany and Italy as trading partners, and later as allies. War reparations set by the Western powers caused an even greater burden on the devastated Hungarian economy which now only had

[7]Dr. László Szarvas, "Transition Periods in Hungary - The Chances for Democracy?" Journal of Theoretical Politics 5 (2), (1993): 270.

one-third of its pre-war resources from which to draw. Horthy's attempts at a separate peace in 1944 were also ignored by the Allies, forcing Hungary to rely on liberation by the Soviet Union. The ultimate factor was the West's apathy in protecting Hungary and the other Central and Eastern European countries from domination by the Soviet Union. Thus, the Hungarian Communist Party was able to control political power, because the Red Army controlled Hungary.

Stalinism - The Sovietization of Hungary

It is not the object of this paper to go into any great length in describing the atrocities committed as a direct result of the *Cult of Personality* of Soviet Communist leader Joseph Stalin--as numerous authoritative sources exist on the subject. Nonetheless, the deep wounds suffered by Hungary (some of which only began to heal after the third period of transition in 1989) as a result of Stalinist policies cannot be ignored.

The political system which prevailed in Hungary after 1949, as in the rest of Central and Eastern Europe, was a one party "dictatorship of the proletariat" embodied in the Communist Party, whose ideology was based on a form of Marxism-Leninism which had been altered by the cruel cult of Stalin. In 1947, Stalin declared that the United States' truly imperialistic intentions--as shown by the Truman doctrine and the Marshall Plan--proved that henceforth the world was divided into two antagonistic camps. It was up to the Cominform to replace the defunct Comintern and lead on the world revolution, and to ensure the Communist Bloc countries followed the official Stalinist line at all times.

In June 1948, the Yugoslav Communist Party leader, Josip Broz Tito, was expelled from the Cominform for failing to acquiesce to Moscow and submit Yugoslavia to strict Stalinist socialism. A wave of purges swept the satellite countries, uncovering "Titoists" and other deviants from the official line. Rákosi used this glorious opportunity to destroy his rivals for power within the HWP, executing László Rajk, a well-liked "home" communist who had been Minister of Interior until June 1948, and imprisoning Cardinal

József Mindszenty, a move designed to break the resistance of the Roman Catholic Church--the last vestige of hope of the opposition. By 1950, the purges had affected some 150 000 communists (including János Kádár, a future leader), social democrats and members of the general population who were arrested, put on trial, forced to sign statements of admission of guilt under torture and then either imprisoned, exiled or killed: a total of about 1.5% of the Hungarian people.[8] The purges left no opposition within the HWP, and the way was cleared for the tyrannical rule of Rákosi and his three henchmen: Ernö Gerö, Mihály Farkas and József Révai. As Imre Nagy recalled in the mid-1950s:

> Rákosi and the Party leaders, Gerö, Révai, and Farkas, seriously impaired the effectiveness of the Communist principle of criticism and self-criticism within the Party and government. They generally considered criticism from below as the voice of the enemy and acted accordingly. They did not criticize one another but shielded each other from criticism. They took even the mildest form of criticism as a personal insult. According to them, mistakes could be made only at the lower echelons. They themselves were infallible and could do no wrong.[9]

With the help of the Cominform, Stalin successfully sealed off Hungarians from the West behind what Churchill described as an "Iron Curtain". Hungarian society was turned inside out: Western and Hungarian national culture was supplanted by programmes of Sovietisation and Russification; regimentation and brutal class discrimination became characteristic of the regime's totalitarian attempt to create socialist super humans; trade unions were subverted and became the agents of state control; and mass organisations were used to ensure ritualistic obedience to the god-like leaders Rákosi and Stalin.

During the years 1945-48, Hungary busied itself with economic reconstruction: the currency was stabilised in 1946, damaged factories were rebuilt, a Three-Year plan would see the gradual nationalisation of industries. In contrast, the peasants were handled cautiously. Their attachment to individual holdings was deeply rooted, and their hatred of

---

[8]Heinrich, 32.
[9]Kovrig, 238, citing Imre Nagy, <u>On Communism: In Defence of the New Course</u>, 279.

communism stemmed from the 1919 experiment with collectivisation. The 1945 agrarian reform aided their individualism by creating 400 000 new small holdings, and the granting of new plots of land ensured the existence of some 200 000 peasants.[10] Regardless, the reform was orchestrated chiefly by the Communist Imre Nagy whose hidden motivation was the *gradual* collectivisation of the land, once the sector became prosperous and the peasants realised the efficiency behind such a system. It cannot be denied that the Hungarian agricultural sector was revolutionised by this reform, as it wiped out the centuries-old feudal system and ushered in a new age of cooperation between agricultural and industrial worker. Social advances were also impressive: the standard of living of workers and intellectuals equalled and even exceeded 1938 levels; new institutions of learning of various levels were established; and the system of workers' benefits was expanded. Plant committees saw a bright future for industry in Hungary, as they enthusiastically participated in management operations. The speed with which Hungary was able to rebuild itself before the takeover of the HWP in 1948 amazed the world.

However, in 1950, Stalin ordered the commencement of the first Five-Year Plan (1950-54), the objective of which was mass industrialisation and collectivisation. The imposition of this Stalinist model had dire economic consequences for Hungarian society and cut short all hopes of a progressive, democratic, industrial future. The elimination of the private sector had already begun in 1948 through the use of various methods, such as over-taxation in order to force the bankruptcies of companies and shops which were then taken over by the state. This first Plan was designed to turn Hungary into an "iron and steel country",[11] according to Gerö, its chief architect. This was required by Stalin's new "war economy"--a paranoic concentration of all resources on the building up of the military in order to protect communism against the imperialist threat. Rapid

[10]François Fejtö. Behind the Rape of Hungary. 13.
[11]Kovrig. 255.

industrialisation was the order of the day. The activities of public sector companies and factories were made independent of price and market effects, making quantitative growth the primary objective. Favourable statistics were fabricated about the fulfillment of unfulfillable quantitative quotas. Production costs and efficiency were neglected. Emphasis was placed on the development of the heavy industrial sector while neglecting the production of consumer goods. What production there existed of consumer goods was not connected to the economic principles of supply and demand, resulting in vast surpluses and shortages. The raw materials needed for such production often had to be imported from the Soviet Union, at rates higher than the international price, and the finished goods were then bought back at rates lower than the international market price.

At the same time, despite the misgivings and protests of the Minister of Agriculture, Imre Nagy, an all out war was declared on the peasantry, especially against the class enemy: the rich *kulaks* (numbering some 70 000 peasants,[12] half of whom were actually middle peasants). They were harassed with increased taxes and quotas at low prices in order to ruin their profitable existence and force them into joining the collective farms (*termelöszövetség, TSz*). Ironically, the 1945 agrarian reform designed to win over the peasantry to the Communists' side actually worked against the latter during this period of collectivisation, as the peasant had tasted the prosperity of private ownership of his own land, and he would not relinquish this without a fight. In 1953, the Communists had managed to collectivise only 20.3% of all arable land,[13] and even these 3 768 collective farms were operating poorly because the government was unable to provide them with adequate guidance and machinery, and their workers were drawn mostly from the less competent landless peasantry (19.1% of the working peasants).[14] Agricultural production suffered, and output declined to well below pre-war levels. As a result, Hungary was

[12]Ibid., 257.
[13]Heinrich. 31.
[14]Kovrig. 259.

transformed from an exporter to a net importer of grain, and the country's standard of living decreased dramatically to pre-war levels.

According to the Communists, the crash industrialisation programme was a tremendous success because the national income had increased, the size of the industrial proletariat class had risen to an impressive number (682 108 in 1954),[15] and total employment had been reached. However, the people of Hungary could paint a very different picture of the "successes" of the first Five-Year Plan. Hungary's social structure was turned upside down: between 1945 and 1953, some 350 000 to 400 000 families[16] belonging to the former middle and upper classes were forced to find new places in society. Their homes were confiscated and they were dismissed from their occupations in order to make room for the new industrial class and the new ruling elite of the Party. Subjected to humiliation and mass deportations to the countryside, they were only allowed a meek subsistence. The old intelligentsia fearfully withdrew from any political activities, and the new intelligentsia was classed mainly by occupation, rather than by education. Public and private morality was degraded as the population realised that this new system rewarded the Party faithful with powerful positions, regardless of education or experience. The Party's perversion of morality induced widespread alienation and anti-social behaviour. Popular dissaffection grew as the people were manipulated by propaganda, and terrified into submission by the Party's reign of terror. The new constitution--which came into force on August 20, 1949, the traditional St. Stephen's Day, celebrating the anniversary of the birth of a nation, being renamed Constitution Day--paid tribute to the Soviet *liberators* and established Hungary as a people's democratic state on the road towards full socialism. The constitution declared that Hungary was a "state of workers and working peasants",[17] and that anyone not belonging to this class of *working people* was denied full political rights in the *democratic* People's Republic of Hungary.

---

[15]Heinrich, 31.
[16]Kovrig, 261.
[17]Ibid., 253.

Thus, the Party made it clear that within the system of Hungarian Stalinism, "Those who are not with us, are against us."[18]

Revolution

Joseph Stalin died on March 5, 1953, and the new Soviet General Secretary, Nikita Khrushchëv, ushered in the period of the "thaw". Rákosi was criticised by the Central Committee for his Cult of Personality, and a programme of reforms was initiated, calling for the realisation of collective leadership, and more focus on consumer and light industries. Peasants were allowed to leave the collective farms (approx. 130 000 out of 380 000 left by December 1953), and consequently the standard of living rose by 15% in 1954.[19] The popular moderate, Imre Nagy, was named Premier, and he attempted to democratise the Party by introducing secret voting ballots, by lifting discrimination against "class enemies", by decentralising authority, and by emphasizing legality (many formerly condemned Communists were rehabilitated, such as Rajk and János Kádár). Of course, these reforms created other economic problems, such as inflation, increased foreign debt, and lower productivity. The re-introduction of a private economy jeopardised the Party's monopoly. Since Rákosi was still General Secretary, he could counter the reforms by calling Nagy's Party loyalty into question. On April 14, 1955, Nagy was expelled from the Party on accusations of having pursued "rightist, opportunist policies... factionalist methods".[20]

On May 15, 1955, Austria's neutrality was declared, ending all allied occupation of that country. This new development made it illegal for the Soviet Union to maintain Red Army divisions on Hungarian soil. However, the Warsaw Treaty Organisation (WTO), a mutual defense pact signed one day earlier between all satellite countries and the Soviet Union, legitimised the continued presence of Soviet troops in Hungary, thereby protecting Rákosi's dominance. Contrary to his own personal feelings, Rákosi was forced to make

18Heinrich, 31.
19Ibid., 32.
20Ibid., 33.

symbolic concessions in the name of the human rights clause of the Paris Peace Treaty signed after WWII. Only then was Hungary admitted to the United Nations Organisation. In 1956, Khrushchëv introduced a "New Course" which reversed virtually every trend that had characterised Stalinism. Consequently, Rákosi's plans to re-establish the status quo as it had existed before Nagy's interference did not materialise, for Khrushchëv sent the Party down a path of economic neo-Stalinism, blended with moderate political relaxation and decentralisation, and a policy of "peaceful co-existence" with Tito and the West.

Khrushchëv's now famous "Secret Speech" read at the Twentieth Congress of the Communist Party in Moscow in February 1956 marked the beginning of a new era in Central and Eastern Europe and precipitated Rákosi's downfall. In July he was replaced by another Stalinist, Ernö Gerö, who tried to take a slightly more liberal path, but he too was swept aside by the tide of change. More people were rehabilitated, and Imre Nagy was reluctantly readmitted to the Party on October 13th due to popular pressure which wanted to see Nagy as Premier once more.

The people of Hungary became swept up in the exhilaration of the new freedoms. A peaceful demonstration by students and hundreds of thousands of other Hungarians on October 23rd--who called for the reinstatement of Nagy as Premier while shouting anti-Soviet slogans--escalated into a full-blown popular revolution when the Hungarian secret police fired on the unarmed crowd. The people prevailed, and on October 24th, Imre Nagy was appointed Premier and János Kádár became General Secretary of the Party, and a multi-party system was restored. On November 1st, Nagy announced his decision to withdraw Hungary from the WTO, and he also requested the United Nations to recognise Hungary's neutrality. Tragically, Red Army troops attacked the capital on November 2nd, crushing the Revolution three days later at the cost of serious destruction to some parts of the city and the loss of 25 000 Hungarian lives. An additional 150 000 people had been injured during the fighting against heavily armed Soviet divisions, and in the next few days, approximately 200 000 citizens fled the country.[21] Kádár, who had secretly collaborated with the Soviets during the Revolution, set up a communist counter-government--renamed the Hungarian Socialist Workers' Party, HSWP (*Magyar Szocialista Munkáspárt*)--after the withdrawal of the emergency Soviet military units.

Restoration and Reform

Kádár was met with strong resistance in all areas, for in the eyes of the Hungarian people, he had betrayed his country. However, all resistance was shortly wiped out by judicial proceedings which resulted in a purging of the old Party, and the arrest of 20 000 citizens, of whom 2 000 were executed and thousands more were deported to Soviet labour camps. The chief instigator of the "counter-revolution", Imre Nagy--who had been abducted by the Soviets and taken to Romania shortly after the Revolution was crushed--was executed on Moscow's orders in June 1958.

Once the HSWP was again heading along the *right* road towards socialism, Kádár began a policy of economic reform which was a middle path between the Stalinism of Rákosi and the very liberal reforms of Nagy. The Revolution and its aftermath had cost the country one-fifth of its GNP.[22] Since a policy of more rational and decentralised planning was rejected, economic recovery was painfully slow. However, industrial production did reach pre-Revolution levels by mid-1957.[23] These successes were due mostly to three years of profitable harvests, a reduced rate of investment, a very low defense budget, external assistance in the form of Soviet credits and goods amounting to some US$ 275 million,[24] and a deeper integration into the Council for Mutual Economic Assistance (CMEA or Comecon) which provided Hungary with much needed raw materials and a guaranteed market. This agency for regional economic coordination had

[21]Ibid., 37.
[22]Kovrig, 339.
[23]Heinrich, 40.
[24]Kovrig, 325.

been established in January 1949, but remained largely inactive during Stalinism. Re-invigorated in 1958, trade was conducted bilaterally between the Soviet Union and each Communist Bloc country, and bilaterally between the satellites, on terms set by the Soviet Union according to interests favourable to the latter. The satellite countries were generally exploited in this way, and the Soviet Union became their largest trading partner, almost to the total exclusion of trade with the West, which increased only in later years.

The most important task at hand for the HSWP was to regain the support of the peasantry and to make the transformation to the final collectivisation of agriculture more attractive. The Revolution had brought about a flight of peasants from collective farms, thus by mid-1957, the proportion of collective farm workers out of the whole reached a low point of 6.1% (122 456 individuals), and the number of farms declined to one-third of the 1949 level, while private farms increased by 15%.[25] In January 1959, a new collectivisation campaign was put into effect which tried to focus on using fiscal incentives and persuasion, rather than force, to get peasants to join the collective farms. Numerically, these measures could be considered successful since 75% of the workforce had been collectivised by 1962.[26] Economically, however, the programme was a failure because the new collective farm workers preferred to cultivate their own private plots, refusing to work during regular hours, which subsequently reduced production to pre-war levels, and dramatically decreased family incomes. Only enormous state subsidies were able to save Hungary's socialist agricultural sector--an investment which paid off in the long term, as the mechanisation of this sector contributed to its eventual prosperity and stability.

In March 1962, the HSWP Central Committee announced that the laying of the foundations of socialism had been completed by way of collectivisation, and that a giant leap towards the integration of "the working class, the collectivised peasantry, and the

[25]Ibid., 340.
[26]Heinrich, 40.

intelligentsia into a unified, socialist society"[27] had taken place. Henceforth, the HSWP was committed to *co-operating* with the population, rather than coercing it--a policy supported by the anti-Stalinist line of the Soviet Communist Party's Twenty-Second Party Congress. In keeping with this, the famous slogan: "Whereas the Rákosiites used to say that those who are not with us are against us, we say those who are not against us are with us",[28] set the mood for Kádár's new "Alliance Policy" (*Szövetségi Politika*).

The Alliance Policy was an official and radical break with Stalinism, and opened the way for future liberalisation and the establishment of a socialist democracy. Class discrimination in education was eased; amnesties were granted to "counter-revolutionaries", and a final amnesty declared in March 1963 freed most political prisoners. Democracy within the Party was revitalized through the secret ballot; more and more non-party experts were called in to assist in Hungary's modernisation; and non-party members were also given important positions within the state and economic apparatus--as Party loyalty ceased to be the single criterion for such appointments. Kádár won an international victory with his new Alliance Policy when in 1963 the United Nations restored Hungary to full member status, and dropped from its agenda the annual resolution condemning the Soviet and Hungarian governments for their refusal to withdraw the Red Army and restore human rights; thus releasing him from "diplomatic purgatory".[29] True, Kádár's new conciliatory policy did thaw public opinion somewhat in his favour, but most Hungarians still saw him as the man who had betrayed Hungary and the Revolution.

The year 1963 was a turning point in the history of Communism in Hungary. It was at this point that the Party officially recognised and accepted the fact that economic problems could not be solved through politics, and that the opposite would have to be the case, thus giving the economic system unchallenged priority. It was clear that the

[27]Kovrig, 350.
[28]Heinrich, 40.
[29]Kovrig, 350.

traditional command economy was no longer viable, especially for a small country like Hungary with limited natural resources. Hence in December 1963, a plenum of the Central Committee directed Finance Minister Rezsö Nyers to devise a programme for economic reform. Nyers submitted his report in November 1965, which was approved by the plenum in May 1966. It was only after two years of impressively careful preparation that Hungary's "New Economic Mechanism, NEM" (*Uj Gazdasági Mechanizmus*), took effect January 1, 1968.

The New Economic Mechanism

It is ironic that the English acronym for the New Economic Mechanism, "NEM", means "no" in Hungarian. One could say that the Hungarians were actually attempting to *negate* and reject their past economic system and to create a new one. This new economic system differed radically from its predecessor. The new model was a clear break with the past socialist command economy. (See Appendix 1 for the main features of the NEM.)

The positive effects of the new mixed economic system were soon felt. The country's gross national product grew faster than its total output as a result of a decline in the intensity of production in the energy and raw-materials sectors. Exports, including those to Western countries, increased in importance as supply became better adapted to effective (monetary) demand. Enterprises were able to obtain necessary goods from the West with more ease. The terms of trade improved yearly at a rate of 1-2%, and foreign trade also became more balanced. Subsequently, economic growth was boosted, and in the first period of the reform (1967-71), national income grew by 6-7% annually, as compared to 4-4.5% in previous years.[30]

These economic successes had a positive affect on the national standard of living. During this first five-year period, the real per capita income increased at a constant rate of

[30]Gábor Révész. Perestroika in Eastern Europe: Hungary's Economic Transformation, 1945-1988. 80.

5-5.6% annually, or by one-third for the entire period.[31] Consumer-goods shortages all but disappeared due to the improved balance between supply and demand, and the consumer-goods market was also stimulated with the import of Western consumer goods (as Hungary's current account improved) by the few companies granted permission to trade with the West. Average Hungarians were able to buy more consumer goods as a result of rising incomes and greater supplies. They also gained the right to buy convertible currency for travel outside of Hungary--including the West--every three years. (The citizens of other East Bloc countries, except for Yugoslavia, were not awarded this right until the mid-1980s.) Ultimately, the subjective value of the forint increased, and Hungarians began to work harder to produce higher-quality goods in order to earn more forints.

Hungary's economic successes gained the country much political respect in comparison with the rest of the East Bloc, and Kádár was internationally hailed as a great reformer. There was some economic jealousy in the Bloc, as the other countries complained that "the Hungarians live too well",[32] and politically there were subdued, vague remarks and criticisms regarding the NEM. But this did not bother the Hungarians who were proud of their new accomplishments, and considered themselves the pioneers of guiding socialism--and the economies of the other socialist countries--towards a more humane course.

Of course, the reform did have its negative side. The new economic model was hampered by the fact that the government and bureaucracy still controlled many aspects of planning and the domestic market, which was characterised by very strong, artificial monopolies and oligopolies. There was also a lack of consumer-price reform, and trade with the CMEA countries was still based on inter-government agreements and the artificial currency called the "clearing ruble"; meanwhile, trade with the West was hampered because of government limits on trading permits. All this strongly distorted the

---

[31] Ibid.
[32] Ibid.

Hungarian market despite the reforms, keeping Hungary relatively independent of, and sealed off from, the world economy. By 1971, a significant shortcoming of this "mixed economy" emerged: a drastic deterioration in the balance of trade had occurred due to the rapid increase in the import of Western technology and consumer goods. Moreover, the reform had not taken into account that a market economy cannot function without the integration of commodity, capital and labour markets, as it had been assumed that the commodity market would be the only one burdened with the pains of reform.

Despite these problems, in 1971-72, the government was making plans and preparations to continue the reform and to introduce more changes. In 1972, Nyers's Committee on Economic Policy had prepared a report summing up the 1968 reform. One of the points in the report states that "*application of the declared principles of economic management* in the specific system introduced in 1968 *was severely limited by circumstances* . . . Consistent and full implementation of the principles of the party resolution on economic management has still not taken place to this day."[33] Thus, the new reforms planned for 1975 would attempt to fulfill the aims of the first reform period, while bringing Hungary more in line with a real market economy. However, national and international events and decisions set a different tone in the early 1970s, resulting in the moderation and eventual dismissal of a new period of reform.

Reversing the Course of Reform

It must be remembered that there was little or no change in the political situation in Hungary during the first period of reform. The HSWP still held complete control over society and Kádár was still supported by Moscow and supportive of Leonid Brezhnev, the CPSU General Secretary since 1964. As a result, there were three undeniable factors causing the reversal of the New Economic Mechanism in the years just leading up to and following 1973: the Soviet factor, the conservative factor, and the external factor.

[33] Ivan T. Berend, The Hungarian Economic Reforms, 1953-1988, 200.

In a radio interview held May 1988 in Budapest, Nyers suggested that "the main factor in the arrest of his programme in the early 1970s was the Soviet Union. Moscow, he claimed, failed to take account of international economic realities and in particular the resilience of capitalism in the midst of the new technological revolution. It therefore behaved in a narrow dogmatic way, failing to listen to a reasoned case and pressing on Budapest the need to change course."[34] Brezhnev was determined to stifle all attempts at reform throughout the Soviet Bloc. In light of his invasion of Czechoslovakia in 1968 to crush the Prague Spring--the aim of which was to develop *socialism with a human face*--Hungary and Kádár were quite fortunate to be allowed to even begin the NEM, but by 1973, Nyers was no longer Minister of Finance. Later in 1980, Hungary looked with apprehension on the birth of *Solidarity* in Poland, and the subsequent imposition of martial law in 1981 at the urging of Moscow, for fear of repercussions and similar tightening of control in the rest of the East Bloc.

In 1971, the Soviet Union did tighten the reins in the East Bloc somewhat, and as a result, the CMEA adopted the Comprehensive Programme in December. It was designed to solidify the self-sufficiency of the region, and to stabilise its inter-nation economic relations. One new agreement, for example, specified that each country would now concentrate its industrial production on certain goods to avoid duplication. Thus, Hungary was ordered to stop producing automobiles, and concentrate its production on buses. This effectively ensured the interdependence of each country. Satellite countries were also entitled to invest in and contribute capital to large (mostly Soviet) projects--using up large portions of their budgets.

Although the Soviet Union may have been the primary evil preventing Hungary from advancing economically to join the world market, conservatism at home also played a large role in the reversal of the reforms. Ironically, it was Kádár himself--the man who

---

[34]William Wallace, "The Context of Reform," Roger A. Clarke, ed., Hungary: the Second Decade of Economic Reform, 1.

had sanctioned the 1968 reform programme--who continued to subserviently follow Moscow's line. He sent an invasionary force into Slovakia when the Prague Spring was crushed, and he clearly opposed Solidarity. Eventually he became opposed to any form of reform, having been in power too long, and personally fearing any degree of its loss.

During this time, the capitalist world market was also undergoing some crises and restructuring: in 1971 the United States withdrew from the international monetary system based on the gold standard established at Bretton Woods in 1945, and the dollar was devalued; the oil-price shock of 1973 had far-reaching consequences as oil prices rose to four times their 1970 level by 1977; the inexpensive labour and production costs of newly industrialising third world countries was forcing down the price of goods world-wide; and in the early 1980s, the European Community began its policy of subsidised agricultural exports which was felt by non-EC countries, and once again pushed down food prices.[35] Many of these external factors did not affect Hungary until a few years after the fact for the simple reason that the country was locked into an artificial economy linked to an artificial trading block which controlled prices and disregarded the law of supply and demand.

Hungary's economic future took a decided turn for the worse when it signed a trade agreement with Moscow in January 1975. Up to this time, the East Bloc had been completely sheltered from the economic consequences of the 1973 oil crisis as the CMEA economic union had not changed its orientation towards heavy industry to reflect world conditions. However, with this agreement, Moscow would gradually bring its energy and raw material prices in line with world market conditions. For a country as poor in such resources as Hungary, this had a devastating inflationary effect on its economy, as the price of raw material and energy imports rose 52%, resulting in a deterioration in the terms of trade within the CMEA.[36]

---

[35]Révész, 86.
[36]Kovrig, 393.

A political policy reversal resulted in the dismissal of many of the architects of the NEM (including Nyers), and brought about a new series of *corrective* measures, introduced in January 1976 to cope with the crisis. The measures would restrain consumption, raise prices of basic consumer goods, and slow the increase in the standard of living. A new system of economic regulators increased the scope of informal state intervention in business, strengthening recentralisation. The 1976-1980 Five-year Plan, which concentrated on joint CMEA investment projects and restricted the competition of enterprises, was not altered. By the 1970s, Hungary's debt had grown to dangerous levels, prices and inflation were increasing, real wages were falling, as was the standard of living. In April 1978, the Central Committee of the HSWP came to the resolution that the NEM was indeed viable, and there was a need for reform and the phasing out of subsidies. A revitalised reform programme was quite possible, for the basic institutions of the NEM--the absence of compulsory planning indicators and the institutionalised market orientation of enterprises--were still in place and could be used to make significant breakthroughs in Hungary's economic system.

The Second Period of Reform

It is true that Kádár's "goulash communism" (as the primitive, Hungarian mixed economy came to be called) had ensured Hungary a greater degree of political freedom and economic stability than any other East Bloc country, but by the early 1980s, the former was also suffering from the protracted crisis in the world economy. It soon became very apparent that the half-measures and conservative state interventionism used to *restore order* would no longer alleviate the economic difficulties, but rather, contributed to them. In order to survive, Hungary had to distance itself from autarchy, and truly break free of its isolation from the world market. This perhaps would not have been as easily attainable, if not for a series of political changes and crises occurring in the East Bloc during the late 1970s and early 1980s.

At the November 1978 meeting of the CPSU, Brezhnev stated that "the improvement of planning should be accompanied by measures aimed at perfecting the entire economic mechanism".[37] Consequently, many Soviet, Polish, and even Chinese economists announced their interest in the Hungarian reform process pertaining to the economy and agriculture, and favoured implementing similar reforms. In Hungary, itself, the old conservative elements of the Party were giving way to reform-minded ones. The Soviet invasion of Afghanistan in 1979 proved to be a turning point in policy in the East Bloc. This invasion, and the subsequent defeat and disgrace of the Red Army, seriously undermined the Soviet economy, and the loss of thousands of Soviet soldiers decreased the popularity of the Soviet government at home. The leaders of Central and Eastern Europe began to question Soviet policy and the Soviet government lost much credibility, for it was no longer looked upon as being infallible. The emergence of Solidarity in Poland and the imposition of martial law that followed discredited the Polish Communist Party and its policies. The fact that the Soviet Union did not intervene, as it had in Hungary in 1956 and in Czechoslovakia in 1968, gave the signal that the concept of reform would survive. After Brezhnev's death in 1982, came the final break with Stalinism, and minute holes began to appear in the Iron Curtain, allowing some rays of hope for progressive change in the future. The slightly more liberal policies of his successor, Yuri Andropov, brought about the prospect for change, which was reinforced by the eventual accession to power of Mikhail Gorbachëv in 1985.

The new period of reform was to take place in two phases: consolidation followed by renewed growth. Consolidation entailed a halt to the deterioration of the hard-currency current account; improvement of Hungary's credit-worthiness; reduction of domestic consumption; monetary contraction; restrictions on enterprises exporting to socialist countries; a lengthy monetary squeeze; and the renewal of measures outlined in the original reform. All this was supposed to take three years to accomplish, and it would go

[37]Berend, 238.

ged period of adjustment to the world economy in the 1980s.[38] The sixth (1981- d seventh (1986-90) five-year plans drew directly upon these proposals, however, ungarian economy was worse off in the second half of the 1980s than at the ning of the decade primarily because the Communist leadership was not concerned h about the possibility of future crises, and therefore, no reserves were ulated; inefficient economic units continued to be subsidized by the state; and gement changes were not strong enough to affect individual companies or to then the market forces.[39]

general, an even less transparent indirect system of macroeconomic management d in the 1980s during which export incentives and import restrictions grew oread; price, wage and credit regulations were used to influence the fortunes of dual enterprises; and the tax system was used to attain a general contraction.[40] All ot in vain, however, for within three to four years after 1978, Hungary had managed ilise its debt and then reduce it.[41] This was an enormous and almost unprecedented which was attained without serious social tensions, but which also exhausted the y's reserves, causing Hungary to stagnate even further in comparison to the rest of orld economy. The realisation that the reforms were failing, that enterprises were singly dependent on state subsidies, and that the economy was stagnating caused ng dissatisfaction amongst the populace which started to lose faith in the nment. There was an outcry for dramatic change. The survival of communism in ary depended on it.

---

sz. 101-103.
103-104.
. 121.
. 123.

Perestroika in Hungary

Mikhail Gorbachëv took office as General Secretary of the Communist Party of the Soviet Union in March 1985. He put his Party and his country to a challenge: the transformation of the Soviet Union into a scientific and technological giant by the turn of the century. It was no longer sufficient to produce great quantities of goods which could not compete on the world market. The Soviet Union had to modernise and improve the *quality* of everything it manufactured in order to catch up to the West. This entailed a major `restructuring' of the entire Soviet economic system--thus was born the idea of *perestroika*. Along with this restructuring, Gorbachëv introduced changes within the actual Party and declared a new `openness' or *glasnost'* which would change East-West relations forever. Gorbachëv's liberal and modern thinking, and plans for wide-sweeping reforms, gave the satellite countries the green light to go ahead with reforms of their own. It was also realised that the Soviet Union was taking less and less direct interest in the political affairs of these countries, giving them free rein to do almost as they pleased. It is paradoxical to think that Hungary needed Gorbachëv to find the road to true economic and political reform, yet Gorbachëv's *perestroika* was based on some aspects of Hungary's liberal and reform-minded 1968 NEM.

The situation in Hungary was changing at a break-neck speed as it entered its third period of transition. The May 1988 Party Conference was the breakthrough for which the country had been waiting: delegates were not elected according to the old election system, but rather by a system of representation. As a result, one-third of the old Central Committee members were replaced by fresh faces, and five members of the Political Committee--all trusted allies of Kádár--were also removed. This one conference ended the thirty-year long autocratic rule of János Kádár within the HSWP. The Party committed itself to constitutional reform, the enhancement of the powers of Parliament, and the establishment of a constitutional court. The Party announced a turn towards a mixed ownership structure (i.e. strong economic privatisation); a mixed economy (unlimited by the qualifier "socialist"); and a policy which combined economic with political reform. Kádár remained in the Party as the ceremonial chairman, but the power and general secretaryship passed to Károly Grósz. Grósz seemed to have accepted the aforementioned changes, but, like Gorbachëv, he was opposed to party pluralism: power could be sampled by others, but he would not share it with anyone. Thus, "political pluralism" could exist as long as it was *socialist* pluralism within the HSWP.

Rezsö Nyers and Imre Pozsgay were elected to the Political Committee in May 1988. Nyers was directed to establish advisory groups to bring new ideas--but not new people--into the decision-making process. Pozsgay's new task was to review the past and future of the Communist Party in Hungary. In so doing, he became strongly reform-minded, and pushed the somewhat less progressive Grósz to take even more liberal steps towards reform.

The year 1989 was a watershed in the history of Hungarian transition. Events changed so quickly--not only in Hungary, but in the rest of the East Bloc, as well--that the world could hardly catch its breath as it watched the disintegration of forty years of communist oppression in Central and Eastern Europe. In January, Pozsgay was able to convince Grósz, who was beginning to see that change was outrunning him, to accept the view that the 1956 Hungarian Revolution was not a counter-revolution, but a popular uprising crushed by undemocratic forces. In February, Hungary was transformed into a true multi-party state (*de facto* opposition parties had existed since 1988, but at the time they were legally only associations or movements). In March, the government announced that it might enter into a coalition. In answer to political and humanitarian pressures, the electrified fence at the Austro-Hungarian border was dismantled in May, allowing hundreds of East Germans to escape to West Germany. In the summer, the honorary reburial of Imre Nagy, the national hero of the 1956 Revolution, and the death of János Kádár a week later, finally closed a solemn chapter in Hungary's history. In October, a momentous decision was made to change the name of the Hungarian Socialist Workers'

(Communist) Party to the Hungarian Socialist Party (HSP), thereby entirely renouncing Leninism, and adopting social democratic reforms. And on November 9th, 1989, the Berlin Wall--the physical embodiment of the Iron Curtain and the Cold War which symbolised a forty-year hatred between East and West--was officially opened, then torn down, marking the end of Communist dictatorial rule in Central and Eastern Europe, and the beginning of true and honest rapprochement and friendship with the West. The true triumph followed in March and April of 1990, as Hungarians freely voted and democratically elected their first non-Communist government since 1948. The third period of transition had brought about a rebirth which would lead Hungary down the road towards a genuine market economy and political democracy.

In the twentieth century alone, Hungary has undergone three periods of transition: 1919, the end of W.W.I and the communist experiment of the Béla Kun government, followed by the conservative government of Miklós Horthy in the interwar period; 1948, the end of W.W.II and the victory of the Hungarian Communist Party over democracy; and 1989, the renunciation of communism by the countries of Central and Eastern Europe, and the end of the Cold War. Each transition period was an attempt by the people of Hungary to gain independence and establish a democratic system of government. However, the first attempt was unsuccessful due to the authoritarian rule of the Horthy regime, and the second did not succeed due to the presence of the Soviet Red Army. The third transition was a success due to the disintegration of the Soviet Empire and its sphere of influence in the region. The Hungarian people must now attain the goal they initially set out to accomplish with the 1848 Revolution for independence from Austria: the establishment of a truly democratic, self-governing state. Today, only the fundamental transformation of Hungary's political, economic and social systems can lead to full integration with the economies of Europe and the world.

CHAPTER TWO
The Transformation Process

Since the fall of the Berlin Wall and the rapprochement between East and West, Hungary has set its sights on finally rejoining the European family from which it had been sealed off for four decades. Due to the fundamental differences between the systems of the capitalist democracies and the socialist dictatorships, this re-Europeanisation will require the CEE countries to first transform their systems so that they become compatible with those of Western Europe. Hungary's political, economic and social transformation will be discussed in this chapter, along with policy changes concerning foreign affairs. The results of the first four years of transformation under Hungary's first post-communist government will be reviewed, followed by a look at the progress of the present government.

As mentioned in the previous chapter, Hungary underwent three periods of transition during the twentieth century, but now the country must undergo a drastic *transformation* in order to accomplish its goal. When speaking of the distinctions between the terms "transition" and "transformation" in an economic or political context, transition often entails measures for short-term stabilisation, whereas transformation involves a long-term systemic change. Thus, in the simplest terms, transformation in Hungary means the replacement of the "socialist" planned economy with a market economy.[1] Before entering into discussion about the recent transformations in CEE, the reason for the initial failure of the previous system will be briefly discussed.

A. Why did the Soviet economic system collapse?

The performance of the Soviet economy had been generally poor in the 1980s, and deteriorated rapidly after 1985, leading to the collapse of the entire system in 1991 with

[1]Tibor Palánkai. Transformation and Integration in Eastern Europe (1994), 3.

the disintegration of the Union of Soviet Socialist Republics. An analysis of the causes of this collapse is relevant to the transformation process of the newly independent satellite countries and former Soviet republics in Central and Eastern Europe, because the old system has left a legacy of severe institutional problems directly related to these causes, which will require radical, yet well planned solutions.

There are two schools of thought concerned with identifying the cause of the collapse.[2] The first school states that socialism was functioning quite well before the ascendance of Mikhail Gorbachëv to the position of General Secretary of the Communist Party of the Soviet Union (CPSU) in 1985, and any difficulties experienced by the Soviet economy at this time could have been corrected by modernisation, discipline, and minor improvements in planning and administration. According to the advocates of this school, it was *perestroika*, with its conflicting objectives and policies, which introduced poorly designed and unnecessary half-measures into a system which was otherwise stable and which held the confidence of the people in general. The first school blames all adverse development since 1985 on the reforms, and accuses Gorbachëv of dismantling the old system before another coherent system could have been erected in its stead.

The second school of thought insists that the "command economy" was a system which had never been viable from the beginning, and had managed to survive for as long as it did only through sustained growth in the basic factors of production (land, natural resources, capital and labour)--at the expense of the standard of living of the population--and through the sheer strength and oppressive measures of the dictatorial regime which controlled the day-to-day existence of every citizen. However, this growth could not be sustained for much longer, as raw material extraction was becoming more and more expensive, technological progress was being retarded by institutional factors, and increasingly inferior goods were being manufactured.

---

[2]Vladimir Treml, "Debate: Why Did the Soviet Economic System Collapse? Two Schools of Thought." RFE/RL Research Report 2, no. 23 (June 4, 1993): 53.

Evidently the case of Hungary is somewhat different since private property and limited entrepreneurism had always played a more prominent role in its economy than in the U.S.S.R., as had the reforms of the 1968 NEM. Nevertheless, the collapse of the socialist systems in the countries of the East Bloc prior to the disintegration of the Soviet Union was due primarily to the non-intervention of the Soviet Red Army in the domestic affairs of these countries--in contrast to previous intervention when these states had attempted to secede from the Soviet family. In Hungary, this began in the early 1950s, culminating in the Hungarian Revolution of 1956. Many western scholars argue that the Soviet system was in fact not socialist, but rather a perversion of Leninist socialism, which in turn was a loose adaptation of true Marxist socialism, and therefore cannot be used to assess the viability of a genuine socialist model. Therefore, although there is validity in the first school's argument that the haphazard manner of Gorbachëv's reforms did contribute to the accelerated deterioration of the Soviet economy in the 1980s, the fact that the Soviet economy was in such a state of total stagnation leads one to asssume that the Soviet Union would have eventually collapsed with or without Gorbachëv and his *perestroika*.[3]

B. Transformation of the Hungarian Political System

Hungary's third period of transition has been called a peaceful, "negotiated revolution"[4] because the change in systems came about through lengthy negotiations between the socialist government and its opposition in 1989, as opposed to a bloody coup d'état. It is to the credit of the representatives of the previous socialist system that they were conscious of the trends developing in this society-in-transition throughout the bargaining process by which they would *willingly* relinquish power. Countless new laws were brought into force between September 1988 and January 1990 by Parliament, the government, and teams of experts who also took pains to ensure that measures were in

[3]Ibid., 54.
[4]Nigel Swain, "Hungary," Judy Batt, Paul G. Lewis, and Stephen White, eds., Developments in East European Politics, 70.

place in order to pave the way for the new political system which would establish government in Hungary by the rules of classical division of power. Thus, during the March and April 1990 elections, the people of Hungary were provided with the option of voting against the old regime and everything for which it stood, in favour of the new political forces representing a Western-type multi-party democracy diametrically opposed to the former.

The 1990 election results were an interesting example of a democracy in the process of being born. A total of 84 parties had been formed since 1988, of which 64 were registered and 48 intended to run for election. Only ten registered parties made it to the national list, and of these six were voted into parliament (see Table 1).[5] However, no party gained an absolute majority, and the Hungarian Socialist Workers' Party (HSWP)--formerly *communist* party--did not even place in the top six. Since it did not win any seats, it was excluded from parliament and from an active political life. Even though the Hungarian Democratic Forum (HDF) was the largest party in parliament, it did not have an absolute majority, and therefore had to build a coalition with three of the other elected parties: the ISP and CDPP were chosen because of their similar ideologies.

Table 1. Parliamentary elections for March 25 and April 8, 1990; share of votes on the regional list (%) and the number of seats won.

Party	List	Seats
Hungarian Democratic Forum (HDF)	24.73	165
Alliance of Free Democrats (AFD)	21.39	91
Independent Smallholders (ISP)	11.73	44
Hungarian Socialist Party (HSP)	10.89	32
Alliance of Young Democrats (AYD)	8.95	22
Christian Democratic People's Party (CDPP)	6.46	
Hungarian Socialist Workers Party (HSWP)	3.68	
Hungarian Social Democratic Party (HSDP)	3.55	
Agrarian Alliance	3.13	1*
Other (incl. jointly sponsored)	5.49	10*

* Candidates won seats in individual constituencies outright in the first round even though their parties did not cross the 4% of the total vote threshold to enter parliament.

[5]Ibid., 73; *Source:* Adapted from Magyar Közlöny ("The Hungarian Government Gazette"). 1990, no. 25.

The six parliamentary parties could be split up into three broad ideological groupings: the coalition government of the HDF (which originated from "populist" dissidents), the ISP and the CDPP (both re-founded parties from the 1940s) represented Christian-nationalists; liberals and social-liberals were represented by the AFD and the AYD; and social democrats were represented by the HSP. All six parties supported a variation of the "social market economy", and all favoured, in varying degrees, an increase in the profile of Hungarian cultural heritage. They disagreed on priorities in social policy, on the pace of privatisation, and on the desirable degree of state intervention in the economy. The most marked difference was in the importance each gave to individual liberties in relation to collective obligations to family, Church and nation.

The most important task which the new government faced after its election was the establishment of new institutions devoted to democratic and pluralistic process. This process of transformation included the founding of a Constitutional Court, the establishment of the unprecedented post of president of the republic, and the re-birth of the Parliament to ensure it truly reflected the existing power relations between the political parties according to the spring elections. The coalition government in itself was a radical break with every aspect of the practises of the previous forty years. The development of local power relations, both in terms of the people involved and government structure, followed suit after local government elections were held in the Fall of 1990. This concentration on the establishment of key democratic and pluralistic institutions was very important for the new system to prove that it was fundamentally different from the old regime, and therefore, more acceptable when presented to the world at large.

Alongside this promising and successful new liberalism, a form of post-communist conservatism was developing within the government of Prime Minister József Antall, the leader of the HDF party. In many instances, Hungarian conservatism was taking the form of interventionism, which translated into state *control* rather than *guidance* in the economic sphere. Examples of this control could be found in the government's, rather than Parliament's, control of the State Property Agency (SPA) which ensured state assets were not undervalued during "spontaneous privatisation"; and in the government intervention of the media's liberties--the long overdue media law has still not been passed. Conservatism also manifested itself in the coalition's nationalist platform, making it difficult to control right-wing party extremism which had intensified as third world immigration increased.

Perhaps the most important political development which has taken place in Hungary is the people's ability to exercise their right to voice their concerns and opinions without fear of retaliation. Countless *peaceful*, mass demonstrations of thousands of citizens, as well as strikes and workers' protests, have taken place in Hungary since 1988. At first, those in power feared that all such gatherings would lead to another 1956, but the population has admirably refrained from any negative action while exercising its rights, showing that moderation often gains the upper hand in such instances.

Despite these breakthroughs, many political issues remain unresolved. One issue concerns the very high proportion of people failing to show up at polls to vote during elections, thus not willing to exercise their fundamental political rights. While this is quite disconcerting, it could perhaps be attributed in part to the people's lack of confidence in the new decision-making mechanism, and their bewilderment over the sudden barrage of *choice* and the necessity to accept the political responsibility which accompanies democratic values. Another issue regards the composition of Hungary's future political elite. In 1990, the ruling elite was composed of professionals without a political background. Although the 1994 Socialist Party victory brought back many former, "experienced" government members, the majority of opposition members remains the same. The question is whether this elite will remain, or whether a new elite of politicians will be produced from within these and other groups which have the support of the population, and then push the present players out of the game.

The only certain thing at the moment is that the old system had collapsed and Hungary is rebuilding in a Western democratic style. The tasks of the initial years in power concerned the laying of the political and institutional foundations of the new system. Hungary can proudly say that it possesses political parties, a genuine Parliament and Constitutional Court, autonomous local governments, and most importantly, the beginnings of a truly democratic political culture amongst the ruling elite and the population in general. The next step in the transformation process required the initiation of economic reforms which would allow Hungary to rejoin the world market and thereby modernise its industry and technology, and raise its standard of living to equal that of the West.

C. Hungary's Economic Transformation

In addition to political reforms, government must initiate reforms in the area of economic policy, since radical economic restructuring goes hand in hand with political transformation. As was already outlined in the first chapter of this paper, Hungary's policy reforms date back to the 1950s when economists attempted to implement their ideas on reforming the Soviet-type centrally planned economy. These previous reforms failed for many reasons: they were only partial and half-hearted; they never dealt with the question of private ownership (the central element of the market economy); the artificially constructed market of the CMEA was not as demanding in terms of quality and speed of delivery as were Western markets. Undoubtedly, the primary reason for failure was the lack of change in the political system. Without concurrent political and ideological reforms, the economic reforms only succeeded in alleviating the effects of the most severe problems. Throughout the 1960s, 1970s and 1980s, truly comprehensive attempts to develop and implement new economic models failed primarily because of the Communist Party's monopoly of political power and its insistence that it retain central control over economic processes to an extent that undermined the effectiveness of the operation of the market. In addition, the regime lacked basic popular legitimacy--since it had *taken* power instead of being democratically elected in the first place--and, therefore, it knew that any reform-induced decrease in the standard of living would cause it to lose its traditional support base amongst the working class.

The events of 1989 fundamentally changed these political conditions by completely sweeping aside the power of the communist party and its ideology. Thus, the economic order of the day was no longer mere *reform*, but actual *transformation*, or, the creation of "a market economy without any qualifying adjectives",[6] as Miklós Németh (the last pre-1990 prime minister) so aptly explained. As a result, the aim of the new Hungarian regime was to separate politics from economics; in other words, to establish an economic system that would function primarily according to the laws of the market rather than according to bureaucratic political preferences imposed, often against all economic logic, through directive central planning. Thus, all the qualitative changes mentioned in the previous section have aided and will aid in ensuring that the economy is guided by the laws of the market, and will be subjected to free criticism and checked by democratic parliamentary control.

The State of the Hungarian Economy

Before delving into the necessary strategies required to ensure a successful economic transformation, one should be familiar with the state in which the Hungarian economy is currently. Beginning with a recession in the 1980s, Hungary has been experiencing a deep "transformation crisis" similar to that felt during the Great Depression.[7] Industry and agriculture have been the most harshly hit: industrial production fell 29.4% between 1987 and 1992, and the value of agricultural investments fell 20% between 1985 and 1992. Since 1991, the sharp fall in agricultural production has been the result of many factors: elimination of state subsidies (completely by 1992); the collapse of the CMEA

[6]Judy Batt, East Central Europe from Reform to Transformation, 72.
[7]Palánkai, (1994), 10.

markets; a sharp reduction in domestic consumption; the growing indebtedness of agricultural cooperatives; the unfavourable price trends for agricultural products; and inconsistent and contradictory government legislation.[8] Since Hungary's economy depends in many ways on the welfare of its agricultural sector, the modernisation of this sector is of a key concern to many planners.

As Janos Kornai states: "In Hungary, the growth of production had slowed down long before the system change, and then it was followed by long stagnation."[9] He explains that when a post-socialist economy makes the transition from one permanent market regime, the seller's market, to another permanent market regime, the buyer's market, it is unable to reach a situation of ideal equilibrium, and so it simply *tips over*. A dichotomy has developed between the rapid growth of mostly private small and medium-sized enterprises (SMEs), and the crisis of the rapidly shrinking large, state enterprise sector. In general, in CEE, the state sector has suffered considerably from the agonies of "pre-privatisation" (high debts, lost markets, large-scale bankruptcies, unskilled management), while private enterprises have increased their production levels by 15-25% a year.[10] However, since the growth of the private sector has been mostly self-financed up to this time, the negative effects of the collapse of state-owned companies have been largely counter-balanced.

According to many economists, the recession has been heightened by the inconsistencies and crises in Hungary's external markets. The sudden collapse of the CMEA markets--and the resultant drop in domestic consumption--has undoubtedly been the cause of many bankruptcies and economic woes. However, Hungary's ability to quickly redirect its trade towards the countries of the European Union and the OECD aided in alleviating this crisis (exports to OECD countries increased by 48% between

---

[8]Ibid., 11.
[9]Ibid.
[10]Ibid., 13.

1989 and 1991).[11] At the beginning of the transformation process, controlled inflation and restrictions on full currency convertibility boosted confidence in the forint, making Hungary the favoured investment target in Central and Eastern Europe. New entrepreneurial energies have been released due to the liberalisation and market-orientation of foreign trade, and cheaper imports for domestic consumption have improved competitiveness in many sectors. In addition, increased exports to the West gave the false impression that the enormous external debt inherited from the Communists could be managed. Realistically, these initial successes could not be sustained. In 1993, Hungary experienced a drop in exports of nearly 20%, with only a 6% increase in imports, resulting in a $2.3 bn trade deficit. Trade liberalisation caused more domestic demand for the Western imported goods, whereas without real structural modernisation, Hungarian goods could no longer compete with those of better quality from the West. Investors are discouraged by high real interest rates (about 10-12%),[12] tax burdens, and low profitability in the industrial sector.

Since 1992, Hungary has been sinking deeper and deeper into a severe fiscal hole, as its budgetary balance continues to grow in the negative. The reasons for this are many-fold: state-enterprises have been squeezed by the recession; the number of bankruptcies continues to grow; economic activity has shifted to the lesser-taxed private sector; unemployment benefits and other welfare programmes are increasingly burdened; subsidies have been re-introduced for financially troubled state-enterprises; the costs of restructuring these enterprises are huge; and, of course, the burden of the growing interest on the accelerating public debt. On top of this all, the Hungarian budget is very heavily burdened by foreign indebtedness, and as a result, in 1992, Hungary sank below the threshold of "critical indebtedness" (30% of the debt service ratio and 15% of interest payments in total export earnings),[13] mainly because it has been faithfully servicing its

[11]Ibid., 14.
[12]Ibid., 15.
[13]Ibid., 20.

ocial tensions are rapidly increasing due to the sharp rise in the unemployment rate (a vely new phenomenon), the decrease in real wages, the fall in the standard of living-eading to the possibility of strikes and social unrest. Inflation is rampant in Hungary. he Ministry of Finance had quoted the prospect of 10% inflation and 6% growth in as a realistic medium-term possibility for stabilising Hungary's economy.[14] ever, much of Hungary's population takes part in the hidden or "black" economy, ting in unaccounted for and untaxable income for many citizens.

summary, the general performance features of the past communist system were icterised by low efficiency, acute shortages, sluggish innovations and slow iological progress, waste and dislocation of resources, stagnation, poor product ty, consumer neglect, unreliability of supplies, low work discipline/ethics and iess morals, distortions of distribution, poor social services (contrary to propaganda, h degree of social injustice exists), and militarisation of the economy. The economic ies of Hungary's post-Communist governments have had to focus on structural ms which would change the actual mode of operation of the economy because the omy's ability to adapt had completely degenerated, and Hungarian suppliers had d it increasingly difficult to match pace with their Western competitors. This lack of tability was mainly the result of the following factors:

- Since the economy was overwhelmingly state-owned and operated, it failed to guarantee profit orientation which is a precondition for the best use of resources.
- Price and cost relations were distorted by state subsidies, and administrative regulations hindered the channelling of resources into the more efficient sectors of the economy.
- Competition was prevented by the absence of import liberalisation and administrative constraints on market entry of products, enabling even loss-making state enterprises to survive indefinitely.

---

l., 17.

- Financial discipline was almost non-existent, thus even companies which regularily failed to meet their debts were able to continue operating.[15]

In order to counteract these factors, economic transformation has had to concentrate on three areas: firstly, the fundamental transformation of the socio-economic structure (creation of an internal market economy), which focuses on marketisation and privatisation; secondly, the opening up of the formerly closed national economy which entails the elimination of the trade monopoly of the state, the reduction of tariffs, the convertability of the national currency, and the liberalisation of foreign investments; and lastly, full (re-) integration into the world economy (this will be discussed in Chapter Three of this paper).

Marketisation[16]

The recognition that the efficient operation of the economy would require the full and complete restoration of the market and its mechanisms was an important breakthrough in the move towards transformation. In many ways, marketisation is being hindered by a lack of modern market infrastructures (telecommunications, credit cards, computerised banking, etc.) which require large amounts of capital and investment in order for them to be introduced. The process of marketisation has entailed the initiation of complex and lengthy measures to ensure the following: autonomy of producers and consumers; availability of goods according to demand; opportunity to freely sell and transfer goods; competition; price liberalisation; international convertability of the national currency. Nothing must stand in the way of market forces from deciding price, cost and competition, because if entrepreneurs are to make rational business decisions, price relations must truly reflect the dynamic relationship between supply and demand. Subsequently, prices must be liberalised and subsidies, which only distort prices and result in irrational decisions, must be eliminated.

---

[15]Álmos Kovács, "Macroeconomic policy in 1991-1993: achievements, failures, conclusions." Hungarian Economic Review 19 (April 1994): 1.

[16]marketisation - defined as the process of creating a market economy.

Marketisation requires that competition between manufacturers be encouraged so that the market share is protected in a fair manner; and new buyers must also be found so that price liberalisation does not create uncontrollable inflation. Competition can be promoted by freeing entry into the market, and by eliminating import restrictions designed to protect domestic producers. In order to achieve all this, the role of the state in the market must be greatly reduced. The proportion of state property in the competitive sectors must be decreased, and the state cannot be allowed to intervene in the corporate decision-making process. Although the degree of state tasks must be decreased, the state should still be in charge of public goods and services, macroeconomic regulation, and income distribution.

Factor markets are also an important consideration in the process of marketisation. Hungary's banking sector was modernised in 1987 by introducing a two-tier banking system which meant the separation of macro-management and financial business activities; moreover, a new banking law was passed in 1991. However, banks are still in a monopolistic position, and much is still needed to be done in the area of infrastructural and technological modernisation. Hungary's stock exchange was originally opened in 1864, then closed in 1948 after the country was forced to turn towards a "socialist" planned economy. The exhange was re-opened in 1990, and although the number of stocks listed is small in comparison to Western exchanges, it now offers all forms of financial services. The labour market has also changed dramatically, since politically guaranteed job security, artificially created labour shortages, high wages unrelated to performance, and the high share of incomes from non-wage sources (company social measures) no longer exist. Instead, Hungary suffers from high unemployment, low wages, high taxation, and a lack of retraining programmes.

In the previous system of economic planning, the so-called "black economy" played a vital role in the erosion of the command economy, as it promoted private entrepreneurism--albeit, sometimes of an illegal kind--and fermented the development of market structures. Considering that the process of marketisation is well underway, one would assume that this "hidden" economy would no longer be necessary, and that the economy could be legally consolidated. However, activity in this illegal economy has actually increased in recent years, due to the relaxation in state control and relative price increases. One of Hungary's former finance ministers, Ivan Szabo, used to joke that his country has a "Bermuda Triangle" which swallows bricks, machinery, workers, automobiles. According to him, economic growth was being simply sucked off the economic map.[17] This strange phenomenon has played havoc with official statistics and the ability of policy-makers and economists to make rational, sound economic decisions.

The black economy is mostly concentrated in small farming, the construction industry and the service sector; and the "black market" profits in the retail and restaurant business are estimated to be between 1/3 and 1/2 of the overall figure.[18] However, this giant "hidden" economy has much wider implications than one would imagine. According to the OECD, although only 44% of Hungary's officially registered economy is private, more than half of the country's real economy is actually in private hands. If the grey economy were included in Hungary's statistics, another 1.5% to 2% would be added to the GDP for each year in the 1990s, thereby boosting the country into the black for 1993.[19] This would seem to be a positive end, despite the means, but in reality, the "black economy" has a negative effect on foreign investment because it is far more competitive (since taxes and social security are not a consideration where legality is disregarded) and less trustworthy. In the past, the "hidden" economy served the function of fulfilling the supply shortages the public sector could not meet, but today, it has caused an endless circle of economic woe: people cheat on their taxes because the rate is so high that they would be left with little to live on, but taxes are high precisely because the government is

---

[17]Henry Copeland, "The false trails of eastern Europe's hidden economies." Euromoney supplement, (April 1994): 124.
[18]Palánkai, 38, citing Világgazdaság ("World Economics"), Budapest, Nov. 14, 1992.
[19]Copeland, 126.

not acquiring enough income from the taxes since the people are cheating the system. Thus, until personal incomes increase and personal income taxes decrease, the second economy will be a normal feature of the Hungary economy for quite a time to come.

Privatisation

Socialism and communism are defined as public sector economies represented by mass nationalisation and collectivisation. The share of the private sector in Hungary between 1950 and 1980 was only 3-5%, in the form of private plots in agriculture; small shops in the area of retail, repair, services or handicrafts; and the very large second economy. In simple terms, "real" privatisation is defined on the micro level as the transfer or exchange of public assets to private individuals, while on the macro level it leads to the dominance of the private sector, or to the creation of a market economy. In more general terms, privatisation means the reduction of the role of the state to the point where state ownership does not exceed one-third of the whole.[20]

Since the transformation process began, the Hungarian government has realised that privatisation is the solution to many problems. In the first place, it aids in the creation of a boundary between economics and politics. Secondly, it ensures the economic independence of enterprises--an essential consideration, if a company is to be financially disciplined by a hard budget constraint. Third, the market dictates that only companies which are independent of each other will be forced to compete. In the fourth place, only private ownership can bring about the restructuring necessary for entrepreneurism and innovation to flourish. Fifth, no socialist planned economy has ever had any rational criteria for the allocation of capital. And lastly, the main precondition of political democracy is pluralist ownership.[21] The Antall government outlined a number of priorities it wished to meet with its programme of privatisation:

---

[20]Palánkai, 40.

[21]László Csaba. "New perspectives on systemic change and stabilization in Central Europe: an overview," László Csaba, ed., Systemic Change and Stabilization in Eastern Europe, 18-19.

1) broadly stated, the creation of an efficient economy;
2) maximisation of state revenues;
3) attraction of a maximum amount of FDI;
4) absorption of the latent purchasing power within the country itself;
5) ensuring maximum transparency and fairness in the privatisation process;
6) creation of a strong and growing middle class;
7) consolidation and strengthening of democratic structures;
8) retribution to those who suffered under communism.[22]

Hungary initiated its intentions to privatise with the adoption of the Transformation Act in 1989, and the establishment of the State Property Agency (SPA) in January 1990, to which the socialist government planned to transfer the ownership of large state enterprises. The agency had been designed to stimulate the privatisation process and to ensure that it complied with existing legislation. The existence of the SPA is crucial to the regulation and supervision of sales of national assets. Prior to its creation, the socially and morally reprehensible practise of "spontaneous privatisation" ensured that communist-appointed managers of companies could obtain part ownership of these enterprises--often together with foreign investors--at incredibly favourable prices. This practise quite understandably discredited privatisation in the eyes of many citizens, who watched helplessly as former communist party members became wealthy entrepreneurs over night. The main shortcoming of Hungary's approach to privatisation is that progress in selling-off large and medium-sized companies has been agonizingly slow; and only 8.5% of the total had been privatised by early 1993, completely off the targeted 50% by the end of 1994.[23]

Many factors currently hinder the continued success of privatisation: the lack of a strong stock exchange and modern banking system; the lack of domestic capital, savings, and purchasing power; the outdated condition and debt-riddenness of the companies now

[22]Palánkai, 13-44.
[23]Vlad Sobell, "Privatisation in Central and Eastern Europe," EIU European Trends (2nd quarter 1993): 77.

on sale; unfavourable macroeconomic conditions; the absence of adequate legal and institutional structures for the process; the lack of a large middle-class with a proper owner and managerial mentality; the continued monopolisation and politisation of the process regarding redistribution of power; deep-seated prejudice against private property, as a result of communist teachings, amongst both intellectuals and the public; and finally, the many misunderstandings about the nature of privatisation.[24]

The most significant benefit of privatisation for Hungary has been the large influx of foreign direct investment (FDI) into the country as foreigners have taken advantage of the opportunities offered by Hungary--low wages and other input costs, and a favourable Central and Eastern European location with easy access to both Eastern and Western markets. At the same time, the lack of domestic interest in the process is very disconcerting. SPA figures show that in 1991 appproximately 90% of sales were made to foreigners; and although this was reduced to 70% in 1992,[25] many domestic investors are still unwilling to re-invest the capital they have gained from their small businesses into larger, former state companies.

The large proportion of foreign investment and ownership is not as positive as it may seem on the surface. Most foreign entrepreneurs are interested only in reaping the benefits of the most promising state companies which guarantee a profitable, short-term return, and stay clear of those less promising enterprises which would require medium or long-term investment before any real profits would be shown; thus the government's biggest privatisation headaches are not being cured by FDI. Another concern is the foreign investors' practise of using the SPA's market research to start greenfield operations rather than to restructure old factories. While this does create employment and other spin-off benefits, it does not solve existing problems. Foreigners are more or less considering the Hungarian market saturated since the most attractive enterprises have

[24] Palánkai, 44-45.
[25] Sobell, 77.

already been sold, and now competition is increasing in the region as FDI is moving into countries like Poland and the Czech Republic. Consequently, despite the good that foreign investment has done and still can do for the Hungarian economy, there are both practical and political limitations to the benefits.

Trade Liberalisation

The process of transformation cannot only be restricted to Hungary's domestic market and institutions, for if the country wants to compete on world markets it must take the necessary steps to dismantle the protectionist, trade defence system which was built up during decades of trade with CMEA countries. When the CMEA collapsed in 1991, Hungary had no choice but to re-organise its trade relations and turn towards the West for new partners. Of course, this meant drastic changes in the way Hungary would trade henceforth because it could no longer count on regulated inter-state agreements, or artificially calculated prices in an artificial currency (the transferable ruble). The key to this change was the process of trade liberalisation. The main elements of the liberalisation process have been:

- the removal of government trade monopolies - this has permitted Hungarian companies to export directly, rather than through state trading companies;
- the implementation of a unified exchange rate - the rate has been coordinated with available supply and demand for foreign exchange;
- increased access to foreign exchange;
- the replacement of implicit quotas and licensing by transparent systems of explicit prohibitions and quotas - Hungary has retained some export licensing, mostly related to goods still under price control, imports received under barter arrangements from former CMEA partners, and goods subject to voluntary export agreements with OECD countries. Import licensing is not as common, as less than 10% of Hungary's imports are licensed;
- the conversion of quotas to tariffs of corresponding restrictiveness - this aims to improve transparency and introduce contestability.[26]

---

[26] Renewal of Reforms in Central and East European Economies. OECD Economic Surveys/CCEET. 1990-1991 Series. p. 87.

In order to reduce the risks of destabilising the international balance of payments, the Antall government distributed the stages of liberalisation over a three-year period: namely, incremental national currency devaluation, and implementation of strict curbs on domestic consumption. Import liberalisation has produced fierce import competition and new competitive conditions for industry in the monopoly-ridden domestic market. It has also aided in preventing manufacturers from raising prices, and has, thereby, introduced the selective factor of international competition into the domestic market.

Hungary has made remarkable progress in liberalising its trade in a relatively short period of time, but naturally some restrictive measures (mainly the universal quota on consumer goods, foreign exchange restrictions, various import fees, and the import pre-financing system) are still in place in order to protect the as yet precarious position of the balance of payments. Hungary has had to pay the price of deteriorated terms of trade, and a decline in production and export for aligning trading conditions with those of the West. A deep structural crisis in the processing industry in general is indicated by reduced production, rapid tightening of market possibilities, under-utilisation of available capacities, and rising unemployment. The above-mentioned conditions have also contributed to the deteriorating financial stability of enterprises, which eventually become deficit makers.

Price liberalisation was necessary because markets cannot function effectively without price flexibililty. It is difficult to judge the effects of liberalisation on inflation, since in many instances, prices were liberalised on goods which were not in demand. The first reaction of suppliers has been to raise prices, but these will eventually normalise when the market can no longer sustain the high rates.

Liberalisation of the capital markets coincided with the adoption of a law in 1990 relating to foreign investment which gave foreign capital the same legal status as domestic capital. It also provided legal and economic guarantees to investors, created favourable economic conditions in taxation and foreign exchange policy, and simultaneously liberalised the socialist administrative licensing system. An open door to FDI is a very influential mechanism for generating competition both abroad and at home; and the most effective way to promote economic growth is to challenge domestic producers with foreign competition. The last major constraint hindering growth was the inconvertibility of the Hungarian national currency, the forint (HUF), which became fully convertable only in December 1995.

D. Transformation in Hungary's Foreign Policy

The mutual-defence Warsaw Treaty Organisation (WTO), established on May 14, 1955 by the USSR and the other Communist countries of Europe, ensured that for the next 36 years, Hungary would be forced to support Khrushchëv's "peaceful co-existence" policy, the "Brezhnev Doctrine" and *glasnost'* before the WTO would be dissolved in 1991. The Pact's disintegration was extremely important for Hungary, since it brought about the complete withdrawal of Soviet troops from Hungarian soil, resulting in an end to the malignant threat and fear of Soviet invasion which had controlled the country since the days of Stalinism. In essence, Hungary has become a neutral country because it does not belong to any military organisation.

Since the dissolution of the U.S.S.R., the CMEA and the WTO, there are many challenges to overcome which did not exist previously. There are new concerns looming on the horizon of European unity, such as new threats to national and regional security, mass migration, environmental hazards, the breakdown of economic infrastructures, crises in national health and social welfare systems. All of these must be solved with international cooperation in order to safeguard the "new democracy" which has emerged in Central and Eastern Europe.

Hungary, like the other post-Communist countries, must grow past the psychological legacy of the past. These states must be committed to working together as neighbours in order to eliminate distrust, ethnic strife, and religious intolerance. The rebuilding of relations in Central and Eastern Europe is an especially daunting task in view of the tense ethnic problems which exist between Hungary and its contiguous neighbours (Slovakia, Ukraine, Romania, Serbia, Croatia, Slovenia and Austria)--a situation brought about by the 1920 Trianon Treaty which diminished Hungary's borders, taking two-thirds of its territory and one third of its population. An estimated total of 3.26 mn ethnic Hungarians live in these countries, two million in Romania alone.[27] The government's policy of seeking friendly and cooperative relations with all of Hungary's neighbours is sometimes made difficult in the face of cruel and extreme ethnic discrimination (caused by rekindled nationalism after the demise of Communism) against Hungarian minorities in the countries with the largest minority populations. As a result, the issue of national border revisions in the region have re-surfaced. Both the Antall and Horn governments have been against forced revisions, but peaceful revisions have not been completely excluded as a possibility.

On a more positive note, regional cooperation was promoted after 1991, and soon political and economic agreements were established between the countries of Central and Eastern Europe. The Visegrád agreement signed in February 1991 was a pledge between Hungary, Poland and the now separated Czech and Slovak Republics, to co-ordinate and support one another's common efforts to join the institutions of Western Europe (primarily the European Union, EU). The "Visegrád Four" then signed the Central European Free Trade Agreement (CEFTA) which created a free-trade zone in 1993. These cooperative agreements are encouraged by Western Europe, and will undoubtedly aid in Hungary's eventual inclusion in the EU, NATO and the Western European Union (WEU).

The possibility of expanding NATO in the future only became a reality in January 1994, when the defense organisation published changes to Article 5 of the original

[27]Alfred A. Reisch, "Hungary's Foreign Policy toward the East," RFE/RL Research Report 2, no. 15 (April 9, 1993): 42.

Washington treaty, opening the door to membership for the countries of Central and Eastern Europe. Although this new document is vague concerning the timetable for enlargement or the order in which new members will be admitted, it does emphasise that all candidate countries will be judged on an individual basis, and that new members will most likely be accepted in waves. It is very probable that Hungary, Poland and the Czech Republic will be in the first round of countries gaining full membership to NATO.[28] The organisation has also concretely stated its conditions for admission of new members: candidate countries must have stable democratic systems of government, a market economy, and respect for human rights; moreover, the military must be placed under the direction of a civilian minister of defense. In addition, only those countries which uphold the principles of the Organisation for Cooperation and Security in Europe (OCSE)[29]--that is, advocating the use of peaceful means of negotiating ethnic and territorial, or internal legal conflicts--will be considered for membership.

The original purpose of NATO--curbing the possibility of conflict between the Soviet Union and the United States--has changed with the dissolution of the WTO, since European conflicts today are in the volatile south-east, rather than along the old east-west divide. It is perhaps for this very reason that the countries in Central and Eastern Europe view NATO as a stabilising force (democratic and economic) in a region shaken by uncertainty in the post-Cold War era. Despite this, popular consensus is not completely pro-Nato membership. Although 58% of Czechs favour membership, only 45% of Hungarians do.[30] Some Hungarians argue that membership in NATO would once again subordinate Hungary's newly-found sovereignty to a greater power. Moreover, NATO membership would place an enormous strain on Hungary's already overburdened budget, and it would also cause tensions between Hungary and Russia, which still considers

[28]Gábor Nagy, "Majd meglátják" ("They'll see"), HVG (Heti Világgazdaság) ("World Economics Weekly") 17 no. 40 (854), (October 7, 1995): 23.
[29]December 1994 conference was held in Budapest, and Hungary is currently the chair.
[30]György Heimer, "Belül tágasabb?" ("Is it roomier inside"), HVG 17 no. 51-52 (865-866), (December 23, 1995): 109.

Central and Eastern Europe to be an area of interest. Regardless of when and how Hungary joins NATO, the latter has intimated that membership will probably occur in parallel with the former's admission to the EU.

Subsequently, Hungary is concentrating on developing a foreign policy based on truly peaceful co-existence and mutual economic gain. The Hungarian post-communist governments have placed much emphasis on honouring such international agreements as the Helsinki Final Act, the CFE/CSBM agreements, the Paris Charter; and in participating in such organisations as the OSCE, the Council of Europe, and the United Nations. It is likely that Hungary wili be included in the OECD by the end of April 1996 (a membership to the club of industrialised countries seen as the first step towards European integration), and the European Union within a decade. For the moment, Hungary must content itself with participation in international accords, conferences and councils, thereby further strengthening its commitments aimed at promoting the values of freedom and pluralist democracy.

E. Transformation of Hungary's Society

The dominance of the Communist Party and its presence in every facet of life in the countries of the East Bloc produced a society completely different from that of Western Europe and North America where people were free to think and say what they willed, and to act as they wished within the boundaries of the law. In Central and Eastern Europe, the Communist Party was to be revered and feared. Political freedom did not exist. Anyone showing anti-Party tendencies was often arrested as an enemy of the Party, and thus an enemy of the people. Social advancement was not based on intelligence or diligence, but on blind loyalty to the Party. Since the Party was the "vanguard of the proletariat", the intellectual classes (teachers, scientists, researchers, doctors, lawyers, etc.) were belittled and the uneducated workers were honoured, and salaries were usually adjusted accordingly. Unemployment did not exist, and so the work ethic was completely destroyed by the practise of guaranteed incomes and job security regardless of how little or inefficiently one worked. Personal income taxes were non-existent, and because the state subsidised practically everything with loans from the West, any available consumer items--as shortages were also a guaranteed occurrence--were extremely inexpensive. Few people were rich--unless they were high up in the Party echelons--and few people were poor thanks to the governments very generous and all-encompassing "cradle to grave" welfare system.

The system was rampant with corruption and the practise of "kick-backs" and tipping. For example, even today, the wages of people in the medical profession are very low in comparison to those in the West. Consequently, they are less motivated to give good care and attention to their patients, who in turn feel compelled to give their doctors "gifts" of money to ensure that they do receive "good" care. Being fully acquainted with this practise, the government in turn keeps the wages of doctors low, because they receive extra money from the patients anyway. This form of corruption benefits the recipients unevenly depending on how many patients a doctor receives, and hurts the patients, usually pensioners, and the state coffers, as the "gifts" are untaxable. And the situation is worse today, since inflation has increased the price of medicines and services--which are no longer completely subsidised by the government--whereas the real value of pensions is decreasing rapidly.

The Hungarian people detested the Soviet soldiers who represented the omnipresent danger of the Soviet Union, and so, when the Berlin Wall came down and Communism ended in Central and Eastern Europe, the Hungarians rejoiced at the prospects for a new democratic future and a prosperous, capitalist life-style for everyone--like the one they believed existed in the West. However, the initial period of elation, enthusiasm and relative prosperity soon gave way to disappointment, discouragement and economic reality. In past sections the economic crisis Hungary is experiencing in terms of increasing unemployment and inflation, decreasing welfare benefits and real wages, and intensified social problems (mostly crime) has been discussed. In a way some of these problems can be ascribed to the social mentality of a population raised under communism. Hungary is suffering from low productivity because the workers still expect to get a pay check without doing the required amount of work. Many unemployed workers will not take another job which pays less than unemployment benefits--not thinking that employers are more willing to employ those who prove themselves to be diligent--thus putting an added burden on the social system and the budget. The practises of tax evasion and the second economy are out of control, and put an enormous drain on the resources of the state. Alcoholism is an ever-present problem; as is the outrageous rise in real estate prices, causing office space and flats to be quite over-priced, and therefore unaffordable to the average buyer/renter. Regional disparity has intensified, as people in industrially depressed areas of the country are now living below the poverty level.[31]

Economic policy is almost impossible to carry out successfully without a solution to these social crises. The Antall government was strongly criticised by the average Hungarian for having let them down, and taken the country towards economic ruin. The average working citizen quickly forgot about the great breakthroughs that occurred in Hungary since the overthrow of the Communists--rule of law, political and social democracy and freedom, freedom to travel to the West, diminished restrictions on hard currency ownership, increased access to Western consumer goods, an end to shortages, almost unlimited freedom of the press, renewed religious tolerance, restitution, international respect. However, an economy in crisis cannot be expected to turn capitalist over night, over five or even ten years time. Understandably, the only thing of consequence to the average person is the price of food and consumer goods, and the purchasing power of his wages. Hungarians reminisced about the prosperity of the 1980s under "Goulash Communism", and many of the less educated strata of society believed

[31]Observations by the author during two years of residence in Budapest (Sept. 1993 - Sept. 95).

the Socialists could bring back this prosperity, not realising that the good years of that decade had been a facade built of foreign loans which now had to be repaid at all costs. Thus, the Antall government was defeated in the 1994 elections by the Hungarian Socialist Party, much to the chagrin of the intelligentsia and the world in general which feared a return to the communism of the past.

The only solution to this social crisis is enhanced economic performance and growth; and the key to economic and political progress is the creation of a large and vibrant middle class. Since WWII, most countries in Central and Eastern Europe have not had this very important middle class, as decades of communism produced only a huge working class, and a class of white collar professionals and public servants. The latter did resemble a middle class, except that it did not own property, therefore having no stake in seeing rule of law established, and it was excluded from the political process by the communist monopoly on power. Today, sociologists agree that "democracy can't work without a middle class, with its own money, its own demands, its own (bourgeois) values"[32] of freedom of expression, property rights, civil rights.

The region has all the pre-requisites for the creation of a sustained middle class (urban, educated population; growing market economy and political democracy), but no one knows exactly how to define the new Central and Eastern European middle class, since the usual measures used in the West have little meaning in this case. Occupation is a misleading category because much of the communist-era white collar class has suffered a dramatic fall in living standards and status since the transformation began, and thus, has fallen below the middle class in terms of purchasing power. Education levels are also misleading, because the majority of the new middle class (private sector entrepreneurs of SMEs) has had little formal training or education. According to one specialist, the new middle class has "a specific lifestyle, a way of thinking, a view of individualism and a

[32]Greg Gransden, with Kimberly Ledbetter, Béla Papp, and Peggy Simpson, "A middle class evolves," Business Central Europe 3 no. 20 (April 1995): 7.

drive to individual achievement, as opposed to the collectivism of the previous system. (...) The basic value system is materialism--eating, drinking, wining, holidays. (...) They like freedom--freedom to earn money. They don't like democracy too much, but there's no alternative, because they don't like communism, monarchy or military rule either."[33]

Another factor which makes official personal income figures unreliable is the ever-present second income earned in the grey economy. Privatisation has also increased the net worth of many citizens who have purchased their own flats or summer houses. In order to define the middle class, one researcher used the simple indicator of measuring satisfaction with living standards. He divided the respondents into two broad groups: the losers, those worse-off under a free market, make up about 70% of the population; and the winners, those whose standard of living has remained stable or improved, make up 30%. Of the latter category, about 5% are wealthy and the remaining 25% can be considered the average size of the new middle class of 78.3 mn people in eleven Central and Eastern European states.[34] Researchers have found that the new middle class has been growing most rapidly in countries where economic liberalisation has gone furthest. In Hungary, specifically, the middle class seems to be shrinking due to the harsh, austerity measures introduced by the Socialist government in March 1995. Researchers have also found that the greater the legal liberty, the more quickly a less pleasant element of the new middle class--the mafia--is likely to evolve. Ironically, today's criminals will be tomorrow's business people, as they will be turning to the law to protect their assets and investments. Regardless of the elements the middle class is composed of, without it Hungary will not be able to create a dynamic private economy and a pluralist society.

---

[33]Ibid., 8.
[34]Ibid., 9.

F. The First Four Years of Transformation

The Spring 1994 elections were another turning point in Hungary's difficult road towards democracy and a market economy. Many critics argued that the country was in worse shape at this point than at the time of the 1990 elections, and thus the new government would be taking control under worse conditions than four years earlier. This is a very serious accusation, and calls for a general assessment of the situation in Hungary after four years of transformation. It must be remembered, however, that even though the Antall-Boross government (after the death of Jozsef Antall in December 1993, Péter Boross became Prime Minister) played a decisive role in these transformations, the whole socio-economic and political transformation of Hungary was also determined by other factors: the recession in the West, the collapse of the CMEA, and the war in Yugoslavia--which not only meant a lost market, but also a steady influx of refugees who put a strain on Hungary's economy.

Dr. Attila Ágh, Chair of the Department of Political Science at the University of Economic Sciences in Budapest, Hungary, discussed this question in a paper he wrote in early 1994, before the May elections. It is Dr. Ágh's opinion that given Hungary's role as a pioneer in the fields of socio-economic development and political transformation, the country had a definitive advantage in 1990 over its neighbours, and the erosion of this advantage could have been greatly minimalised had the performance of the first coalition government not been so poor.

Political Transformation

It cannot be disputed that the establishment of new democratic institutions occurred during the early 1990s, marking a turning point in Hungary's political history, but despite this, polls showed the growing general dissatisfaction of the Hungarian people with their new democratic government (see Table 2.)[35]

[35]Attila Ágh, "After four years: The general situation in Hungary in 1994," Budapest Papers on Democratic Transition no. 79 (1994): 24.

Table. 2 - The percentage of Hungarians satisfied or dissatisfied with the coalition government between March 1991 and June 1993.

	91/03	91/09	92/03	92/09	93/03	93/06
satisfied with government	31	33	29	30	34	25
wanted new elections	09	12	17	30	41	41

Dr. Ágh states that many Hungarians desired a return to the pre-1990 socialist government of Prime Minister Miklós Németh which began the transformation process towards democracy and a market economy in the late 1980s. Ágh feels that this process was "broken, or slowed down, in the early nineties by the Antall government".[36] The Antall government was somewhere in the middle between new authoritarian rule and future democracy--a traditional conservatism of the political class, coupled with extreme right-wing nationalism--which eroded the confidence of the people in the HDF.

The 1994 election was crucial for Hungary because it tested democracy and proved that the country was capable of continued peaceful and democractic changes of government. The Antall government had ensured relative stability, but the country had not gone through the process of changing its political elite--which lacked political experience and skills to govern in a European-type system--as had other countries (a process which naturally selected out the less capable politicians). According to Ágh, Hungary must completely break the recurring historical cycle of alternating periods of authoritarian and more democratic, reform-minded governments.

Economic Transformation

Hungary was already on the road towards marketisation with the 1968 New Economic Mechanism (NEM), which was halted then accelerated again in the late 1980s. Even before the collapse of CMEA, Hungary had started to re-orientate its trade from East to West. Privatisation was making *relatively* large leaps and bounds. It seemed at the time

[36]Ibid., 4.

that the changes would help Hungary to quickly integrate itself into the Western economy. Instead, structural transformation of the economy and large state enterprises has moved at a snail's pace; socio-economic crisis management was neglected; and privatisation was slowed down in 1990-91 and replaced by a wave of re-nationalisation, i.e. so the government could regain political control over the economy. Although the private sector has continued to develop, legally and in the realm of the second economy, thus far a significant middle class has not been able to evolve. Perhaps the most disturbing data concerns Hungary's GDP, which has been decreasing since 1989 (this is most apparent in agricultural and industrial output), and the cumulative inflation for the 1989-93 period was 300%--equalling the figure for the last three decades before 1989,[37] a very sobering fact.

Social Transformation

Although both political and economic transformation are important parts of systemic change, it is arguable that social transformation is more important than the other two for the simple reason that all political change begins with social tensions, and economic change cannot occur without the development of a middle class in the new social order. According to Dr. Ágh, the social crisis which began in the late 1980s was handled badly by the Antall government. It had three main aspects: a drastic drop in the standard of living of the average Hungarian; widening social disparity, as the rich became richer and the poor became poorer; and a deep psychological crisis which has left many Hungarians feeling out of place, abandoned, frustrated with the government, willing to sell their pride, honesty and self-worth for a better job and more money (many feel the price they have paid for political liberty has been too high and not worth it). One major problem was the fact that Hungary's old social structure collapsed before a new one could be created to take its place: privatisation has created a quasi state-dependent bourgeoisie and some smaller independent owners, instead of a flourishing entrepreneurial bourgeoisie and

[37]Ibid., 9.

middle class; and in agriculture, where modernisation has been halted, mass compensations have resulted in the emergence of a traditional small peasantry and a large group of "absentee" urban, small land owners.

A general assessment

Dr. Ágh gives a generally pessimistic assessment of the first four years of the democratic experiment in Hungary. This negativism seems to be a trend amongst sources of Hungarian origin, whereas non-Hungarian sources are somewhat more forgiving--undoubtedly due to a more distanced and less personally felt perspective. It is true that Hungary is in a markedly deeper economic, social and political crisis than it was four years earlier. Certainly, the Antall government's proud refusal to reschedule Hungary's foreign debts used up monies which could have been better spent elsewhere. However, the situation could have been much worse, and it must not be forgotten that quite a significant amount of progress was accomplished in all areas during those first four, *very short*, years of democracy. One must look positively on the establishment of a democratic institutional base, the impressive wide-ranging privatisation of the economy, an end to the period of stagnation, and the growing social maturity of Hungarian society as it begins to become aware of and participate in the political process and to demand the rights and liberties guaranteed to all Western citizens. The next ten years will be a crucial period in the progressive socio-economic development of Hungary towards a Western-type market economy. The Antall government can very easily be blamed in hindsight for its mistakes, most of which were due to misguided policy-making which tried to re-create the inter-war era, and a sheer lack of experience in the area of politics--afterall, these people were not politicians, but members of the intellectual elite (Jozsef Antall was an historian by profession). It seems that Hungarians sometimes tend to be passively pessimistic and accusatory instead of trying to work together to solve the problems at hand. Regardless of the methods and the pace, Hungary has passed the point of no return as it travels down the road to democratisation, privatisation and marketisation. As to how long the journey will be, and which side roads, good or bad, will be taken is a question to be answered by the governments of the future.

G. Socialism Re-Born

In 1990, no one would have dreamed that four years later the Hungarian people would willingly bring to power the socialist party it rejected during the first elections. Why is it then that after two rounds of elections in May 1994, the Hungarian Socialist Party (HSP) was once again voted into Parliament? This event was the cause of great despair for those who saw an imminent return to the hated Communism of old. For many, it meant the revival of the illusory economic prosperity, job security, low productivity requirements, and free health and education systems of "Goulash Communism". And for others, it meant the return of "professional", experienced politicians. On the fundamental level, the vote for the opposition seemed no more than the usual expression of voter dissatisfaction for a previous administration. However, since the first reversal of the NEM in the early 1970s, Hungary had been living on borrowed money, and borrowed time. The days of completely subsidised consumer products and limitless social support were driving the country to an early grave. It may be a harsh reality to live with, but Hungarians must stop bemoaning the "good old days", and simply accept the fact that Hungary can never go back to the economic and political systems of yesterday.

It seems that even the new socialist government has accepted this fact, and now the question to be asked is, "How can socialists build capitalism?" By the end of the 1980s, most European socialist parties abandoned many of their old policies, grudgingly advocating leaner government, lower taxes, and privatisation; thus "socialist" parties have enjoyed renewed popularity because they no longer truly espouse socialism. The only way "new" socialism will work is if the socialist parties of Central and Eastern Europe accept the fallibility of the market and stop trying to correct this by directing the economy through planning--something which has not worked successfully in the past--and instead, use socialism as a programme of social and economic reform with the aim of reducing poverty, promoting equality of opportunity, and improving the equality of public services for all.

A coalition was formed in June 1994 between the HSP and the Alliance of Free Democrats (AFD). The ultimate goal of the coalition government is to develop a market economy which creates a sound basis for economic growth and the reduction of unemployment. Its objectives are outlined in the documents "Agreement on an Economic Policy Program" and "Economic Policy Guidelines for the Government Program" (see Appendix 2). The coalition government realises that the Hungarian economy cannot be consolidated and developed without assistance from external sources. Foreign economic relations must be solidified because the country is in dire need of capital imports, markets for its commodities, and technological modernisation (the transfer of advanced knowledge). This will be accomplished through closer ties with the European Union, and an effort to regain the lost CMEA markets. The government established a short-term crisis management programme for the second half of 1994 and for 1995 (see Appendix 3), but how successful has the coalition been up to this time in meeting its goals and fulfilling its policies?

1994 was considered a year of economic and political wavering which threw Hungary into turmoil, forcing many to draw comparisons with the Mexican financial crisis of that year. The warning signs of economic collapse instilled fear in economists and business people alike. The beginning of 1995 seemed to be more of the same, as the country witnessed the resignation and dismissal of several key ministers and state secretaries as a result of friction between them and Prime Minister Gyula Horn over economic policy. It was not until March 12th that the government finally brought some resolve to the situation in the form of an economic programme developed by Finance Minister Lajos Bokros and central bank governor György Surányi which was comprised of five main austerity measures (see Appendix 4).

The aims of this radical and tough stabilisation programme were to curb the current account and budget deficits[38], to bring the forint into equilibrium and to eliminate currency speculation, and to boost exports. Before the programme was implemented, the external imbalances in Hungary's economy had become almost unmanageable, jeopardising the government's ability to finance its obligations. By the end of 1994, the current account had registered a $3.9 bn deficit ($3.5 bn in 1993), with no sign of exports increasing to counteract the plunge.[39] Moreover, FDI inflows were slowing down as privatisation came to a virtual standstill--due mainly to the problems of consolidating the privatisation apparatus, and the delayed passage of the new privatisation law.

This new law, approved on May 9, 1995 by Parliament, should prevent the re-occurrence of such privatisation scandals as the early 1995 Hungar Hotels debacle during which a bid from American General Hospitality to buy 51% of the chain was initially accepted by the SPA, but then prohibited upon the personal intervention of Prime Minister Horn. Although the reversal of the deal was favourably viewed by Hungarians who fear that their country is being sold out to foreigners for peanuts, the intervention caused waves amongst the foreign business community which feared a return to the state control of yester-year. Moreover, the state coffers suffered tremendously from the absence of the $57.5 mn which would have flowed in from the deal to help ease the state budget deficit.[40]

Thus, the austerity programme was desperately needed, and after months of labour pains, it would seem that at the close of 1995 the "Bokros package" had already begun to pay off. Some shaving did occur on the current account deficit which came in just below $3 bn, but this was still nowhere near the programme's target of $2.5 bn or the IMF's

[38]current account - a bank account from which money can be withdrawn at any time.
budget - a national financial plan based on expected revenues and expenses.
deficit - the amount by which expenses exceed revenues.

[39]Béla Papp, "The next step," Business Central Europe 3 no. 27 (December 1995/January 1996): 35.

[40]"Privatizációs csúcsév" ("A peak year for privatisation"). HVG 17 no. 51-52 (865-866). (December 23, 1995): 102.

requisite $2 bn. The budget deficit also dropped from 6.8% to approximately 5% of GDP. This should result in more liquidity flowing into the economy instead of the state treasury, spurring fixed investments in 1996. And with domestic demand on the rise, the GNP should also register a healthier increase. On the darker side, additional measures included higher taxes and cuts in public expenditures (about 10% of public administration staff was laid-off last year). Also, due to the 10% fall in real wages, consumer demand has declined drastically, which in turn has constrained import growth.[41]

The austerity measures have been anything but popular with Hungary's Constitutional Court which ruled on four separate occasions that elements of the programme were unconstitutional, each time softening the impact of the welfare-cutting measures. This will make it more difficult to deal comprehensively with the country's inefficient and expensive social security system (which accounts for a quarter of government spending), where real savings could be made. Moreover, the business community has been lobbying for quite some time for a massive reduction of the social security tax burden--a measure which institutions such as the World Bank also advocate. This 54% tax rate (43% levied on enterprises and 11% on individuals) is the highest in the region, and is considered to be the main factor for driving businesses into tax evasion and the grey sector.[42]

The fact that 1995 was the most outstanding year of Hungary's privatisation history was a godsend for the domestic economy. As of November 1995, more than 250 bn forints worth of state assets were sold for cash into private hands--a sum which virtually equalled the 260 bn forints received for the entire period of 1990-1994.[43] In addition to this, another 200 bn (approx. $1.54 bn)[44] forints worth of state assets were sold during the month of December--in the form of five gas distribution companies, six electricity distributors and two power stations, 18% of the gas company MOL, and 37% of the

[41]Papp, 36.
[42]Ibid.
[43]HVG, (December 23, 1995), 102.
[44]At the end of 1995, the US dollar/Forint exchange rate was approximately 1:130. Thus 200 bn forints would equal approximately $ 1.54 bn.

telecommunications company MATÁV--to bring total privatisation revenues to $3.4 bn for 1995, almost twice the expected amount. The fact that the deals were completed before the January 1st deadline proved that the government, which has wavered in the past, is now seriously committed to the privatisation process. It also shows that European investors are more eager to close such deals with as much expediency as possible in order to get more market share in Hungary now that membership in the European Union has become a distant certainty.

On the down side, a new storm is brewing on Hungary's economic horizon: Finance Minister Bokros was to announce a restructuring of Hungary's welfare system in March of 1996, but instead submitted his resignation to the Prime Minister one month earlier, citing lack of freedom and support to make the policy decisions he felt necessary for economic recovery. (Bokros was Hungary's fifth finance minister in six years.) This move once again places the stability of the reform process into question. Prime Minister Horn has pledged to continue with budgetary reforms, but Bokros's resignation came at a most inopportune time when Hungary was about to receive a $300 mn stand-by loan from the IMF to assist with economic reform, and the country is next on the list to join the OECD, perhaps by the end of April 1996. After giving in to strong lobbying for social programme funding, the government also seems to be going back on its promise to use all of the 1995 privatisation revenues to reduce Hungary's $33.5 bn external debt (less the interest savings amounting to $250 000 which were slated for public reforms).[45] Such faltering and indecision will make it difficult to stand steadfastly behind the much needed overhaul to the pension, health and education systems which consume one-quarter of the country's GDP (compared to an average 22% in the EU).[46]

The Bokros package has received mixed reviews from all sides. The average Hungarian is pessimistic and desperate, as he is hardest hit by the continued inflation and

[45]Theresa Agovino, "Leaping Ahead," Business Central Europe 4 no. 28 (February 1996): 20.
[46]Theresa Agovino, "Aversion to pain," Business Central Europe 4 no. 29 (March 1996): 15.

rising food and energy prices, the decrease in wages and purchasing power, and the planned severe cuts in social programmes. The business community and world financial institutions, on the other hand, are applauding the new measures which have already dramatically improved Hungary's macroeconomic situation, and which should have been implemented years earlier by the Antall government. These positive developments have been marred, however, by countless incidents of friction stemming from disagreements within the coalition, and by economic policy wavering.

In 1996, the present Socialist-Free Democrat coalition government will have to make the fight against inflation its top priority, and stand steadfastly behind all the measures in its austerity programme despite strong pressure from trade unions demanding wage increases, and more conservative government members who do not agree with the severity of the "Bokros package" or the planned welfare cuts. A repeat performance of 1995's privatisation successes is highly unlikely since mostly small and medium-sized companies remain in the government's portfolio--the remaining large ones, such as the Hungarian Oil Company (MOL) bring considerable income to the government, and will not be privatised for some time--and the problems relating to the privatisation of financial institutions have put banks into a unique category. Hungary will have to tighten its belt by quite a few notches in 1996 if it wishes to see signs of growth in the near future.

Since 1990, Hungary's transformation process has gone through a series of ups and downs, brought on by inexperienced politicians, resistance from conservative elements in both the government and society, and the effects of a global economic recession which is only now beginning to ease up. Too little time has passed for us to objectively judge and evaluate the policies and actions of the Antall government in comparison to the Horn government, since both have had tremendously difficult tasks to perform, and have had to deal with the economic disasters created by forty years of communist planning. It can

[redacted]

CHAPTER THREE
Re-Europeanisation[1] and Re-Integration

The tragedies of the Second World War taught the world a useful lesson: any future conflicts may escalate to international proportions, causing such *global* destruction that the world as we know it may never recover. This new reality provided the incentive for Europeans to make a clean break with past political, economic and nationalist policies, and work towards political union and the concept of harmony between European nations. It was in this spirit of international cooperation that a number of economic, political and security organisations were formed in the next two decades, impressing upon the world, and especially Europe, that all countries are inter-dependent to varying degrees.

The development of the European Community (EC) and its relations with Hungary--before and after the demise of the Council for Mutual Economic Assistance--will be discussed in this chapter, focusing on how the changing European and global environment has led to Hungary's increased efforts to "re-Europeanise" itself and become integrated into the EC (now European Union, EU)[2]. The process of European integration and unification, and how this affects Hungary, will be outlined; and alternative options to EU integration, such as the European Economic Area and the Central European Free Trade Agreement, will also be considered. The Europe "Association" Agreements between the European Union and the countries of Central Europe will be analysed, including a review of the advantages and disadvantages the agreements hold for both parties. Lastly, issues such as matters of security and culture in the new Europe, will also be discussed.

---

[1]Re-Europeanisation - defined as the process of re-joining Europe and once again becoming European (as used to describe the goal of the Central European countries).
[2]The European Community was renamed the European Union as of Novermber 1, 1993 after the Treaty of European Union was ratified by all member-states.

A. Europe After World War Two

The European Community

The trading bloc of fifteen countries known as the European Community finds its origins in the European Coal and Steel Community (ECSC) which was founded in 1952 with six member countries: the "Benelux" trading bloc (Belgium, Netherlands, Luxembourg), France, Italy, and West Germany. The idea behind the ECSC was to provide a base for gradual economic and political achievements in a peaceful framework. The signing of the Treaty of Rome in 1957 established two new organisations: the European Atomic Energy Community (Euratom), advocating the peaceful utilisation of atomic energy, and the European Economic Community (EEC), which brought about a common market in order to gradually reduce internal tariffs and trade barriers between the members states. The success of this trading bloc quickly attracted new members (Denmark, Ireland, and the United Kingdom joined in 1973, Greece in 1981, Spain and Portugal in 1986, and Austria, Finland and Sweden in 1995); and eventually, because of the political and other non-economic activities and movements existing within the three organisations, in 1967 they were fused into one body, henceforth being called the European Communities or the European Community (EC). There are four major institutions within the EC which deal with the formulation and implementation of economic and other related policies. The *Commission* provides the bureaucracy of the EC. It proposes new policies, implements existing policies, is the Guardian of the Treaty of Rome, and has a formal right to attend Council meetings. The *Council of Ministers*, which is composed of the Heads of Government of the member states, has the ultimate power as it carries the burden of coordinating existing policies and principles, and of adopting new policies. The *European Parliament* has a mainly consultative role, but it does have the power to approve the Community budget. The *European Court of Justice* has the responsibility of assessing the actions of the other institutions and of the member states against the Treaty of Rome and other fundamental principles.

EFTA

The European Free Trade Association (EFTA) was established in 1960 as a reaction to the dynamic integration process which was centering around France and West Germany in the late 1950s. It was immediately joined by Austria, Denmark, Norway, Sweden, Switzerland and the United Kingdom, and soon thereafter by Portugal. Finland became an associate member of EFTA in 1961. From the start, EFTA was viewed as a sort of "bridge" to the EC, and as such, its aims were somewhat more limited. Whereas the EC was both a Customs Union and a Common Market, the EFTA merely aimed to remove internal trade barriers on industrial goods, while its member states maintained their sovereignty and remained free to maintain their own external barriers. The EFTA did not foresee a common agricultural policy, or any joint policies aimed at preventing internal trade distortions, since it would not set up a common market. The face of the EFTA has changed somewhat over the years as new members joined, and some old members opted for EC membership instead. EFTA membership consisted of Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland before January 1, 1995, when Austria, Finland and Sweden became EU members. The remaining four members--which wanted to safeguard a policy of neutrality in foreign affairs--have had to reassess the role of EFTA in the European and global trade framework. Over the years, the original goal of establishing a free trade area has diminished in importance, for by 1995, the share of trade amongst the members of EFTA amounted to less than 1% of their total trade.[3] EFTA's new *raison d'etre* seems to be increased cooperation and trade relations with the EU.

Hungary and the CMEA

Hungary was one of the founding members of the Council for Mutual Economic Assistance (CMEA or Comecon)[4], a trade organisation initiated by the Soviet Union in

[3]Kjarton Johannsson. "New Challenges for a Slimmed Association," Emil Ems, ed. Thirty-five Years of Free Trade in Europe. Messages for the Future, 194.

[4]Members in 1949 included: Albania, Bulgaria, Czechoslovakia, Poland, Hungary, Romania, and the Soviet Union. East Germany joined in 1950, while Albania suspended its participation in 1961. The

1949 in response to the West's Marshall Plan developed after World War Two which was designed to give economic assistance to rebuild the war-torn countries of Europe. Even though countries like Czechoslovakia and Hungary wished to benefit from this economic aid, Stalin rejected any contact with the West and effectively re-oriented all Central European economic activity and trade towards the East, making CMEA partners, especially the Soviet Union, Hungary's most important trading contacts for the next forty years, until the dissolution of the CMEA in 1991.

Cooperation within the CMEA was based on a centralised, administrative and directive system of management, which initially corresponded to the domestic models of communist planning. Market impulses and rationales were basically eliminated from trade relations, and instead, all the anomalies of bureaucratic planning (poor quality production, supply shortages, disregard for costs, consumer neglect, lack of contractual discipline, etc.) were forced upon the member countries. Isolation from the global economy and world trade, created serious deficiencies in development in technical and technological fields, and eventually led to crises in the working apparatus of the entire organisation. In addition, this internal integration promoted East Bloc inter-dependence which made it difficult for Central and Eastern European countries to seek out new markets. Market misuses resulted in low efficiency, sub-optimal allocation and utilisation of otherwise scarce resources, and enormous waste of human and capital resources. It was impossible to realistically calculate the costs and benefits of the international division of labour because of severely distorted market signals, and thus, any potentially substantial gains in efficiency were either neglected or lost completely. CMEA economies took to the extreme the monopolisation of practically all economic activities, and the protectionist isolation of these countries created an import-substituting industrialisation.

former state of Yugoslavia had a special status after 1964. Other non-European members joined later: Mongolia in 1962, Cuba in 1972, and Vietnam in 1978.

Over the years, wide-ranging domestic, economic reforms were applied in many of the CMEA's member-states, but the character of cooperation amongst the members remained almost unchanged until the late 1980s. Throughout this period, the CMEA had been criticised most strongly by its more reform-minded member-states, but after 1985, ev Soviet economists could openly criticise the organisation and propose reforms. As Soviet economist Margarita Maksimova stated, "not only do economic relations among CMEA countries not solve their internal problems--reduction of a growing deficit, low quality of production, technological lags, material-financing imbalances--but they may even create new problems and strengthen external disequilibria."[5]

The October 1987 meeting of CMEA member states could be considered a turning point of sorts, but still only one of intentions and not actions. At this meeting, the CMEA accepted for the first time the ideals and consistent forms of a market economy, and the member countries committed themselves to the creation of a "socialist common market" (allowing the free flow of goods and factors of production), the introduction of convertible currencies, the decentralisation of relations to the enterprise level, and radical changes in the price and credit systems. It soon became obvious, however, that whereas these initiatives were favoured by the more reform-oriented member-states, they were quite coolly and even hostilely received by the more traditional ones which resisted internal changes in their own economies and societies.

EC-Hungary Relations under the CMEA

At the start, a strong enmity existed between the European Community and the CMEA because the Soviet Union saw the EC as an organ of West European monopoly capitalism, and as a threat to its super power status. The Soviets eventually took a more pragmatic and realistic approach to East-West relations in the 1960s, but the atmosphere of the Cold War kept these relations understandably strained until the mid-1980s.

[5]Tibor Palánkai, The European Community and Central European Integration: the Hungarian Case. Occasional Paper Series 21, 40; citing Margarita M. Maksimova, "Razdum'ia o perestroike SEV" (Thoughts on restructuring the CMEA), MEMO 4 (1989): 65.

Nevertheless, Hungary was one of the first CMEA countries to *recognise* the EC as a political entity. From the beginning, Hungarian economic and political literature regarding the EC was fair and balanced, and the Community had been described as an organisation of integration, based on "world economic processes". Furthermore, several leading Hungarian politicians in the early 1960s stated that the EC was an "objective reality," and that EC-Hungary relations must be formed accordingly.[6] Despite its positive disposition towards the EC and what is represented, Hungary was forced to comply with CMEA policies, thereby refuting international recognition of the EC in two very significant ways: Hungary did not establish diplomatic relations with the organisation, abstaining from signing any agreement on the Community level, and more importantly, it did not accept the validity of a common commercial policy. However, it must be emphasized that "while the CMEA countries were united in refusing *de jure* recognition, in the case of *de facto* recognition they applied diverging solutions".[7]

After 1968, Hungary and other Central and Eastern European (CEE) countries did conclude some bilateral technical agreements with the EC which mainly affected the export conditions of a few agricultural products. Thin as these lines of contact may have been, they nonetheless marked official contact between the EC and the members of the CMEA. In 1973, Hungary joined the General Agreement on Tariffs and Trade (GATT), and as a contracting partner, the EC granted Hungary most favoured nation (MFN) trading status. However, this special status only applied to tariffs, which meant that economic Cold Warfare between the EC and the CMEA continued on other fronts as the EC continued to apply protective measures (quantitative quotas, import levies or tariffs, restrictions on acquiring modern technologies, harsh and discriminative application of dumpings) against CMEA imports. These measures were somewhat justified, as the EC was forced to reckon with the trading practices of centrally planned systems which used

[6] Ibid., 8.
[7] Ibid., 9.

such discriminative measures as import targets as quotas, trading partner discrimination, hidden taxation of imported products, distorted prices as a result of subsidies which were then passed on to the producer and consumer, etc. Hungary and the EC concluded a number of sector-specific agreements between 1978 and 1982, but it was not until after 1982 that changing circumstances encouraged Hungary to take the initiative, and abandon the CMEA's policy of multilateral dealings with the EC, and seek direct, bilateral normalisation of relations with the Community.

The turning point came at a CMEA summit meeting in June 1984, when the member-states agreed to initiate a normalisation of relations with the Community. Following a lengthy negotiation process, a "Joint Declaration" was signed in June 1988 between the two trade organisations, and even more importantly, trade *and* cooperation agreements were signed in September 1988. These agreements established a three-stage timetable for the complete abolition of quantitative restrictions by December 31, 1995. As a result, Hungary was hence removed from the category of "state trading country" and accepted as a viable, future market economy. Both sides considered the agreement as recognition of and a reward for the measures Hungary had undertaken in the process of reform. Thus, in August 1988, official diplomatic relations between Hungary and the European Community were finally established.

EC-Hungary Relations in Transition

The revolutionary changes which occurred in Central and Eastern Europe in 1989 not only altered the way these countries viewed the world, but the manner in which the world viewed them was also transformed. After forty years of isolation from the mainstream of European development, and being locked into a system of centralised political and economic control, the countries of Central and Eastern Europe were faced with the daunting task of democratising their political systems and marketising their economies in order to catch-up to the changes which had taken place in Western Europe over the past half century. But these attempts would not succeed without the West's assistance:

> There is no doubt that the West recognized not only the importance of the emerging reform process in (Central and Eastern Europe), but also its frailty. There is the danger that the transformation of the economy and the necessary reform measures undertaken during this period of heavy indebtedness may produce serious social tensions that could endanger the success of the reforms themselves. Therefore, the West is interested in easing the pains of structural and model changes.[8]

All twenty-four OECD (Organisation for Economic Cooperation and Development) members were committed to helping the newly developing countries, and the EC was authorised to coordinate a support programme for Hungary and Poland--the two most "developed" of the group. The PHARE Programme (Poland and Hungary: Aid for the Restructuring of the Economy) took effect in December 1990. PHARE assistance was given on condition of political stability in the country concerned, and a continuing commitment to democratic ideals and free market principles. The conditions for financial support were that the two countries would have to come to terms with and meet the requirements of both the IMF (International Monetary Fund) and the World Bank. Initially, only two countries were considered under the EC's aid programme, but by the end of the PHARE's first five years of operation, in December 1994, more than fifteen countries in Central and Eastern Europe (CEE) received a total of 4 248.4 mn ECU in aid, and of this amount, Hungary received 490.8 mn ECU. And for the next five-year period between 1995 and 1999, the PHARE programme will be contributing some 425 mn ECU to these countries, of which Hungary will receive almost 75 mn ECU in assistance.[9]

Through the PHARE Programme, eligible countries receive know-how from a wide range of non-commercial, public and private organisations. The programme acts as a multiplier by stimulating investment and responding to needs that cannot be met by others. The main priorities for PHARE funding include: restructuring of state enterprises

---

[8]Ibid., 10; citing HVG. October 7, 1990: 10.
[9]Tamás Vajna, "Segély e kéj" ("It was a pleasure to give assistance"). HVG 17 no. 47 (861). (November 25, 1995): 141.

including agriculture; private sector development; reform of institutions and public administration; reform of social services, employment, education and health; development of energy, transport and telecommunications infrastructures; and environment and nuclear safety. Under the Europe Agreements, PHARE funding is being used to make laws compatible with European Union norms and standards, and to align practises.

The development of the PHARE assistance programme by the EC was a vital step in terms of political prestige and the Community's recognition of the reconstruction efforts of the countries of Central and Eastern Europe. However, this was only the beginning of "inter-European" cooperation and assistance, for the countries of Central Europe--Hungary, Poland, the Czech Republic and Slovakia--wished to become actual members of the Community from which they had been secluded for so long. At first, the EC's reaction to such a concept was overwhelmingly negative, but in time, the West's intransigence gave way to compromise, and after a year of negotiations, an association agreement was signed between the EC and Hungary on December 16, 1991, followed by like agreements with the other Central and Eastern European countries. However, it would be two more years before these countries actually would become associate members of the EC, for the documents would have to be ratified by the Parliaments of each of the members of the Community. One reason for the delay was the EC's more urgent programme to implement full Community integration (a "deepening" process which would eventually realise an internal market, monetary union, and political integration). Achieving this goal of a completely integrated and unified Community of European countries would be a lengthy and sometimes unpleasant journey, as is to be expected when one is dealing with twelve very different and individual nations and their interests.

B. The Integration and Unification of Europe

Integration is a complex process which must be viewed in the broader context as a process of unification involving economic, political, military and social aspects. Generally, the process of unification embodies four developmental stages:

1. The elimination of obstacles that block cooperation and the free movement of goods, services, people or ideas across national borders (this would entail abolition of tariffs, visa requirements, etc.). This opening towards other states is often called "negative integration".
2. The expansion of ties and cooperation in different fields of economic, political, social and cultural life, from trade to tourism to scientific cooperation.
3. The establishment of common institutions aimed at promoting, coordinating and regulating relations, and stimulating cooperation.
4. The unification of states by setting up supranational institutions, giving up and transferring national sovereignty to federal (or confederal) political and legal structures. This would be an entirely voluntary economic and political unification, and forced unification (by military occupation or colonisation) is out of the question.[10]

Moreover, the theory of integration distinguishes between several forms of trade and economic blocs or groupings which are listed below in ascending order of integrated cooperation (most countries in CEE have reached the first two forms of integration):

1. Preferential Tariff Zone: Countries give each other preferential tariffs which are lower than those applied to other countries, or even engage in tariff-free treatment. This is a step towards creating a free trade arrangement in the field of tariffs.
2. Free Trade Area: Trade is completely liberalised in a given region, but each contracting country maintains an individual, national tariff policy towards outsiders. In order to avoid redirecting trade from countries with low external tariffs to others, the rules of origin are generally applied.
3. Customs Union: Internal trade in a given region is totally free, but common, regional external tariffs are applied towards outsiders by each country.
4. Common Market: Such a market is based on a customs union, but the flow of labour and capital is also liberalised.
5. Economic Union: Member countries harmonise, unify and coordinate their national economic policies, and in certain fields, community policies are

[10]Palánkai, 7.

introduced. It is assumed that a common currency is needed for full economic union.[11]

The European Union

Napoleon was the first ruler to aspire and endeavour towards the unification of the European continent under his empire, but it was not until after World War II that the states of Europe were motivated to set in motion the real process of European integration and unification. Although many post-war organisations (EC, EFTA, NORDEC, CMEA, NATO, WEU, WTO, etc.) transcended national boundaries, and relations broadened in all possible areas, Europe remained fragmented along socioeconomic lines, producing hostility and confrontation between East and West. All movements towards integration and unification remained concentrated in the West, and centered on the European Community--the only organisation where progress towards integration has existed in both *real* economic terms and in institutional framework.

The Single European Act of 1986--an updated version of the Treaty of Rome on which the European Community is based--provided the legal framework for accelerating European integration by improving the functioning of the institutions (widening of powers) and by allowing greater flexibility in the decision-making process. Consequently, the process of European economic integration was taken one step further with the near completion of the internal common market by December 31, 1992. This entailed the promotion of economic and social progress in the EC through the creation of a "Single Market" without frontiers, through the strengthening of economic and social cohesion, and through the creation of an economic and monetary union. The Treaty of Rome of 1957 also laid the foundation for the gradual move towards a union of European states. The "Treaty on European Union" (EU)--known as the Maastricht Treaty after the

[11]Ibid., 8.

Dutch town where it was signed in 1991 and which entered into force on November 1, 1993--is seen as a vital step in bringing the peoples of Europe even closer together.

Similar to the Single European Act, the majority of the Maastricht Treaty is comprised of amendments from the Treaty of Rome. However, it also stands on three "pillars" used as a base of common cooperation between the members states of the EU. The first (and most ambitious) of the three pillars establishes a *new community* which is centered around the controversial component of Economic and Monetary Union (EMU)--leading to a single central bank and a single European currency. (In December 1995, it was decided that the new European currency, the "euro", will be used by EU member-states for internal transactions and accounting beginning January 1, 1999, whereas the first euro bank notes and coins will be entered into public circulation on January 1, 2002.[12]) The EMU will require member states to have low inflation, low budget deficits, and stable exchange rates. This last goal cannot presently be attained by any EU member due to the near collapse of the Exchange Rate Mechanism (ERM) during the summer of 1995. (The EMU will be guided by the European Monetary Institute, which was set up in 1994.)

EU citizenship will be guaranteed alongside national citizenship, and the European Parliament's powers are to be enhanced with the power to veto legislation proposed by the European Commission. The admission of Austria, Finland, and Sweden as members may change the Parliament's (and thus the EU's) stand on trade barriers and other matters close to Central and Eastern European hearts. While outside looking in, the Visegrád countries and other hopefuls--which must "harmonise" their laws with that of the EU in order to join--will have to follow how Maastricht centralises Community policy-making across a wide range of issues including consumer protection, education, the environment, labour, and public health. Central and Eastern Europeans should also note that the treaty creates

---

[12]Gábor Nagy, "Beindultak?" ("Have they gotten off the ground?"). HVG 17 no. 51-52 (865-866), (December, 23, 1995): 33.

a fund which will help the poorest EU members--at present, Greece, Spain, Portugal and Ireland--to lift their economies up to the standards of the rest.

The second pillar, *foreign policy and defense*, seeks to improve co-operation on foreign policy issues by laying down rules for joint action. The member states, not the Commission, decide what to act on, and may make some decisions by majority voting. This pillar provides the base for a common defense policy which is compatible with NATO policies.

Co-operation in the domestic sphere comprises the third pillar, as judicial and police affairs become a common concern for the first time in the Community. This means changes in policies concerning asylum, drugs, fraud, immigration, terrorism and fighting organised crime--issues which are increasingly sensitive for all member states and CEE, as well.[13]

The Visegrád Four and CEFTA

Several months before the dissolution of the CMEA and the Soviet Union, Czechoslovakia, Hungary and Poland signed a declaration of political and economic cooperation in the Hungarian city of Visegrád on February 15, 1991. The establishment of this "Visegrád Triangle" (later "Quadrangle", since the dissolution of Czechoslovakia into the independent Czech and Slovak Republics in January 1993) was a bold initiative which declared the signatories' intent to re-focus political relations from Moscow to the countries of Central Europe. Even before the existence of CMEA, both Western and Eastern powers were always interested in integrating the Central European nation-states into their respective empires, and no attempts were ever made to create a lasting network of trade and cooperation amongst these states. Consequently, intra-regional cooperation remained limited, weak and burdened with numerous economic, political and psychological obstacles. Under these circumstances, any attempts at fundamental

---

[13]Eva Kaluzynska, "What Maastricht Means," Business Central Europe 6, (November 1993): 18.

modernisation inevitably had to be linked to an external (non-regional) power, which had adverse consequences for the strengthening of intra-regional cooperation.

Intra-regional trade and cooperation amongst the Visegrád countries was greatly impacted by the CMEA system. In the first place, the role of regional trade was predominant for all CMEA members, with the highest proportion of turnover occurring with the Soviet Union. Secondly, this system caused and preserved technological backwardness and low quality, and delayed adjustment to global standards in the region's economies. Thirdly, the state-owned enterprises (SOEs) in the region were not autonomous, as they were directed by artificial commands from the centre, and not by market price signals. Lastly, the regional structure and the commodity structure of the foreign trade of the Visegrád countries was distorted away from their comparative advantages, both in terms of regional turnover and in trade with other non-CMEA countries.[14]

At the time of the Visegrád agreement, Hungary had attempted to enlist the support of Poland and Czechoslovakia in the creation of a trilateral free-trade zone, but the focus of the declaration was instead on the countries' common goal of joining the EC. Another attempt by Hungary brought a generally positive response from Poland, but Czechoslovakia was more skeptical due to the collapse of the CMEA markets in 1991, which hurt 65-70% of the latter country's foreign trade, more so than that of the other two.[15] Nevertheless, all Visegrád countries recognised that the success of any economic modernisation vital to their survival in the global market place depended on avoiding a political and security vacuum in Central Europe, and on integrating the region into the Western European system of political and security institutions. They also realised that in order to attain their goal of full membership to the EU, closer cooperation would have to

---

[14]András Inotai and Magda Sass, "Economic Integration of the Visegrád Countries: Facts and Scenarios," Eastern European Economics, (November-December 1994): 13.
[15]Károly Okolicsányi, "The Visegrád Triangle's Free-Trade Zone," RFE/RL Research Report, 2, no. 3 (January 15, 1993): 19.

be in order, since past international experience has shown that small, semi-developed (modernising) countries outside the main trading blocs of the global economy require a developed economic centre from which to receive stimuli for growth and modernisation.[16]

Additional incentives for cooperation came in the form of a flood of good will and free trade sentiment from the EC, when in 1991, tariffs were lifted on a range of industrial goods in and out of the EC, placing the Visegrád countries in the unusual position of welcoming duty-free products from the Community, while charging customs duty to each other. Moreover, negotiations with the EC on association agreements and with the EFTA countries regarding free-trade agreements also gave the Visegrád Four extra impetus to formalise closer ties amongst themselves. Since the association agreements promised the "Four" better treatment on their exports to Western Europe than for those goods traded within the region itself, the only way to avoid trade diversion was to apply similar conditions to intra-regional trade as well. Aside from this, the rules of origin specified in the association agreements promoted intra-regional economic cooperation by permitting the Central European countries to include 60% "local content" in the agreements, as long as there was a free-trade agreement amongst them. Thus, following very difficult and extensive negotiations, an agreement on the establishment of a regional economic organisation called the Central European Free Trade Agreement (CEFTA) was signed in the Polish city of Cracow on December 21, 1992 between Czechoslovakia, Hungary and Poland.

The agreement was never intended to be a customs union, or a form of monetary union requiring financial contributions from its members. The goal was simply to establish a free-trade zone that would lower trade barriers by reducing inter-regional customs duties and import quotas on traded goods. The agreement discriminates against goods imported from non-Visegrád, former CMEA members which are subject to higher import duties

---

[16]Inotai, 8.

(thus making them more expensive) than the same goods produced and traded within the zone. The agreement does not, however, prohibit the "Four" from concluding bilateral customs agreements with non-member states.

The CEFTA, which came into force on March 1, 1993, was considered a practical way to increase the intra-regional trade which had declined drastically between 1990 and 1992, in an area which possesses a potential market of 64 million consumers. The volume of Hungary's trade with Czechoslovakia and Poland decreased in 1991 by 60% from the 1990 level, amounting to only 4.2% of Hungary's total foreign trade.[17] The decline was due primarily to new protective customs measures introduced after the collapse of the CMEA markets which were aimed at regulating the pricing systems in which production and retail prices had been distorted by an assortment of state pricing subsidies. Without these customs barriers, additional state subsidies would have been required to meet the increased foreign demand.

The fundamental structure of the text of the free trade agreement was based on bilateral agreements with the EU and the EFTA. The individual articles follow the EFTA model, whereas the grouping format (i.e. industrial, agricultural, and general provisions) follows the EU model. The underlying principles of the Central European Free Trade Agreement are as follows:

- The scope of the agreement extends to all industrial and agricultural products.
- All trade barriers applied to industrial products shall be gradually dismantled by January 1, 2001, at the latest. This transition period coincides with the transition period outlined in the EU Association Agreements.
- The sequence of liberalisation was determined to ensure a global balance of advantages throughout the transition period. This arrangement differs from the EU Association Agreements, which are based on the principle of asymmetry.
- It is intended that the free trade agreement will guarantee preferences at least corresponding to those granted by the parties to the EU respectively.[18]

[17]Okolicsányi, 20.
[18]Newsletter Hungary, vol. 5, no. 1, Hungarian Ministry of International Economic Relations: 3.

The nature of the EU's aims advocate support for the CEFTA, although these aims may differ from those of the Visegrád group. The EU views the free-trade area amongst the "Four" as a new *cordon sanitaire* that will guarantee Western stability by limiting regional instability in Central and Eastern Europe, and by shielding Western Europe from the threats from the East, including mass migration and organised crime. Community norms make it clear that *all* regional disputes, irrespective of their origins or nature, are a threat to stability, and a sign of "immaturity" for future EU membership. The Western European powers also maintain, though there is no evidence to support this argument, that countries with seemingly similar backgrounds, levels of development, and production structures have a good base on which to build mutual economic relations. In this manner, the havoc which was wreaked by the collapse of the CMEA would be reversed, and the region would have a way out of its deep recession.

However, it could be argued that the Western powers have more selfish interests in promoting regional cooperation in Central and Eastern Europe, that is: self-protection from potential competitors which now threaten the traditional economic stability of the OECD countries on the global market; staving-off new demands for assistance in financial and other resources from developed countries; and fears of the Visegrád countries' application for EU membership, which will surely hinder the slow and careful development of the structure of Western European integration.[19]

One would expect that intra-regional cooperation would be a welcomed situation amongst the Visegrád countries, since four decades of CMEA trade had produced similar economic development, and the detrimental effects could more easily be combatted together rather than as individual countries. However, these countries lack unity and a true will to cooperate stemming from sharp national differences. For example, each country is using different stabilisation measures to accomplish the transformations to a market economy. There is strong competition for external markets, available external

[19]Inotai, 10.

resources (including foreign direct investment, FDI), and for the endorsement of individual transformation strategies by the international political and business communities. Differences in foreign trade--including the timing and depth of import liberalisation--and the pattern of implementing protective measures, could lead to regional trade wars. The dichotomy between the CEFTA officials' eagerness to quicken the pace of liberalisation and their unwillingness to tackle the equally serious problem of non-tariff barriers is making many skeptical about the prospects of free-trade in the region.

Moreover, ethnic tensions, especially the resentment of the treatment of Hungarian minorities in Slovakia and Romania, are another serious hindrance to cooperation. It seems that the most important factor hindering cooperation is that all focus on prospective modernisation is located outside of the region, and thus it appears that intra-regional ties will only play a complimentary role in the goal of modernisation. The diverging interests of the two independent, yet somewhat interdependent, Czech and Slovak Republics has caused a certain degree of polarisation. Since 1993 there have been signs that the Czechs are not that interested in regional cooperation, while the Slovaks have placed a low priority on marketisation by retaining state ownership at a level of about 50%, using ambivalent stabilisation measures, and maintaining a high level of trade relations with non-Visegrád, Eastern European countries, such as Russia and Ukraine.[20]

Nonetheless, there has been some progress since the summer of 1994 in the way of further cooperation and liberalisation talks amongst the CEFTA members. More importantly, bilateral free-trade agreements, following the same structure as the CEFTA agreement, were signed between the individual Visegrád countries and Slovenia in 1995 in preparation for the latter country's integration into CEFTA on January 1, 1996. As a result, duties were abolished on 80% of industrial products, whereas bilateral negotiations

[20] Ibid., 11.

continue with the aim of reducing duties on agricultural products.[21] This "widening" of the CEFTA proves that it is a potentially viable economic organisation which is mutually beneficial to its members, and holds promise for the future of regional trade.

The European Economic Area

Since the mid-1980s, there has been a rapid development of arrangements linking European non-EC members to the Community. The process started in 1984 with EC-EFTA dialogue on the establishment of a European Economic Area (EEA) which would replace the bilateral foreign trade agreements between the EC and individual EFTA countries signed in 1972. The EEA Treaty concluded in June 1992 amounted to the full adaptation of the EFTA countries to the rules and regulations of the EC internal market. However, because the treaty was rejected in December 1992 by Switzerland, it had to be re-negotiated and ratified by the remaining EFTA members (Iceland, Liechtenstein and Norway), and thus did not come into force until January 1994 (with the exclusion of Swiss membership), after the implementation of the Maastricht Treaty in November 1993 which transformed the EC into the European Union (EU).

The EEA agreement ensures the free movement of goods, services, capital and labour; the preparation of similar conditions for free location; the elimination of trade barriers on manufactured goods by creating equal rules for competition; and "flanking" and horizontal areas between the EU and most EFTA countries.[22] The *aquis communautaire*[23] forms the legal basis of the EEA, however, unlike the internal market, the EEA maintains the autonomy of its contracting parties, particularly regarding third countries. Consequently, the EEA does not include policies requiring common decision-making or management institutions, such as a customs union, a common agricultural

---

[21]Gyula Horn, "CEFTA Works," Business Central Europe: The Annual (December 1995): 18.
[22]Wolfgang Danspeckgruber, "The European Economic Area, the Neutrals, and an Emerging Architecture," Gregory F. Treverton, ed., The Shape of the New Europe, 96.
[23]Defined as the legal acts published in the official journal of the European Union.

policy, a common fisheries policy, a currency or monetary union, or regional and structural income transfers.[24]

During the course of negotiations with the EU, the objective and the function of the EEA changed, as it came to be seen as a prelude to accession negotiations to the Community. However, not all EFTA countries felt that the EEA was essential as a sort of "associate membership" to the EU, since Austria began association negotiations even before the EEA negotiations had started. On the other hand, in some EFTA countries--like Norway and Switzerland--where EU membership caused serious divisions in domestic political opinions, this incrementalism was essential. During negotiations, there was a generally accepted view that the EEA regime would be the central framework for regulation of the EFTA's relationship with the EU for quite some time to come. Even so, the EFTA countries never felt a contradiction between the EEA and eventual full EU membership--projecting the idea that the EEA was a "waiting room" and "training school" for prospective members of the Community. The EEA could be seen as a compromise between the proponents of an extended free-trade agreement and those of full membership in the Union; and the latter certainly did view the EEA as one stage of an incrementalist strategy for joining the EU.[25]

EU Integration or Enlargement?

The most fundamental issue facing the European Union today is the oft-asked question of whether the Community should concentrate on deepening the already existing political and economic union, or direct its efforts instead towards widening the union to include new members, thereby possibly slowing the process of integration. Enlargement of the Community brings both advantages and difficulties for the EU and its new members. Problems range from the practical (the addition of new languages to the nine official ones

---

24Per Magnus Wijkman, "EFTA Countries," C. Randall Henning, Eduard Hochreiter, and Gary C. Hufbauer, eds., Reviving the European Union, 87.
25Thomas Pedersen, European Union and the EFTA Countries: Enlargement and Integration, 125.

would complicate the work of EU institutions) to the economic and political (the coordination of policies and laws).

There are a number of formal and informal conditions to be met during the process of admission to the EU, but surprisingly few formal and explicit conditions defining membership. This is mainly due to the highly contentious nature of enlargement amongst EU member-states in relation to the European periphery. Moreover, the surprisingly rapid changes in CEE have caught the EU off-guard, leaving its enlargement policy as yet unadapted to take these events into consideration. It is, however, stated in the Treaty on European Union that two basic conditions must be met by any country seeking membership of the Union: European identity, and democratic status and respect for human rights.[26] The concepts regarding the latter have been rather precisely defined in numerous, lengthy international agreements, but it is more difficult to precisely define the qualifier "European"--should this be based on geography, values and morals, ethnicity, religion, culture, economic or political systems? So far, no formal attempt has been made by the EU to define this term, which is perhaps for the better, since such a debate could become the source of conflict that would only serve to prove the Union's lack of cultural and ideological unity to the outside world.

Aside from the formal requirement of "Europeanness", there are a number of practical criteria which must be fulfilled at the time of accession: acceptance of the *acquis communautaire* and the *acquis politique*[27] which are the legal acts, and political and foreign policy positions held by the members of the Union; well-functioning private and public administrations which can take on and implement new laws and regulations, full capital liberalisation, and the European Monetary Union (EMU); a developed market economy which can cope with increased competition after accession. This economic

[26]Ibid., 131.
[27]Defined as the official policies of the European Union.

flexibility is important to the Union itself because it determines the extent to which enlargement could have negative effects on the EU and its budget.

General concern over the institutional implications of enlargement should not be confused with resistance to enlargement, for on the whole, EU members believe that the Union will benefit from enlargement. The debate focuses rather on when to enlarge and under what conditions. The fact that Austria, Finland and Sweden (formerly EFTA countries) became full EU members as of January 1, 1995 would suggest that the Union has opted for the choice of widening. However, it must be emphasised that economic factors weighed heavily in the favour of the EFTA countries, as their advanced economies are easily adaptable to the internal market and EMU, and their standards of living and GDPs match those of the richest EU members; therefore, the Community will not be burdened with the added economic strain of giving them financial assistance. In fact, the EFTA countries will be net contributors to the EU budget, probably taking over the role of Germany as the Community's "paymaster". For example, Sweden's estimated net contribution to the EU budget has been set at about ECU 1 billion annually.[28] Thus, the inclusion of the EFTA countries in the Union may also quicken the pace of monetary unification.

The EFTA countries are not the only ones in line seeking integration into the European Union. Of the CEE associate members, Hungary was the first to submit a formal application for full membership on April 1, 1994. For these countries, membership in the EU would signal a return to Western Europe... a return to normalcy. For example, in 1928, Western Europe accounted for 70.5% of exports from Hungary,[29] a level which was regained only after the dissolution of the CMEA. For Hungary and the other countries of CEE, full membership in the EU is seen as a crucial element in the process of modernising their economies. The goal of membership is also of important symbolic

[28]Ibid., 139.
[29]Ibid., 151.

value in the expression of their European identities. Thus, integration into the Union is of utmost importance to Hungary and the other associate members.

The CEFTA member-states are by no means homogenous in respect to their populations, level of industrialisation and economic stability. Despite this, they are strongly linked together in the minds of cautious EU policy-makers who judge the region by the performance of the weakest state. Consequently, the EU government has put forth five explanations as to why it cannot yet admit the associate Visegrád countries into the Union. They are, in increasing order of plausibility:[30]

1. Migration: The EU guarantees the free movement of people, thus it fears a large influx of workers from the poorer region of Central and Eastern Europe. However, migration is usually the result of war, not different national standards of living, as is shown by the low rate of migration across the Austro-Hungarian border, and the high rate across the borders of the former Yugoslavia.
2. Sensitive Industries: The EU fears that competition from low-cost producers of textiles, footwear, coal and steel in Central and Eastern Europe will jeopardise these industries. However, the Associate Agreements restrict the trade of these products which make up only about 10% of imports from Central and Eastern Europe. In fact, trends show that competition is more likely to increase in the area of high-technology products, which will mostly be handled by international firms, thereby lessening trade tension.
3. Central and Eastern Europe is not ready: In 1989, the Visegrád countries were about as rich as Greece or Portugal, but over the next three years, their economies contracted by one-third, meaning it would take a 10% annual growth rate to regain the previous level, by which time Greece and Portugal would have received enormous transfers from the EU, requiring the "Four" to work even harder to stay afloat. Aside from this, the EU argues that free-trade competition would flatten the Visegrád countries' industries, and their economies would buckle under the strain of economic obligations--which are difficult for even Greece, Portugal and Spain to fulfill. The Visegrád Four reject these charges. For one thing, already 15-20% of EU trade enters the region tariff-free, and in ten years time, the figure will be 100%. In addition, they

[30]"Eastern Europe: The old world's new world," The Economist, (March 13, 1993): 20-22.

claim that they are as integrated into the EU's economy as some of the current members, aided greatly by foreign direct investment, tax harmonisation, and adjustment of the legal systems. As for the fulfillment of the obligations of EU membership outlined in the Maastricht Treaty: the Visegrád countries are now able to fulfill most of the criteria about as well as some EU members, leading to the conclusion that they are readier for membership than some current members.

4. Institutions: The EU's institutions represent the pinnacle of bureaucratic diplomacy, and because they were designed for six members, they are buckling under the weight of 15. Further expansion would require that the function of every EU institution be re-negotiated--an open invitation to conflict about how federalist the Union should be. Such problems give cause for restricting all expansion, including that of the EFTA countries, not just for countries of Central and Eastern Europe. True, the character of the Union would be irreversibly altered, as it has been after every past accession, but this time, it would no longer be a strictly *Western* European "club", but an institution for all of Europe--which had been the original intent of Monnet and Schuman.
5. Cost: Enlarging the EU to include the countries of Central and Eastern Europe would be very costly, indeed. Budget transfers from the EU's regional fund (accounting for about a quarter of the Union's budget), plus the cost of supporting Visegrád farmers under the Common Agricultural Policy (this accounts for about one-half of Union expenses) would amount to between $6 and $10 billion annually, adding 14-20% to the current all-Union budget.

Of course, there have been precedents for integrating poorer countries into the Community. However, the cases of accepting Greece, Portugal and Spain into the EC cannot be used to argue pro Visegrád integration because the Community which these countries entered no longer exists, since their accession fundamentally altered it and its redistributive policies. Moreover, this group of countries, now benefiting greatly from EU largesse, would likely oppose the accession of another group of poor countries which would diminish the former's share of financial aid from the EU in general. Some estimate that it will take several decades before all CEE countries are admitted to the Union as full members, partly because their per capital incomes are roughly two-thirds of what efinitely balk at the added expense hat they would have pay.

All facts support the argument that after the accession of the EFTA countries, for the ext decade at least, the European Union will concentrate more on deepening the Union, ather than widening it. This is not written in stone, of course, for economics are not the nly factor in such a decision, as was shown by the accession of Greece, Portugal and pain when it was decided that integration was necessary in order to stabilise the ledgling democracies in those countries. If a serious threat to democracy in CEE ppeared, the EU may be forced to re-appraise its enlargement policy. In any event, the referred choice of action will be deeper integration of the existing 15 members. As it is, ne EU's commitment to radical integration since the Single European Act was signed has een so extreme that many members have not yet been able to fulfill the required criteria. The final stage of economic integration, Economic and Monetary Union (EMU), is set for 999 at the latest, but experts believe that even this deadline will not be met because EMU requires too large of a step for the majority of Western European economies to take n such a short time.[32] Having said this, it seems that Hungary and the other Visegrád ountries may have to seek other alternatives to integration into the EU, at least emporarily.

Are There Alternatives to EU Membership for Hungary?

Presently, it appears that Hungary and the other associate members in Central and Eastern Europe will have to wait a decade or more before they meet the formal criteria set ut by the European Union. Cynics say that these criteria exist merely to discourage hose who are not welcome, and even when the criteria have been met, the usual excuse or not admitting a new member is the perceived negative impact of accession on either

---

[1]Pedersen. 153.
[2]Richard E. Baldwin, Towards an Integrated Europe, 147.

the applicant country or the Union or both, and thus, a long period of adjustment is needed. In other words, when the EU is ready to accept the CEE countries, it will let them know.[33]

One thing is certain, recent accessions to the Community have occurred in waves, with groups of similar countries joining at or about the same time--this was evident at the accession of the Iberian countries, and the three EFTA members. This pattern of "bloc" integration indicates that the Community prefers bilateral talks with countries within a grouping rather than dealing with individual states. This being the case, it would be beneficial for the Visegrád countries to initiate some "deepening" of their own, and attempt closer political and economic cooperation within the framework of the CEFTA. Once this is successfully achieved, the CEFTA group could consider enlargement, as well: the instance of "widening" with Slovenia's recent accession is only the first step. Nonetheless, CEFTA would still remain only a free-trade area *outside* of Western Europe. Rapprochement with the West requires inclusion in Western European trading blocs.

The EEA provides European countries with a range of options represented by concentric circles of Western Europen trading blocs which lead to deeper integration. Theoretically, the circles allow a country to proceed from an institution providing primarily free trade in industrial goods (EFTA), via one embracing most of the four freedoms (EEA), to an economic, monetary and political union (EU). Thus, countries in Central and Eastern Europe may choose from the option which best suits their needs, subject to their acceptance by the organisations. It would be beneficial for the CEE countries to be included in the EFTA (bilateral trade agreements exist between the EFTA countries and Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia), which is the entry point to the FEA, giving them access to the wider European economy, and preparing them for eventual EU integration. However, since the Visegrád

---

33 Armand Close and Phedon Nicolaides, "The process and politics of enlargement." EIU European Trends (1st quarter, 1994): 79.

countries are already associate members of the EU and aim to achieve full member status within a decade, it seems that the EFTA and EEA may be more attractive to those East European countries which have so far only made slow progress in their transition to a market economy (the Baltic States, Albania, Bulgaria and Romania)[34] and require an interim solution to EU integration.

C. The Europe "Association" Agreement between Hungary and the EU

The re-integration of Hungary and the other countries of Central and Eastern Europe into the world economy is of absolute necessity if they are to survive in the global marketplace; and integration into the European Union is the only way they can modernise their economies and "re-Europeanise" themselves. The unexpected changes which occurred in the former Communist Bloc countries in 1989 opened the door to negotiations on bilateral agreements between the European Community and Czechoslovakia, Hungary and Poland which were signed in December 1991.

The Association Agreement (commonly known as such because it is based on Article 238 of the Treaty of Rome which deals with associations) has an indefinite period of validity and covers national and Union spheres of influence. The Agreement between Hungary and the EU--which entered into force on February 1, 1994--belongs to the so-called "second generation agreements", concluded by the EC with third countries, which stresses the particular importance given by the EU to cooperation with the newly emerging democratic state of Hungary. This is the first time that an agreement has gone beyond the aspects of commercial and economic cooperation and taken into account the dimensions of political dialogue, scientific exchange and cultural cooperation. The Association Agreement affects several spheres of Hungarian society and the economy, and provides for the establishment of complete free trade for industrial goods under a

[34]Pedersen, 74.

precisely laid out timetable within a ten-year transitional period which includes preferential market access for agricultural goods.

The goal and task of the Association is to contribute to the development of the Hungarian economy, market institutions and legal system, as well as to prepare Hungary for future EU membership by increasing harmonisation with the Community. The Agreement establishes the institutions required for the Association to come into effect. Hungary's determined intention to integrate into the political, economic and security systems of the new Europe is made explicit in the Agreement, and is in fact stated in its preamble: "Having in mind that the final objective of Hungary is to become a member of the Community and that this association, in the view of the Parties, will help to achieve this objective".[35] (see Appendix 5 for the main elements of the Europe Agreement.)

Hungary, like the other countries, has pushed for membership in the EU for three basic reasons brought about by the transformation process it is undergoing. First of all, Hungary has had to re-orient most of its trade flows to Western markets since the collapse of the CMEA and the contraction of domestic markets in CEE. Although Hungary had already travelled quite far along this path as compared to others in the region before the dissolution of CMEA in 1991, a complete re-orientation towards the West did not occur until after 1991. Consequently, the EC became the "trade anchor" of the transformation process in CEE. Secondly, it is expected that the Community will play a stabilising role during Hungary's economic and political transformation, and that this stabilising factor will also aid in calming ethnic conflicts in the CEE region. Finally, the EU is expected to act as a moderniser in this region of technological and economic backwardness.

Benefits of EU Association

One of the major forces behind the Visegrád countries' drive to join the EU, and the latter's consideration of them is the fragility of the still new, democratic political systems in CEE. These democracies have only recently been freed from enforced foreign

---

[35]Official Journal of the European Communities. no. L 347 (31.12.93): 3.

domination. Should the situation in the former Soviet Union change and become hostile once more, EU membership would give Hungary and the other CEE countries the political anchorage and security guarantees required to safeguard against external and internal opponents of democracy and capitalism.

Formal economic relations with the EU have already helped bring about substantial structural and institutional changes in Hungary where there are large potentials for "static" gains (latent comparative advantages which are creating export possibilities, thereby improving the external balance for the country). A free trade association has allowed producers and consumers to use the least expensive import sources both for production inputs and final consumption, leading to mutual trade "creation". Opening up the formerly closed Hungarian economy has broken up monopolistic structures, and created true market conditions--cutting monopolistic prices and costs, almost completely eliminating shortages, improving the quality of products, and improving overall efficiency. The newly opened markets are allowing both sides to take advantage of the economies of scale, and reduce production costs in different areas.

Market competition and direct company contacts with Western partners promote technological progress, as well as structural change, diminishing the gap between East and West. In the past, the monopolistic position of state-owned companies and bureaucratic central planning promoted slow technological development, a lack of interest in innovation, and a general structural rigidity in the Hungarian economy. Technological revolutions (i.e. mechanisation and computerisation) are dramatically reducing costs, and are leading to radical transformations of services and infrastructures. New technologies are allowing Hungary to compete on the world market, thereby eventually overcoming its tremendous difficulties in the areas of internal and external debt.

Larger markets have attracted joint ventures and private capital investment to Hungary, and extensive participation in trans-national company relations has increased the country's microeconomic efficiency and ensured better access to global markets. These advantages will increase even more as barriers to trade and cooperation are slowly removed over the next five to ten years. Capital resources can now be better mobilised and allocated (particularly in common markets) in the framework of market integration, where the flow and trade of technology and related capital movements are interconnected. Larger markets allow national economies to more easily break through structural and institutional bottlenecks in capital supplies, thereby improving opportunities and competitiveness for Hungary.

Association will also improve Hungary's macroeconomic performance, as the dynamic effects of market integration generally increase growth rates. This growth process can be stabilised beyond market impulses by appropriate economic policies, and in certain areas, by the coordination of policies. Structural change will definitely aid in Hungary's improved utilisation of labour resources (thus, decreasing unemployment). Monetary cooperation (some form of interaction with the EMS or a monetary union) is, as is evident from the present global economic situation, indispensable for stabilising exchange rates and for establishing the full convertibility of the Hungarian forint, thereby reducing the domestic rate of inflation. Finally, trade preferences and other support mechanisms guaranteed in the Association Agreement are helping Hungary improve its chances of avoiding serious external imbalances due to future integration into the world economy.[36]

We have mentioned some of the primary negative effects that CEE integration would have on the European Union, but there are also many positive factors from which the Union will benefit during this association. First of all, the prevention of the drawing of another "Iron Curtain" across Central and Eastern Europe is a prime consideration for Western Europe, and integration will solidify the former's newly developing democracies and free-market economies, and moderate any tendencies towards radicalism. Secondly, the inclusion of Central and Eastern Europe in the EU will act to balance the voting rights of the mighty German Republic which has long been the European economic

[36]Palánkai, 22-24.

powerhouse, and therefore, a determining factor in all EU policies and decisions. Third, open Central and Eastern European markets have allowed EU national companies to establish their influence in the region before other international companies discovered the region's latent potentials. At the moment, wages are much lower than in Western Europe, but exposure to western work practises and ethics is resulting in increased labour productivity and quality for a fraction of western costs. This situation is also benefitting the EU by stimulating the production of labour-intensive goods in Central and Eastern Europe, while discouraging the practise in the West; thus freeing Western resources for more productive activities. Since this increased specialisation will allow nations to concentrate their resources on producing those items they are technically most suited for, the pan-European allocation of resources will improve, increasing per capita output throughout the entire Western and Central and Eastern European region.[37]

The Disadvantages of EU Association

As with anything else, there are always two sides to an argument, and so the countries of Central and Eastern Europe do have to pay a certain price for integration into the Western European economy:

1. Hungary has already suffered some uncontrollable negative economic and social consequences and tensions due to structural changes based on and induced by market integration. High unemployment has resulted from the rapid elimination of inefficient enterprises and sudden bankruptcies, a trend which will probably be intensified by institutional and intrastructural deficiencies (i.e. the immobility of labour due to a shortage of housing). These processes should be moderated by the asymmetric and gradual liberalisation measures of the Association Agreement, as well as by comprehensive social policies. However, increased EU protectionism is still eroding any gains which might be had by the countries of CEE.
2. Structural change based on market integration has sometimes been subordinated to the short-term commercial interests of foreign companies, at times reproducing the structural distortions on a new scale. Increased foreign enterprise involvement in Hungary has often concentrated on the region's inexpensive labour, and has not

[37]"Eastern Europe: The old world's new world," The Economist. (March 13, 1993): 22; Baldwin, 160.

introduced the promised technological benefits. Moreover, if these foreign interests concentrate on specific areas of investment--thereby leading to structural dependence on global markets or a strengthening of existing monopolistic structures instead of the creation of competitive environments--Hungary's troubles during a recession may be augmented. Therefore, the government has had to consider the interests of both foreign and domestic companies by ensuring that the Association is accompanied by comprehensive national structural policies based on preferences and incentives.

3. Servicing the growing debt will require a surplus in the balance of trade and payments over a lengthy period of time. However, the process of market integration has led to a deterioration in this balance, primarily because Hungary is a less developed country with inherited economic rigidities and structural weaknesses. It is possible to counterbalance this by unilateral liberalisation in certain areas on the part of the EU, such as by direct support to debt servicing or by an acceleration of structural change in direct measures. Hungary's present debt crisis is the most crippling hindrance in its bid for EU membership.
4. Integrating Hungary's market into that of the EU has caused a deterioration in its macroeconomic performance. The country has suffered some trade losses through trade liberalisation and increased EU protectionism, and external imbalances have forced a continuous devaluation of the national currency, leading to increased inflation and unemployment.[38]

Trade and the Association Agreement

Since the dissolution of the CMEA, Hungarian trade has been almost completely rerouted to trade with the European Union. There have been many positive changes since the Association Agreement was originally signed in 1991, creating better market access conditions in the West for Hungary. First of all, a surprisingly larger than expected portion of originally CMEA-oriented Hungarian exports proved competitive in EU markets. Secondly, Hungarian products withstood competition in a wide range of commodity types. Thirdly, the outstanding dynamism of exports did not originate in the areas initially believed the most competitive ones--like agriculture or sensitive industrial

[38]Palánkai, 24-25.

goods--rather, machinery products and industrial consumer goods proved to be the driving force behind Hungarian export growth to the Union.[39]

Unfortunately, in addition to the above-mentioned disadvantages relating to the country's economy, other negative factors also come into play regarding Hungary's trade situation with the European Union:

1. The Association Agreement, although more binding and comprehensive than the 1990 Generalised System of Preferences (GSP) which provided preferential rates of duty on imports and abolished tariffs and quotas on industrial goods, has not provided much more substantial market openings for Hungary.
2. The protection of sensitive EU markets, i.e. agriculture, has deprived Hungary of some new export opportunities.
3. Hungary's surplus in agricultural trade has drastically diminished since 1991, while agricultural imports from the EU have sky-rocketed.
4. Hungary is unable to compete with highly subsidised EU exports to former CMEA countries, causing Hungary to lose ground in its traditional, agricultural export markets.
5. Hungary's textile and clothing industry is ironically threatened by increased exports to the EU, because inputs are being diverted away from domestic manufacturing sources.
6. The rules of origin outlined in the Agreement may become disadvantageous for the reconstruction of Hungarian manufacturing in the medium-term, as the preference given to EU inputs will divert Hungarian import sources from low-cost non-European producers to high-cost EU producers. Moreover, this rule may discourage non-European FDI from considering Hungary as an efficient investment location for Europe-wide production.[40]

Certainly, these shortcomings of the Association Agreement have some negative impact on Hungary, but they cannot be held solely responsible for Hungary's disappointing export performance during recent years, for the recession in Western

---

[39]András Inotai, "Looking forward to full membership," Hungarian Economic Review, (June-August 1994): 65.
[40]Ibid., 66.

European and domestic problems are equally to be blamed. Due to the fact that the Agreement has not given Hungary everything that it had hoped for through association, the country is looking to full membership to help alleviate the difficulties in trade that it is finding hard to cope with today. However, it is not necessarily the proportion of trade with the EU which will determine Hungary's ability to integrate into that bloc, but its successful incorporation into the European (and global) intra-industry trade and subcontracting network, and its enhanced competitiveness. And as we have mentioned above, the process of integration extends well beyond trade relations, embracing all areas of economic activity and the acceptance of the *aquis communautaire*.

D. The New European Architecture

The European Union is viewed as the foundation of the new European house, and with the disintegration of the Soviet Union and Yugoslavia, the EU has become the only stabilising force in Europe. However, the EU has not been oblivious to the turmoil experienced by its Eastern neighbours, and it too is now undergoing economic and socio-political problems which are far more serious then mere cyclical difficulties. In the past five years, especially, the Community of Europe has been faced with a structural and integration crisis. The EU's declining share in international export markets for manufactured goods, its high labour costs, its technological shortcomings, and the alarming increase in its rate of unemployment (more than 10%)[41] have all contributed substantially to its structural problems, which have been compounded by a welfare crisis.

The integration crisis is far more important in relation to this paper, as EU integration troubles are also affecting Hungary's chances of integration in the coming future. The most fundamental problem the EU is facing today is the fact that the economic principles on which the European Community was based in the 1950s and 1960s no longer reflect the economic realities of the 1990s. The elements of this outdated model are the coal and

[41] Henning, Hochreiter, Hufbauer, 161.

steel community, agricultural self-sufficiency, and a customs union. At present, all these elements are contributing to a considerable amount of conflict and friction amongst the members of the modern economic union. Enlargement to include the CEE countries will finally force the EU to restructure its outdated and costly institutions and policies.

Recently, the EU seems to have lost its most important driving force--a medium-term vision for integration. Since the Community was established, it has had a clear itinerary for incremental stages of integration: from free trade to customs to monetary and political union. When attempts to achieve the final stage faltered, the Community tried to stimulate interest in the agenda for deepening, and Maastricht seemed to be the logical means to achieving this end. However, the breakdown of the European Monetary System and the lack of a unified policy in dealing with the turmoil in Yugoslavia have raised critical questions about the viability of the monetary and political objectives outlined in the Maastricht Treaty.

Moreover, the very essence of the integration philosophy lost its meaning when the Communist bloc collapsed and the "us versus them" Europe of the Cold War was eliminated. The European Community, in its original form, was designed, and over the years perfected, to fit the specifications of a bipolar system whose challenging task was to overcome any possible confrontation, be it ideological, military, political or economic, with the other side. All this has changed now that the former "enemy" has applied for membership in the EU, adding to the problems of integration.

With the end of the Cold War, the European Union was given the opportunity of fulfilling its original purpose: transforming Europe into an open society without borders. The political viability of the Community had originally been based on a Franco-West German alliance, and on the conviction that national interests can be best represented at the Community level. Once the status quo had become unbalanced, the Community was revealed to be not a collective body, but an association of states whose behaviour has been, and will be, guided by national self-interest, and not the common interest of all participants. The unification of Germany, the EFTA enlargement, the associate status of the CEE countries, and the dynamic developments in the successor states of the former Soviet Union have all deeply challenged this fundamental alliance, pushing the Community's centre of gravity steadily towards the East. In response, tension is increasing between the EU centre and Southern Europe, which fears the integration of the Central and Eastern European countries for obvious reasons of economic self-interest.

Internal Community conflicts which had been staved off for years due to a common front against communism are now erupting in regards to Union issues such as voting rights; the battle between the rich north and the poorer south, and between the big and small members; disputes between those members which desire a looser Union based on inter-governmental co-operation, and those federalists which are pushing for faster integration and stream-lined decision-making. In addition to these problems, the EU parliamentarians are being forced to confront issues which tug more deeply at the heart strings of every Union citizen, that is, national culture. Even the prospect of giving up their national currency to a common "Euro" is causing concern amongst some European citizens who see this as only the first step towards the loss of their national cultural heritage and identity, and more concretely, their national language, in the face of deeper integration.

In light of these current difficulties, the EU is making every effort to delay the integration of Hungary and the other Visegrád countries into its elite grouping of Western European nations. Certainly, the EU's arguments of economic protection are valid and understandable, but the Visegrád countries can no longer be lumped into one common basket as when the Association Agreements were being negotiated. With the collapse of the CMEA, the united front was eliminated, and now the Central and Eastern European countries are also experiencing conflicts due to their growing economic and political differentiation, and the re-emergence of historical ethnic antagonisms which are once again putting up barriers against regional cooperation and integration.

The benefits of integration for Hungary are clear: structural and technical modernisation, the opening up of new markets and trading opportunities, economic stabilisation, financial assistance, and national security. It is also clear that the EU favours the concept of bloc integration, and so membership in CEFTA is not a substitute, but a supplement to all-European integration. Despite all the above-mentioned negative trends directed away from integration, it is in the interest of both communities--the EU and the CEFTA--to work towards closer integration within their own organisations and between one another. One of the most effective ways to achieve the goals of both organisations is through increased FDI to Hungary, creating a stabilising and modernising effect on the economy as a whole.

CHAPTER FOUR
Business and Investment

One of the most important contributors to the progressing transformation of Hungary's economy and the development of its market mechanism has been the presence of foreign direct investment (FDI) in this country since the very beginning of the collapse of Communism in Central and Eastern Europe (CEE). Much of the change which has taken place since 1989 would not have been possible without the crucial investment funds which entered Hungary in various forms of FDI. And although most of this investment initially came only from Western Europe, the world soon took notice of the business opportunities which were cropping up in Hungary's ripening economic climate. The aim of this chapter is not to give an exhaustive survey of all investment in Hungary since the beginning of the reforms. Its purpose is to review the key developments in legislation and infrastructure which have assisted in supporting the on-rush of investment since the early 1990s, and the pros and cons experienced by foreign investors who contributed to the growth of Hungary's economy and business sector. In addition, Hungary's relations with the European Union (EU) and how this affects investment will be discussed, as will Canada-Hungary business relations.

A. Communist Reforms Invite Capitalism

Theoretically, it has been possible to invest in Hungary since 1970 when the country became the first in CEE to open its doors to foreign working capital by decree of a vaguely formulated law. However, this decree was restricted by ideological constraints, and further limited by placing all decision-making power in the hands of the finance minister whose whim dictated whether or not a foreign entrepreneur could obtain a share in a prospective domestic venture. Foreign capital investors were also discouraged from entering capital into Hungary for other reasons:

- from a practical aspect, the idea of foreign capital investment was not compatible with a socialist economic order or with the concept of public ownership of the means of production since, technically, even the investor's private means of production would revert back to the state;
- it was stipulated that the maximum foreign investment in any venture may not exceed 49%, so as to ensure the socialist character of the enterprise in the long run;
- since centrally planned systems could not be reconciled with the sovereign decisions made at the lower levels of enterprise planning, entrepreneurs stayed away--except during periods of economic decentralisation, as during the reforms of the New Economic Mechanism (NEM) in 1968;
- governments of centrally planned economies failed to understand the need to offer tax incentives and to attract foreign working capital by granting state guarantees for investment.[1]

With the coming of Hungary's reform movement in 1988, all this changed. Ironically, it was the original socialist government which introduced tax reforms, a legal framework for private business investment, and laws for company formation--before the Antall government was voted into parliament in 1990--providing Hungary with an early lead in developing a market-based economic infrastructure, and giving it the reputation as the most promising and open former-Soviet Bloc country in which to invest.

B. New Legislation

Regardless of present difficulties, one must always keep in mind that Hungary and the countries of CEE have only had 5-10 years to produce the market conditions which have existed in the West for decades. Over the past two decades, Hungary has slowly been introducing new legislation which would make the investment of foreign capital in the country feasible and attractive to foreigners. In 1972, Hungary passed a joint venture law and as a result, by 1990, some 628 joint ventures had been registered with the Hungarian

[1] Zsuzsa Oroszlán, "Investing in Hungary," Hungarian Market Report, (4/1991): 38.

government. In comparison, Poland only had 170 joint ventures, Bulgaria and the former Yugoslavia 41 each, the former Czechoslovakia 20, and Romania 5.[2] Since then, numerous other laws and acts have aided in Hungary's marketisation.

In 1988, the Németh government passed two vital pieces of legislation in order to aid with the reform of the Hungarian economy. Act VI on Economic Associations (Companies Act) is fundamentally important to the government's efforts of renewing Hungary's economy. Its sphere of authority encompasses the organisation of the economy, the grouping of capital, and the legal forms that associations are to take (i.e. unlimited partnership, deposit or limited partnership, business union, joint company, limited liability company, public company limited by shares). Act XXIV (Investments Act) is the basic law which governs foreign investment in Hungary, and over the years, in the wake of practical experience, it has been amended several times.

The Antall government continued the reforms started by its predecessor after being elected to Parliament. Act LXXXVI (Competition Act) of 1990 offers protection to competitors, consumers and the market. The scope of the Act extends to the economic activities of entrepreneurs in Hungary, including those of the foreign firms in the Hungarian market. The Act is structured to prevent two types of conduct: unfair economic activity, and the restriction or preclusion of competition. The 1990 Property and Privatisation Law set out the fundamental direction of privatisation and ownership reform. Since it was passed, however, both the concepts and practise of privatisation have undergone considerable changes, hence the need for the new privatisation law which entered into force in 1995. Since bankruptcy is an unfortunate, economic alternative to privatisation, the 1991 Bankruptcy Law has provided a legal framework for businesses to settle cases of insolvency so that creditors and debtors can coordinate their interests. The Concessions Act was also passed by Parliament in 1991, providing investors with

---

[2]Nicholas V. Gianaris, The European Community, Eastern Europe, and Russia: Economic and Political Changes, 20.

concessions in return for investing in the development of infrastructure and specific sectors in Hungary.[3]

Although these key laws do have shortcomings and other laws have yet to be enacted, the fundamental legislation required for a market economy has already been passed. Granted, Hungary's laws have been frequently amended to ensure that the best interests of all parties concerned are upheld--resulting in accusations of instability and unpredictability--but one can hardly expect anything less during the dynamic process of social and economic transformation which has enveloped the country. Moreover, in such a situation, stability could be harmful, as it would only aid in preserving previous communist tendencies.

C. Hungary's Investment and Business Climate

Hungary set out on the road towards a genuine market economy almost overnight, leaving behind the rigid Soviet system of planning and entering into a new world of uncertainty where it had few allies and still fewer guaranteed markets for its exports after the collapse of the CMEA trading bloc. Unlike East Germany, Hungary could not lean on a "Big Brother" in the West for assistance, nor could it count on the vast natural resources possessed by "Mother Russia". Despite this, Hungary managed to steer clear of the hyper-inflation plaguing the latter, the sharp wage hikes dragging down the former; and the ethnic violence engulfing the states of the former Yugoslavia.

Hungary's friendly investment climate has favoured it with a "Top Ten List"[4] of reasons why foreigners do invest in that country:

1. Stable political environment - since 1990, Hungary has arguably had one of the most secure governments in the region, focusing on a democratic political process and a business oriented environment.

[3]János Ay and Ildikó Potori, eds., Investment and Business Guide to Hungary - 1993, 40-59.
[4]Albert Warson, "Exploring Hungarian Opportunities," Inc. International, (June 1993): 96; Árpád Abonyi, Hungary: The First Choice for Business in Central-Eastern Europe, 3.

2. Economic policies - while the restructuring of the economy has been accompanied by serious costs, the government has introduced policies designed to reduce the debt, inflation, unemployment, and to build the country's currency reserves.
3. The most liberal investment environment - a solid commitment to at least 50% privatisation of the state sector; foreign companies have been allowed 100% ownership since 1991; the national currency is fully convertible; investments are guaranteed through international and bilateral agreements, and the Foreign Investment Act protects foreign investors against losses resulting from nationalisation, expropriation, and joint venture liquidation; tax incentives are provided; since 1990, legislation has allowed, through the National Bank of Hungary, full hard currency repatriation of invested capital, capital gains, profits and dividends; duty free imports of goods necessary to establish a joint venture is allowed; foreign exchange is available on demand to conduct business; and there is no double taxation.
4. A pro-business attitude - with a quarter century history of market reforms, and as a pioneer in the introduction of new commercial legislation and the promotion of small business development and privatisation since the early 1980s, Hungary was the first country in CEE most uniquely oriented towards business.
5. FDI - more than US$16 bn had been invested by foreign countries in the CEE region between 1990 and 1994, and Hungary alone attracted more than half of this amount over this five year period.[5]
6. Competitive human resources - the labour force is highly adaptable by European standards and is comprised of a large number of well trained, skilled workers whose average wage is well below that of Western Europe. Moreover, Hungarians have quickly picked-up on Western management know-how and the benefits of a Western work ethic.
7. Financial assistance - foreign companies are eligible for subsidies from the $20.5 mn Investment Promotion Fund if they have equity capital of at least $685 000 and a 30% interest in the project.
8. Geographical location - Hungary is geographically the gateway to Western and Eastern markets because of its Central European location (a market of 550 million people can be reached within a 2 000 km radius from Budapest).
9. Technology - although Hungary is far less modernised than the West in many respects, it possesses a high level of scientific and technical expertise which has produced very positive results in the area of Research and Development, and it has responded positively to technology transfers through foreign investment.
10. Infrastructure up-grading - while Hungary's infrastructure has always been comparatively better than those of other CEE countries, it recognises the need to attain Western standards, and is doing so by actively modernising its transportation and telecommunications infrastructures.

---

[5]"Hungary: A Partner of Choice," CanadExport 13 no. 8 (May 1, 1995): II.

Of course, as with any period of change, there are negative aspects to Hungary's transformation process which make investors cautious or even pessimistic: the internal rate of return of investments is initially low or non-existent; volatile market conditions make forecasts unreliable; very high inflation prolonged the full convertibility of the national currency until December 1995; the domestic market is small (10.3 mn people); telecommunications and transportation infrastructures are out-dated; political wavering and foot-dragging hinder economic decisions, as does bureaucratic "red-tape"; constantly changing faces in government ministries, and continually changing laws and policies reduce confidence and stability; pre-communist owners of property are challenging new acquisitions under the new restitution act; nationalist voices are crying out against the "selling-off" of Hungary for pennies to foreigners; tensions between Hungary and Slovakia and Romania over ethnic Hungarian minority rights continue to cool inter-governmental relations; Hungary is being inundated by refugees from the former Yugoslavia. These are all difficulties which will eventually be alleviated as Hungary pulls itself out of its current recession, and finds the resources and gains the experience needed to satisfy both domestic and international concerns.

Understandably, the ups and downs of Hungary's economy are reflected in foreign investment figures, since foreign companies are less willing to invest in a country which is sinking deeper into recession rather than climbing out of it. The initial investment ecstasy and enthusiasm of the early 1990s has been likened to the North American "Wild West" in the 1800s. However, the country's reputation suffered greatly when Standard and Poor's Corp. revised its Hungarian rating outlook from stable to negative in February 1995, citing the budget deficit and privatisation problems as the reason for the revision, urging the government to adhere closely to conservative financial policies. The economy's recent stabilisation seems to be signaling the beginning of a new phase in Hungary's investment and privatisation saga: government and foreign investors alike are realising that the economic "boom" is over, and the more mature investment environment which is taking shape cannot be left to chance, but must be nurtured with solid and unwavering economic policies and legislation. (This new outlook was supported by the introduction of the "Bokros package" in March 1995.) The successful privatisation of a large part of Hungary's utilities at the end of 1995 did much to restore investor confidence in the country and to reduce its budget deficit. Present indicators show that the government will be continuing with its present line of strict economic policy in the near future with the aim of strengthening both the economy and investor confidence.

Foreign investment is vital to Hungary's survival in the global economy, for without the new technical knowledge, management methods and better organisation which foreigners have brought into the country, there would have been no rapid increases in labour productivity and efficiency, no technology transfers and no modernisation of industry (although, it is true that for longer term development, Hungary must possess its own R&D capabilities, and be able to domestically manufacture advanced technology). As one Canadian businessman in Hungary observed, "Representatives of international financial corporations who have been all over the world tell us that the only reason (Hungary) isn't a Switzerland is (due to) what it has undergone in the past 40 years."[6] Therefore, Hungary needs all the help it can get from all outside sources in order to regain its proper place amongst the rest of Europe--the best means of achieving this being its Association with the European Union.

D. Hungary's Future with the EU

It is without a doubt that Hungary's new democratic system and fledgling market economy is still struggling with the development of a stable banking system and commercial framework. The process of privatisation has had serious setbacks and is only now beginning to take a more steady pace, thereby drawing in more foreign investment. It is the view of representatives of the European Union that the way to enforce and

[6] I. Castaneda and A. Dani, "Four Years Old and Maturing," Invest in Hungary (1993/6): 9.

encourage democracy in Hungary and the former East Bloc is through economic and financial instruments. Subsequently, the Rome summit during December 1990 approved the establishment of the European Bank for Reconstruction and Development (EBRD) to assist in the economic recovery of Central and Eastern Europe. The EBRD draws on a capital fund of £7 billion supported by 41 countries, and provides financing for a combination of investments in new infrastructure and private investment in CEE.[7]

In addition, it is recognised that an indispensable condition for the continued inflow of foreign investment into Hungary from the EU is the creation of a favourable business infrastructure through the introduction of appropriate laws and regulations. Hungary's current and future legislation is increasingly following the form of EU legislation--a condition which is laid out in the Association Agreement, and which is a necessary process if Hungary is ever to gain entrance into the Union. Of course, close integration of economic policies with the EU will not always be favourable to Hungary, since these policies are increasingly centered around tight monetary and fiscal control which might be less compatible with the rapid growth strategies which Hungary desires.

Regardless of the hardships stemming from the process of trying to align Hungary's policies and legislation to that of the EU, the very fact that Hungary is an Associate member and will be considered for full membership in the Union within a decade has changed the way foreign investors view the country. Saturated Western domestic markets, the need for growth and a trend towards globalisation have forced multi-national companies to seek opportunities for expansion. Although Asia and Latin America play important roles in FDI location decisions, Hungary and the countries of CEE represent a foot in the EU's jealously guarded door. And even though most companies are wary of the current state of Hungary's economy, they realise that this market has enormous future potential for penetrating new markets and for gaining long-term market share, either in the EU or in other CEE countries.

---

[7]Kate Prescott and Richard Welford, European Business: An Issue-Based Approach, 259.

One example of how Asian multi-national companies are taking advantage of the investment opportunities in Central and Eastern Europe is the joint venture between Japan's Suzuki automobile manufacturer, a Hungarian consortium and the Itochu Co. trading house (with 40-40-11% shares in investment, respectively). The first Suzuki cars, which are assembled from both Japanese and Hungarian components, rolled off the assembly line in October 1992. Suzuki is allowed to import the Japanese components duty-free because its investment has created 300 jobs for Hungarians. When local content and EU content (now at 50%) reaches 60%--the threshold stipulated in the EU's rules of origin--the cars will be regarded as "made in Hungary", and EU tariffs will fall away. Such a label enables Suzuki to export to the Union with few restrictions, due to Hungary's Associate status, and Suzuki can also sell at lower prices than its competitors in the EU because of lower Hungarian production costs.[8] This is only one example of how foreign investors are taking advantage of Hungary's future inclusion in a very tightly sealed and protected market, which would otherwise be almost impossible to break into without such maneuvering. When Hungary becomes a full member of the Union, companies such as Suzuki will have both feet firmly planted in a duty-free market of circa 500 million people (including the populations of the present 15 EU members and those of the Visegrád countries) ready to reap the benefits of patience and long-term planning.

E. Canadian Investment in Hungary

Canadian investment in Hungary is by no means as substantial as that of the United States or other European countries, but Canada is still considered the sixth or seventh largest investor in Hungary, with bilateral trade amounting to $73.9 million in 1994. The total value of Canada's exports during this period was $27.3 million, comprised of such products as precision instruments, machinery, electrical equipment, and meat. In 1994, Canadian imports from Hungary totaled $46.6 million, made up of such imports as

[8] Zoher Abdoolcarim, "The Gateway to the EC," Asian Business (February 1993): 43-44.

chemicals, machinery, fruits and vegetables, and alcoholic beverages.[9] Most Canadian investors in Hungary are people of Hungarian origin who emigrated to Canada after the Second World War, or children of those who left Europe even earlier. Their knowledge of the language and the country provided them with a significant advantage in penetrating the market and establishing themselves amongst the growing ranks of foreign investors.

Canadian management expertise has been put to good use in Hungary, where the service sector, generally neglected in the past, is now expanding rapidly. Many Canadians work for multi-national firms of accountants and management professionals, as well, many others own their own small businesses. The pharmaceuticals sector has traditionally been very strong in Hungary, and Canada is well represented by Novapharm. Linamar has earned a strong reputation in Hungary, and is currently manufacturing a wide range of automobile parts, pumps and farm machinery. In the construction field, a group of Canadian investors has designed a banking centre in the heart of Budapest for US$120 million, of which only $20 million came from Canada, with the rest financed by local and foreign investors.[10] In addition, Canada's Huang and Danczkay has been awarded the multi-million dollar project of building a third terminal for Hungary's international airport. Other Canadian successes include Alberta's ATCO, which is building trailers in Hungary for Russian oil fields; Fracmaster, which is involved in the Hungarian oil sector, and Maple Homes, which is building pre-fabricated, Canadian-style homes for nouveau-riche Hungarians.

Unfortunately, Canadian presence in Hungary's buoyant market has been rather limited, even though there are numerous opportunities to be found in both greenfield investments and acquisitions. Naturally, the key to a successful business venture is locating a good business partner, which is what Canada's European competitors have done in the past. Today, key sectors of investment include telecommunications, utilities

[9]"Hungary: A Partner of Choice." CanadExport 13 no. 8 (May 1, 1995): I.
[10]Ibid., VII.

and energy, as well as the environment, which is a growing concern in CEE. Although Canada's Eastern and Central Europe Technical Assistance Programme has supported the reform process in Hungary's banking system, it remains to be seen whether Canadian banks will take the opportunity to establish themselves in a sector they have helped to modernise, and which is still undergoing major reconstruction. Canadians are highly respected and well-liked by Hungarians in general, and as a result Canadian investors have been warmly welcomed into the Hungarian market which has definite potential for long-term gains.

F. Hungarian Investors in the East

Western investors are not the only ones these days who have seen potential business opportunities in the East. Investors from Central Europe are now also moving eastward to take advantage of low wages and future markets. When the CMEA fell apart in 1991, many Central European investors turned their backs on the East and slammed the door, looking towards the EU to take them in. Today, these same investors are waking up to the enormous latent potential in the former CMEA markets. Central European governments are turning more energy towards boosting exports to the East--especially since many companies have reached a ceiling in the EU, where import quotas cover many of their most competitive products (foodstuffs, textiles, steel).[11] However, Russia is no longer a guaranteed market since Central European firms also have to compete with Western and Asian multi-nationals. Moreover, today's investors have a tough time dealing with a business environment permeated with corruption and crime, and an economy in crisis due to high debt and inflation, and an unstable currency.

Nevertheless, this does not seem to be cooling investor enthusiasm about Eastern markets. Hungarian companies invested approximately US$16.3 mn outside of their borders in 1993, bringing their stock of investment abroad to nearly $115 mn. Contrary

[11] Greg Gransden, "Pipe dreams?" Business Central Europe 3 no. 25 (October 1995): 9.

to the investment trends of the early 1990s when Central European investment was directed at a few large projects in the West, recently, the vast majority of investment is going to small projects in Romania, Ukraine, Russia and Slovakia. Again, the main motive is low labour and production costs. In Ukraine in 1992, for example, wages were 40-50 times lower than in Hungary and Romania.[12] Hungarian investors realise--just like the Western investors now coming into Hungary--that if Hungary wants to have any sort of presence in Eastern Europe in the future, it must get in on the action at the ground level when costs are still low and competition is still manageable. In the end, investing in the East will not only help employ Hungarian experts abroad, it will also open the way to successful companies which will be repatriating their profits, and thus aiding in the rebuilding of Hungary's domestic economy with foreign-earned capital. It seems that the socialists of yesterday are quickly transforming themselves into the capitalists of tomorrow, with very promising results.

When the countries of Central and Eastern Europe began their transformations from centrally-planned socialist economies to market-oriented capitalist economies, Hungary already had a head-start of two decades of reform which enabled it to adapt more quickly to the conditions and needs of foreign direct investment. From day one, Hungary was seen as the most appropriate location to start a joint venture, primarily because of its openness to foreign investors, low production costs, highly skilled labour force, and its access to other markets.

Today, Hungary's place in the investment environment of the new Europe is best described as that of a "middle man". Being strategically located in the geographic heart of Europe, foreign investors now recognise Hungary as the "back door" to the European Union and the "front door" to the markets of the former CMEA countries. Regardless of

[12]"Turning the tables," Business Central Europe 2, no. 10 (April 1994): 47.

how tedious and frustrating the process of privatisation and foreign investment may be to Westerners, and how "unpatriotic" and unfair it may seem to the domestic population which believes its country is being sold out, Hungary needs FDI in order to modernise its economy and infrastructure so that it can compete in today's global market place, and attain its ultimate goal of being integrated into the European Union.

CONCLUSION

Hungary has travelled quite a distance since it started along its journey of transformation in the Spring of 1990. The country is no longer merely the subjugated satellite of an empire, but an independent nation fighting to regain its dignity and respect in the eyes of the world. Hungary was more fortunate than the other Central and Eastern European countries in that it had a head-start in the reform process which made it the preferred choice for financial aid and foreign direct investment from the West. This gave Hungary a solid foundation on which it could proceed with the transformation of its political and economic systems. Nevertheless, political backsliding and conservatism have caused Hungary to lose the "edge" it had on Poland and the Czech Republic.

Both of these countries are becoming more and more popular for FDI, and regarding certain facets of politics, the economy and privatisation, they are considered more stable than Hungary, at the moment. The Czech Republic, for example, was already awarded a coveted membership in the OECD in November 1995, whereas Hungary will probably only receive this membership at the end of April 1996. However, according to a study prepared by the Japanese Nomura Research Institute (NRI), the Czech economy has only just now reached that point where the Hungarian economy was two years ago. The study states that the surprisingly low rate of unemployment is due to the out-dated Czech industrial structure, which has made bankruptcies extremely rare. Moreover, the study warns that the FDI which has entered the country over the past two years could leave at the slightest sign of trouble. (In response, the Czech CTK news agency rejects the study claiming that it was prepared by the Hungarian branch of the NRI, and is therefore biased.)[1]

---

[1] "Felvétel, csapó" ("On your marks"), HVG 18 no. 4 (870), (January 27, 1996): 29.

It seems the present coalition government has once again started the economy on the right track, but the situation is still quite unstable and unpredictable. There may be some validity to the above-mentioned study, which reveals a trend in the Visegrád region characterised by overwhelming success in the initial stages of transformation giving way to a realistic down turn in the economy, which can only be followed again by positive recovery. In the case of Hungary, economic recovery cannot be counted as the only deciding factor: the Hungarian people must also transform themselves in order to meet the demands and responsibilities expected of a Western society. The transformation of the very being of a nation is possibly the most difficult of all tasks which may take an entire generation to accomplish, but with the necessary assistance, Hungary can overcome all these difficulties.

In this case, Hungary requires the assistance of foreign investors and the European Union, in order to ensure the continued modernisation and transformation of the country. It may take another decade of stalling and negotiations on the part of the EU, but despite the latter's misgivings, all-European integration is possible, and would only require the EU to rethink the meaning of an open society, for it is no longer adequate to define its existence in terms of a closed society (the Communist Bloc) which no longer really exists. This open society could be regarded as a middle ground helping a more closed society to open up, and preventing a more open society from closing in on itself. This middle ground could help both sides achieve that which would be mutually beneficial to all: a politically and economically stable Europe, and a unified, peaceful continent without borders. It seems that this is the only way that Hungary will be able to rejoin Europe and find its place in today's global economy.

BIBLIOGRAPHY

I. Primary Sources

A. Books & Official Documents

Abonyi, Árpád. Hungary: The First Choice for Business in Central-Eastern Europe. Budapest: Hungarian Investment and Trade Promotion Agency, 1992.

Ay, János, and Potori, Ildikó, eds. Investment and Business Guide to Hungary - 1993. Budapest: Hungarian Chamber of Commerce, 1993.

Official Journal of the European Communities, no. L 347 (31.12.93).

Palánkai, Tibor. Transformation and Integration in Central Europe. Budapest: Budapest University of Economic Sciences, International Studies Centre, 1994.

Palánkai, Tibor. The European Community and Central European Integration: the Hungarian Case, Occasional Paper Series 21. New York: Institute for East-West Security Studies, 1991.

B. Articles

"Agreement between the Hungarian Socialist Party and the Alliance of Free Democrats on an Economic Policy Program and on Economic Policy Guidelines for the Government Program," Hungarian Economic Review 20-21, (June-August 1994).

"Felvétel, csapó" ("On your marks"), HVG (Heti Világgazdaság) ("World Economics Weekly") 18 no. 4 (870), (January 27, 1996).

"Privatizációs csúcsév" ("A peak year for privatisation"), HVG 17 no. 51-52 (865-866), (December 23, 1995).

Ágh, Attila. "After four years: The general situation in Hungary in 1994," Budapest Papers on Democratic Transition no. 79. Budapest: Budapest University of Economics, 1994.

Castaneda, I., and Dani, A. "Four Years Old and Maturing," Invest in Hungary (1993/6).

Heimer, György. "Belül tágasabb?" ("Is it roomier inside?"), HVG 17 no. 51-52 (865-866), (December 23, 1995).

Inotai, András. "Looking forward to full membership," Hungarian Economic Review, (June-August 1994).

Kovács, Álmos. "Macroeconomic policy in 1991-1993: achievements, failures, conclusions," Hungarian Economic Review 19 (April 1994).

Nagy, Gábor. "Majd meglátják" ("They'll see"), HVG 17 no. 40 (854), (October 7, 1995).

Nagy, Gábor. "Beindultak?" ("Have they gotten off the ground?"), HVG 17 no. 51-52 (865-866), (December, 23, 1995).

Newsletter Hungary 5 no. 1, Hungarian Ministry of International Economic Relations.

Oroszlán, Zsuzsa. "Investing in Hungary," Hungarian Market Report, (4/1991).

Szarvas, László Dr. "Transition Periods in Hungary - The Chances for Democracy?" Journal of Theoretical Politics 5 (2) (1993): 267-276.

Vajna, Tamás. "Segély e kéj" ("It was a pleasure to give assistance"), HVG 17 no. 47 (861), (November 25, 1995).

II. Secondary Sources

A. Books

Baldwin, Richard E. Towards an Integrated Europe. Centre for Economic Policy Research, 1994.

Batt, Judy. Central and Eastern Europe from Reform to Transformation. North America: Royal Institute of International Affairs, Council on Foreign Relations Press, 1991.

Berend, Ivan T. The Hungarian Economic Reforms 1953-1988. Cambridge: Cambridge University Press, 1990.

Berend, Ivan T., and Ránki, György, eds. The Hungarian Economy in the Twentieth Century. London: Croom Helm Ltd., 1985.

Csaba, László. "New perspectives on systemic change and stabilizaion in Central Europe: an overview," in Csaba, László, ed. Systemic Change and Stabilisation in Eastern Europe. London: Dartmouth Publishing Company Limited, 1991.

Danspeckgruber, Wolfgang. "The European Economic Area, the Neutrals, and an Emerging Architecture," in Treverton, Gregory F., ed. The Shape of the New Europe. New York: Council on Foreign Relations, 1992.

Fejtö, François. Behind the Rape of Hungary. New York: David McKay Company, Inc., 1957.

Gianaris, Nicholas V. The European Community, Eastern Europe, and Russia: Economic and Political Changes. WestPort, CT: Praeger Publishers, 1994.

Heinrich, Hans-George. Hungary: Politics, Economics and Society. Boulder: Lynne Rienner Publishers, Inc., 1986.

Johannsson, Kjarton. "New Challenges for a Slimmed Association," in Ems, Emil, ed. 35 Years of Free Trade in Europe: Messages for the Future, Proceedings of EFTA's 35th Anniversary Workshop, Geneva, March 9 and 10, 1995. Geneva: European Free Trade Association, May 1995.

Kovrig, Bennett. Communism in Hungary: From Kun to Kádár. Stanford: Hoover Institution Press, 1979.

Pedersen, Thomas. European Union and the EFTA Countries: Enlargement and Integration. London: Pinter Publishers Ltd., 1994.

Prescott, Kate, and Welford, Richard. European Business: An Issue-Based Approach, Second Ed. London: Pitman Publishing, 1994.

Renewal of Reforms in Central and East European Economies, OECD Economic Surveys/CCEET, 1990-1991 Series. Paris: OECD, 1991.

Révész, Gábor. Perestroika in Eastern Europe: Hungary's Economic Transformation, 1945-1988. Boulder: Westview Press, Inc, 1990.

Swain, Nigel. "Hungary," in Batt, Judy, and Lewis, Paul G., and White, Stephen, eds. Developments in East European Politics. London: The MacMillan Press Ltd., 1993.

Wallace, William. "The Context of Reform," in Clarke, Roger A., ed. Hungary: the Second Decade of Economic Reform. U.K.: Longman Group UK Limited, 1989.

Wijkman, Per Magnus. "EFTA Countries," in Henning, Randall C., Hochreiter, Eduard, and Hufbauer, Gary Clyde, eds. Reviving the European Union. Washington, D.C.: Institute for International Economics, 1994.

B. Articles

"Eastern Europe: The old world's new world," The Economist 326 no. 7802 (March 13-19, 1993).

"Hungary: A Partner of Choice," CanadExport 13 no. 8 (May 1, 1995).

"Turning the tables," Business Central Europe 2, no. 10 (April 1994).

Abdoolcarim, Zoher. "The Gateway to the EC," Asian Business (February 1993).

Agovino, Theresa. "Leaping Ahead," Business Central Europe 4 no. 28 (February 1996).

Agovino, Theresa. "Aversion to pain," Business Central Europe 4 no. 29 (March 1996).

Close, Armand, and Nicolaides, Phedon. "The process and politics of enlargement," EIU European Trends (1st quarter, 1994).

Copeland, Henry. "The false trails of eastern Europe's hidden economies," Euromoney supplement, no. 300 (April 1994).

Gransden, Greg. "Pipe dreams?" Business Central Europe 3 no. 25 (October 1995).

Horn, Gyula. "CEFTA Works," Business Central Europe: The Annual (December 1995).

Inotai, András and Sass, Magda. "Economic Integration of the Visegrád Countries: Facts and Scenarios," Eastern European Economics 33 (November-December 1994).

Kaluzynska, Eva. "What Maastricht Means," Business Central Europe 1 no. 6, (November 1993).

Meth-Cohn, Delia, with Papp, Béla. "Fuzzy Growth," Business Central Europe 3 no. 20, (April 1995).

Okolicsányi, Károly. "The Visegrád Triangle's Free-Trade Zone," RFE/RL Research Report, 2, no. 3 (January 15, 1993).

Papp, Béla. "The next step," Business Central Europe 3 no. 27 (December 1995/January 1996).

Reisch, Alfred A. "Hungary's Foreign Policy toward the East." RFE/RL Research Report 2, no. 15 (April 9, 1993).

Sobell, Vlad. "Privatisation in Central and Eastern Europe," EIU European Trends (2nd quarter 1993).

Treml, Vladimir. "Debate: Why Did the Soviet Economic System Collapse? Two Schools of Thought." RFE/RL Research Report 2, no. 23 (June 4, 1993).

Warson, Albert. "Exploring Hungarian Opportunities," Inc. International, (June 1993).

APPENDICES

Appendix 1: Main features of the 1968 New Economic Mechanism (NEM)[1]:

1) Introduction of market mechanisms - the daily coordination of the economy would no longer be state-controlled, but would rely on the relationships between supply-demand-price. A profit incentive would be introduced.
2) Central planning and economic management would remain mainly in the macroeconomic sphere - fixing the main macroeconomic proportions, calculating development goals and supervising their fulfillment. Henceforth, the state would not interfere with microeconomic events, and the central plan which formulated the aims of the economic policy would only be compulsory for the government. Thus, instead of compulsory orders and laws, the government would try to use indirect economic regulators to influence and direct the activities of enterprises.
3) Flexible price structure - a multiplier price system would be introduced which would provide for centrally fixed prices (fuel, raw materials, basic agricultural and food products), prices which could change between centrally regulated limits (certain materials and some mass consumption goods), and free-floating prices (machines, semi-finished products, consumer goods) for different categories of goods. However, the reform would not aim to immediately link domestic prices with world market prices, so as not to subject the hitherto hermetically sealed Hungarian market to the dangers of inflation.
4) Enterprise and cooperative autonomy - companies, as buyers and sellers, would be active in the marketplace and substantially independent. They would draw upon their own production plans, according to their view of local market conditions, thereby abolishing the counter-productive system of quotas. Enterprises would no longer be forced to conduct foreign trade with CMEA countries through the state import-export companies. Trade with the West, however, would require special state permission which would be granted to only a few enterprises.
5) Investment and credit policy - a more flexible policy oriented towards profitability and innovation would be required for anticipated growth.

[1] Ivan T. Berend and György Ránki, ed., The Hungarian Economy in the Twentieth Century, 242.

Appendix 2: Agreement between the Hungarian Socialist Party and the Alliance of Free Democrats on the objectives of an "Economic Policy Program" and of the "Economic Policy Guidelines for the Government Program"[2]:

1. Development of a new programme for consolidating loss-making companies.
2. Privatisation used as company-level crisis management.
3. Management of assets remaining in state hands in conformity with market rules (under the control of trustees).
4. Creation of institutional and legal conditions for expanding the scope of banks, and privatisation of large banks--since the banking system has already been consolidated.
5. The gradual redirection of functions which are normally not the responsibility of a bank of issue from the National Bank of Hungary, resulting in a more consistent separation of monetary and fiscal instruments.
6. In addition to the development of legal and institutional frameworks, it is crucial to reach a positive real interest for the development of the capital market, which should also be promoted by monetary means.
7. Acceleration and completion of the process of compensation, with the rights specified by enforced law.

Appendix 3: The primary elements of the coalition government's short-term crisis management programme for the second half of 1994 and for 1995[3]:

1. An anti-inflationary policy which limits unjustified increases in communal and private consumption and prevents spiraling inflation.
2. Curbing unemployment, improving access to jobs, encouraging projects that promote export, establish modern capacities and create jobs.
3. Decreasing the deficit of the general government budget by curbing costs, collecting the outstanding debts of the central budget and the social security authorities more efficiently, and increasing fiscal revenues.
4. Reducing the foreign trade deficit by improving the conditions of export and keeping the rate of the forint at a level which increases competitiveness. Reaching more favourable terms of trade and payment at talks with international economic organisations.

---

[2]"Agreement between the Hungarian Socialist Party and the Alliance of Free Democrats on an Economic Policy Program and on Economic Policy Guidelines for the Government Program." Hungarian Economic Review 20-21, (June-August 1994): 18.

[3]Ibid., 21.

Appendix 4: The main elements of the "Bokros package"[4]:

1. Currency devaluation - An immediate 9% devaluation was followed by a crawling peg system which devalued the forint by approximately 1.9% a month for the first three months, then by about 1.3% every month thereafter.
2. Import surcharge - An 8% import tariff was applied over and above existing customs duties, which can be claimed back on imports of energy, investment goods and components for export products.
3. Hard-currency accounts - Companies no longer have to sell foreign-currency earnings for forints. This saves time and money when financing imports, and it increases flexibility.
4. Public expenditure cuts - Social security programmes are being means-tested, university tuition fees introduced, and bloated bureaucrats slashed. State-sector wage increases are to remain below the level of inflation.
5. Crack-down on the grey economy - It is estimated that real GDP and public revenues would be up to a third higher if the grey economy were brought into the mainstream, the government is working on introducing more direct measures to combat tax evasion.

Appendix 5: Main elements of the Association Agreement between the EU and Hungary[5]:

Political Dialogue: The goal of association is determined in Article 1 where the Parties place utmost importance on political cooperation. The goal of the Agreement is "to provide an appropriate framework for the political dialogue between the Parties, allowing the development of close political relations".[6] This section addresses the consolidation of the new political order which aims to achieve political and economic convergence between the Parties, and increased rapprochement between Hungarian and Community positions on matters of international (foreign) policy. It introduces and institutionalises regular meetings at the highest political level on all topics of common interest, it schedules information exchanges between the Parties, as well as cooperation at multi-lateral forums.

General Principles: The format of the Agreement follows the fundamental four freedoms, that of the free movement of goods, capital, services and labour, which comprise the principles of the European Union. The Association includes a transitional

---

[4]Delia Meth-Cohn, with Béla Papp, "Fuzzy Growth," Business Central Europe 3 no. 20, (April 1995): 13.
[5]Official Journal of the European Communities, L 347, (31. 12. 93).
[6]Ibid., 3.

period of ten years which is broken into two equal stages of five years. However, this breakdown does not apply to the trade component of the Agreement (free movement of goods).

Free Movement of Goods: The Agreement is preferential, and is aimed at establishing a free-trade zone between Hungary and the Union in the area of industrial goods--agricultural goods are excluded--by December 31, 2000. This means that at the end of the above-mentioned transitional period, goods will be freed from all customs duties and other tariffs, as well as quantitative restrictions, and will also flow freely in those industrial sectors (metallurgy and textiles) whose trade systems had been traditionally regulated by the Community by means of special controls. The concessions granted for liberalising trade in industrial products are reciprocal, but the Agreement is asymmetrical, meaning that Hungary has a longer period in which to liberalise its markets. Thus, Hungary has a 4-5 year grace period during which it can finish its transformation into a market economy and improve the competitiveness of its industries. Certain *sensitive products* form the subject of separate, special protocols, in particular textiles and products of the European Coal and Steel Community (ECSC). Textile products will be liberalised by the Community in accordance with a special timetable which is nevertheless in line with the general dismantling of industrial tariffs. In addition to the Generalised System of Trade Preferences (GSP) which suspended quantitative restrictions, further concessions for trade in agricultural goods are being applied on a reciprocal basis. Trade in processed agricultural products and in fishery products is governed by specific provisions. Other trade provisions include standstill clauses which prohibit the introduction of new trade restrictions, and anti-dumping and shortage provisions. The rules of origin and customs cooperation are also dealt with in separate protocols. Special safeguard clauses uphold Hungary's interests regarding the development of the balance of payments and the protection of infant industries.

Movement of Workers, Establishment, Supply of Services: With regard to workers, the Agreement aims primarily to improve the labour and living conditions of workers legally established in the Community. It invites the Member States to preserve and, if possible, to improve existing facilities for access to employment by Hungarian workers accorded under bilateral agreements, encouraging other Member States to consider the possibility of concluding similar agreements. With regard to establishment, the Agreement grants companies and nationals of the Contracting Parties a treatment no less favourable than that accorded to its own nationals and companies, save for the banking and insurance sectors, where such treatment will be granted to foreigners in Hungary in ten years time. With regard to the supply of services, the Agreement provides that in keeping with the development of the service sectors of the Parties, they will incrementally remove those barriers which restrict the financial institutions and civil service activities of Community and Hungarian companies.

Current Payments and Movement of Capital: The Contracting Parties undertake to authorise, in freely convertible currency, any payments on the current account of balance of payments to the extent that the transactions underlying the payments concern movements of goods, services, or persons between the Parties which have been liberalised pursuant to this Agreement. Both Parties will ensure the free movement of capital relating to direct investments, and the liquidation or repatriation of these investments and of any profit stemming therefrom, however, Hungary guarantees this only five years after the Agreement enters into force.

Competition and the Approximation of Laws: The Association Agreement establishes that the Community's regulations are to be used as the standards for the rules on competition. The Contracting Parties recognise that the major precondition for Hungary's economic integration into the Community is the approximation of that country's existing and future legislation to that of the Community. Hungary shall act to ensure that future legislation is compatible with Community legislation as much as possible. The approximation of laws will extend to the following areas: customs; banking; company accounts and taxes; intellectual property; on-site protection of workers; rules on competition; protection of health and the life of humans, animals and plants; food legislation; consumer protection including product liability; indirect taxation; technical rules and standards; transport; and the environment.

Economic Cooperation: The Agreement establishes cooperation between Hungary and the Community aimed at strengthening economic links on the widest possible foundation to the benefit of both Parties, and at contributing to Hungary's development, enabling it to meet the challenge of restructuring its economy and making it competitive by the end of the transitional period. The policies are designed to bring about economic and social development in the following Hungarian sectors: industrial cooperation; investment promotion and protection; industrial standards and conformity assessment; cooperation in science and technology; education and training; agriculture and the agro-industrial sector; energy; nuclear safety; environment; water management; transport; telecommunication, postal services and broadcasting; banking, insurance and other financial services; monetary policy; money laundering; regional development; social cooperation; tourism; small and medium-sized enterprises; information and communications; customs; statistical cooperation; economics; public administration; and drugs.

Cultural Cooperation: The Parties undertake to promote cultural cooperation in order to promote mutual understanding and esteem between individuals, communities and peoples. The Parties agree to cooperate in the promotion of the audio-visual industry in Europe.

Financial Cooperation: In order to assist in the development of Hungarian infrastructure, and the stabilisation and systemic reconstruction of the Hungarian economy, Hungary is eligible to receive grants (under PHARE) and loans from the European Investment Bank. In certain circumstances, the Community is ready to examine the possibility of granting macro-economic financial assistance.

Institutional Provisions: An Association Council is hereby established which will supervise the implementation of this Agreement. It will meet at the ministerial level once a year, and when circumstances require. It will examine any major issues arising within the framework of this Agreement and any other bilateral or international issues of mutual interest.