Tibor Palánkai

STABILIZATION AND MODERNIZATION IN CENTRAL EASTERN EUROPE
The Hungarian experience

ABSTRACT

The author analyses the processes of stabilization and modernization in the CEE countries and Hungary at the end of the 1980s, in the period after the fall of communism, the resulting deep economic crisis, and recession. There was a fall in GDP and industrial output, and a decline in private and public consumption. 1994 was marked by economic revival both in the CEE countries and in Hungary. The author sees foreign investment as the source of the re-surge in the Hungarian economy and in this sense calls attention to the dual character of the Hungarian economy.

Key words: economic crisis, recession, direct foreign investment, structural modernisation

The countries of CEE face the complex tasks of **stabilization** (short-term and long-term) of their economies, (coping with economic and social crisis) and that of **structural and technological modernization**.

A. The stabilization of economies

Patterns of the transformation crisis

The revolutionary changes in 1989 and 1990 were followed by an **unprecendented, deep crisis** in the CEE region, which is historically matched only by the "Great Depression" of 1929-33 or the damages of a war. It was called a "transformation slump" by professor János Kornai. Professor Béla Kádár, former Minister of Trade and Industry, challenged the notion of "transformation crisis." According to him, one can hardly speak about a transformational crisis, as "the process of transformation, even if at different speeds from year to year has been progressing continuously." The economic disturbances of early 1990s were rooted in the "structural crisis" emerging since the 1970s (Kádár, 1993).

Growth of real GDP in CEE countries
(percentage changes, annual averages)

	1981-86	1989	1990	1991	1992	1993	1994	1995
Czechoslovakia	2.3	1.4	-0.4	-16.0	-6.7	-	-	-
Czech Rep.	-	-	-	-	-7.1	0.9	2.6	4.8
Slovakia	-	-	-	-	-7.0	-4.0	4.8	6.5
Poland	-0.8	0.3	-11.6	-8.0	1.5	4.5	5.1	6.5
Hungary	1.5	-0.2	-3.3	-11.9	-4.5	-2.3	3.0	2.0
Slovenia	-	-1.8	-4.7	-8.1	-5.4	1.3	5.0	5.0
Croatia	-	-	9.0	-14.0	-9.0	-3.0	0.8	2.0
Central Europe*	-	-	-	-12.6	-9.1	-1.8	1.9	5.3
East Germany	-	-	-	-28.4	5.5	7.1	7.5	7.0
Bulgaria	3.7	-1.9	-11.8	-23.0	-7.0	-4.0	1.4	2.5
Romania	3.6	-5.9	-8.0	-13.5	-15.4	1.5	3.9	4.5
Albania	3.4	2.0	-10.0	-27.0	-10.0	11.0	7.0	6.0
Estonia	-	-	-8.0	-12.6	-14.0	-3.0	4.0	6.0
Latvia	-	-	-0.2	-3.5	-33.0	-25.0	3.0	5.0
Lithuania	-	-	-5.0	-13.5	-39.0	-16.0	2.0	5.0
Former Yu	1.1	0.6	-8.5	-15.0	-	-	-	-
Small Yu	-	-	-	-	-27.0	-30.0	6.5	-
Macedonia	-	-	-9.5	-10.0	-14.7	-14.0	-7.0	-3,0
Former SU	3.0	2.5	-2.3	-11.8	-17.8	-13,7	-	-
Russia	-	-	-9.0	-11.0	-20.0	-16.3	-15.0	-5,0
Ukraine	-	-	-3.0	-11.0	-17.0	-14,0	19.0	-11,0
Belarus	-	-	-	-	-11.0	-14,0	-22.0	-12,0
Azerbaijan	-	-	-	-0.4	-22.0	-13.0	-22.0	-6,0
Armenia	-	-	-	-11.0	-42.6	-15.0	0.0	5,0
Kazakhstan	-	-	-	-10.0	-14.2	-12.0	-25.0	-19,0
Uzbekistan	-	-	-	0.9	-12.9	-2.0	-3.0	-4,0
Twelves (EU)	-	-	2.8	1.4	1.1	-0.4	2.6	2,8
USA	-	-	0.7	-1.2	2.6	3.0	3.9	2,7
Japan	-	-	5.2	4.4	1.3	0.1	0.7	2,2
OECD total	2.7	3.3	2.5	0.8	1.5	1.9	2.9	2,8

The estimates of different sources.
*For 1995 CEFTA. National statistics, OECD Statistics and Economic Survey of Europe in 1992/93, Geneva. CIS, Committee of Statistics. EBRD, WIIW.

In all countries of CEE, there has been a recession since the end of the 1980s, which accelerated to double digit drop in real GDP after 1990-91. The recession has been more moderate in the CEEcs. Till the end of 1993, the cumulative decrease in their GDP had been about 20% (in Hungary 20-21%, in Poland 18-19% and in CSFR 20-21%). According to the Economic Research Institute (GKI Rt.) till 1992, the decrease of real GDP was 19% in Hungary, but if we take "hidden economy" into consideration, it was only 15-16%. At the same time, some historical statistical analyses indicate, that the volume of national income in Hungary dropped only by around 10% in 1929-33 (Figyelõ, March 7, 1994, p. 17.).

In some other countries (Bulgaria, Romania, Albania and the Baltic countries), the fall of GDP reached 30-40% or more. In these countries the recovery also started in 1994 - after a sharp fall rapid growth occured in Albania already in 1993 - but as result of lack of the appropriate structural changes Bulgaria, Romania and Albania, although in different degrees, fell into financial crisis in 1996-97 (i.e. accelerating inflation, growing budget deficit and indebtedness, etc.). In most of the former SU and YU republics, the recession continued in 1996.

Effects of transformation slump in CEE

	Fall of GDP 1989-94	1989-95**	Fall of industrial production* 1989=100
Czech Republic	-18	-15	-38 (1993)
Hungary	-19	-14	-33 (1992)
Poland	-9	-3	-32 (1991)
Slovakia	-24	-16	-45 (1993)
Slovenia	-13	-6	-34 (1993)
Bulgaria	-29	-25	-55 (1993)
Romania	-33	-19	-51 (1992)
Russia	-45	-51	-51 (1994)
Ukraine	-54	-57	-44 (1994)
Croatia	-51	-16	-50 (1994)

* With the year of bottom of the slump in brackets.
National statistics. (Kunjunkturajelentés. Kopoint-Datorg. 1995/2.)
**EBRD. Transition Report, 1995.

It was unfavourable that paralelly there was a "crisis" in world economy, in general, and in Europe, in particular (1991-1993). Since 1945, 1991 was the first year in which the world aggregate GDP dropped by 0.4%. The world economic crisis was accompanied by the growth of the budget and the balance of payments deficits; disproportions in supply of financial resources; dampened consumer demand, particularly in certain sectors (industries); the growth of financial flows much faster than the growth of trade, leading to greater vulnerablity to speculation on financial markets, growing gap between the First and the Third World. The monetary and fiscal policies were holding back growth in most of the countries and the crisis has lead to growing protectionism as reaction to constraints of globalization.

The recovery started in Europe in 1994, but on the long run, the growth of the EU seems to stabilize on more moderate rate (2.5-3%), than before 1973, when it was around 5%.

In 1993, there was a recovery in Poland (4%) and the production levelled out in the Czech Republic. **Since 1994**, there has been already **a recovery** in all CEcs (the Visegrad Four, and Slovenia). The growth rates reached 4-6% in most of the CEcs in 1994-96 and the relatively rapid growth (above 5%) continues in 1997. In Hungary, (and war hit Croatia) the growth has been more moderate (2%). In the context of overcoming the recession, the stabilization seems to progress successfully. Of course, it depends to a great extent on world economic conditions. As it has been the case so far, CEE has to implement its historically unprecedented transformation, "in a 'cold' world economic environment, without the external help of definite magnitude and with its own tough and bitter sacrifices" (Endre Gömöri, Without Locomitives, Figyelõ, January 4, 1996, p. 17.).

The recession particularly effected **investments**, but **the private and public consumption** also fell in all countries with different degrees. In Hungary, the private comsumption dropped by 10% and the investments by 30% between 1980 and 1992. In Bulgaria, the GDP fell by 20% and the investment by more than 40% between 1991 and 1993. In Latvia, the investments fell back by more than 80%, the private consumption by 60%, but public consumption increased by 40% between 1990 and 1994. In Romania, the drop of GDP was 26%, but the fall of investments was 55% between 1990 and 1992. In East Germany, the investments increased by 70%, the private consumption by 17%, between 1991 and 1994.

The 1994 recovery was based on an investment and export boom in most of the countries. But only those countries have produced relatively high growth rates, where paralelly the consumption has also increased. The growth of export of CEEcs (except for the former Soviet republics) was 16.4% in 1994 and 26.8% in 1995. The same data for the Baltic states were 13.2% and 32.9%, respectively.

In Hungary, there was a levelling out in investments in 1993, and then the investments increased by nearly 20% in 1994 and 7% in 1995. Although, the private consumption increased by 1-2% in 1993-1994, and the public consumption by 3-4% in 1992-94, due to the restrictive measures in March of 1995, the private consumption fell by 4% in one year. As a result, inspite the rapid growth of export (17.6% in 1994 and 21.5% in 1995), the general growth of Hungarian GDP was only around 2% both in 1994 and 1995. The growth of import was only 7% in 1995.

In the Czech Republic, on the other hand, the consumption played an important role in the recovery after 1994-95, although it has been based on import to a large extent.

Between 1993 and 1995, the growth of export slowed down from 20% to 14% and then to 9%, the annual import growth accelerated from about 3% to nearly 20% both in 1994 and 1995.

In Slovenia, the private consumption increased by 20% between 1993-1995, while the export by less than 10%.

The recovery was accompanied by **rapid productivity growth**. In this respect, Hungary seems to play a leading role by increasing its industrial productivity by 50% in 3 years between 1993-95. As Mr. Surányi, the president of the HNB noted, "the economy has shown a high degree of responsiveness to market signals. The speed of response surprised me" (Financial Times, October 31, 1995). The about 15% annual growth of productivity, to a large extent, was the result of the intensive modernization and the reconstruction of foreign owned companies. As Chuck Pieper, GE Lighting Europe's chief executive officer noted, the key to Tungsram's good performance lies in "double digit productivity gains for each of the last five years" since 1990 (Financial Times, November 21, 1995). In this respect, the relatively large amount of foreign investment seems to yield its fruit. Between 1994-95, the annual growth industrial productivity was 14% in Poland, around 10% in Slovenia, 7% in Czech Republic and 6% in Slovakia.

One of **the sectors of economy most severely hit by recession was industry**. In CEE, while the GDP dropped by around 20% during crisis years, the fall of industrial production reached about 35-40%. In Hungary, the industrial production fell back to 70.6% compared to 1987 (100%) (engineering industry to about 55%) till 1992. According to the Ministry of Trade and Industry, the volume of industrial production in Hungary shrank to half between 1988 and 1992 (Figyelõ, March 30, 1995). In some other countries the industrial production has been halved and dropped even more. The manufacturing sectors were most exposed to shrinking demand of domestic and former export markets (collapse of CMEA) and to the increasing foreign competition due to opening. Hungarian industry has lost about 44% of the domestic market. The sectors most severely hit were the engineering, electrical instruments, vacuum technology and the transport equipment, which in the West enjoyed a rapid growth.

However, in most of the countries, industry was the first to get out of recession with relatively high growth rates. **The recovery already started** in 1993 in Poland, and some countries (Poland, Hungary, Romania) produced relatively high industrial growth (7-8%) **in 1994 and in 1995**.

There has also been **a deep crisis in the agriculture** of the CEEcs (it somewhat delayed the recovery at least in some countries, for example in Hungary or some of the former YU and SU republics). The sharp drop in agricultural production between 1990 and 1993 reached more than 1/3 in Hungary, and in 1992 the value of investments in Hungarian agriculture was only about 20% of that of 1985. This has lead to breakdown of productive capital.

In Hungary, the agriculture, particularly after the 1960s, developed more favourably than in the other CEEcs. Instead of exploiting the agricultural sector, there have been substantial investments and the food shortages have been mostly eliminated. The reforms and the loose forms of cooperative created favourable market atmosphere and helped the growth of production. The CMEA markets, particularly the Soviet Union secured big outlet for export.

Inspite of recovery in general, the agricultural production in Poland also fell by 1% in 1993, while in Slovakia the agricultural production was 6.7% and in Hungary 10.2% less than in 1992 (Világgazdaság, February 23, 1994). **In 1994, the recovery started in agriculture as well**, and most of the countries of CEEcs produced already a positive growth in the following years.

At the same time, it was encouraging that **the service sectors** have managed to produce much better performances. In Hungary between 1986 and 1993, the share of trade increased from 9.4% to 14.1%, and the non-material services from 15.1% to 31.8% of the GDP. In Hungary, while the number of total employed population fell by about 26% between 1990 and 1995, the number of employees in the non-material services increased by 58% in the same period. This meant 650,000 new jobs in a period when unemployment increased from less than 100,000 to almost 500,000 unemployed persons.

Main factors of the crisis and the recovery

It is not easy to exactly analyse and identify **the main causes** of the transformational crisis in CEEcs. Most of the experts agree that the process was **multicausal**, and the controversies were rather about ranking the different factors.

There is a broad agreement, that the structural factors played an important role in the recession. The structure of economy, enforced by central planning and excessive military production, did not correspond to the demand structure of a market economy, where the formerly supressed comsumer needs played dominant role. And, it appeared not only in relations of sectors of material production and the services, but they were reflected also in the internal distortions of the supply of manufacturing products, particularly concerning certain consumer goods. This can be the explanation of the phenomenon, **that although the production has been shrinking**, the demand, particularly for certain products has been rapidly growing in the early years of 1990s. As it was noted by the Economist: "In normal countries, consumption and production move more or less in step. Yet loosing this production did not affect consumption" (March 13, 1993). **The sales** of cars, PCs and many **products of consumer** electronics and telecommunication have been expanding rapidly, which largely explains the dicrepancies between production and consumption, output and turnover. It was typical, while the retail sales in CSSR rose 16% in 1992, the GDP fell by 10%. In some cases, the supply was simply met by the newly liberalized import, but in dynamic demand sectors, the domestic output was also rapidly expanding. Paralelly taking into account the West European recession, it was not by chance, that the **sharp fall in GDP concentrated on the years of 1991-1992**.

There was also a dichotomy between **the rapid growth of small and medium-size companies** (mostly private ones) and the crisis and **shrinkage of large enterprise sector**. Even in the reform economies, the small and medium-size company sector remained underdeveloped, while large companies, created formerly on the ground of political and bureaucratic considerations survived almost unchanged. The latter ones, although they were mostly small compared to their Western counterparts, which evolved on economic rationals (economy of scale or rational business structures), now fall apart, due to their outdated production base and output structure. They were hit by the lack of financial sources for their modernization by the state, which still owns them, or the lack of interest of private investors. At the same time, the small business sector was flourishing, despite the entries to the market have been accompanied by large number of exits.

Another dichotomy, characterizing the macro-economic developments in CEEcs, in fact, closely connected with the above ones, was between the state-owned and the private sectors. The state sector suffered the "pre-privatization agony" (high debt, lost markets, large-scale bankrupcies, weak and hesitant management under uncertainty of his future), while the private enterprises produced rapid growth. In Poland, the manufacturing and the construction industry recovered to a great extent already after February 1992, which was result of rapid growth of the indigenous private sector. In the Czech Republic the construction sector showed an impressive growth from 1992 and the same dynamic growth characterized the private services and trade sectors. "In most of the countries of Eastern Europe, output of private companies is growing by 15-25% a year," while the state-owned part of the economy shrinks fast. In Poland, the private manufacturing firms are growing by 25% a year. The economy has been split into two tiers: a fast-growing private sector and the ailing state industry (The Economist, March 13, 1993; December 3, 1994). So far, private sector growth has been largely self-financed. These largely offset the effects of the collapse of state-owned firms. According to the EBRD, the private sector was growing about 10-40% in the CEE region, in 1993 (EBRD Transition Report, 1993).

The "natural selection" and the Schumpeterian "constructive destruction" is a normal and natural phenomenon of the cyclical correction mechanisms of market economy. "In our transformational recession, this process is more intensive and complex" (Kornai, 1993: 580). Therefore, it takes time, for the positive tendencies to become overwhelming and able to counterbalance the consequences of the collapse of the old system.

Many analysts feel, that the recession was due to a great extent to the shrinkage of **the external markets**. No doubt, that many sectors and companies, sometimes even with viable capacities, have bankrupted simply because of the sudden collapse of CMEA markets, which was then coupled by the drop of domestic consumption. On the other hand, others stress, that the effects of the collapse of CMEA should not be overestimated and particularly the CEcs have been successful in increasing and redirecting their trade to OECD (EU) markets, particularly betveen 1989-91.

The **value of import** of OECD from CE increased by 16% between 1989 and 1991. Poland increased its export by 63%, CSFR 59% and Hungary "only" by 48%. Between 1989 and 1992, Hungarian export grew annually by an impressive 14%. The export increased by 1-2% (to developed countries by 15%), while import dropped by 8% in 1992.

The liberalization and marketization of foreign trade have released great enterpreneurial energies, and the cheaper import inputs, due to liberalization, have improved competitiveness in many fields, particularly in CEEcs. The other countries has been less successful.

The performance was less impressive in terms of **volume of foreign trade**. According to UN statistics, the volume of export of "economies in transition" fell by 9.8% in 1990, 29.7% in 1991 and 8% in 1992. In Hungary, the volume of export decreased by 20% between 1990 and 1993, which roughly corresponds to the fall of GDP.

The export performances, however, **deteriorated after 1992**, and the impacts of European recession could not have been avoided. This effected particularly the export of CEEcs in 1993, when the shrinkage of European markets cumulated. Hungary was especially hit by the recession of the main importers (Germany, Italy and Austria), by high wages and by overvalued forint. The volume of Hungarian export fell back by 13.1% in 1993, which meant the worst year of the recession in this respect.

The reasons for deterioriation were more complex, however, than simply recession in the economies of West European partners. The effects and advantages of liberalization (import of cheap inputs) and the diversion of trade from the East to the West have been rapidly exausted and therefore the drop in export from the end of 1992, was inevitable in most countries. The first export "successes" in 1989-91 were results of the domestic recession, and therefore, could have been only transitory. Another one of the main reasons according to the Hungarian government, was the lack of proper export financing (HVG, July 17, 1993).

It was also known, that the export to the West has been conducted **with loss by most of the companies**, and this could have been compensated only transitorily by living up the assets. It was very discouraging and negative, that the Hungarian industrial firms made loss in their export. In 1991, the export prices were about 4% bellow the costs, and according to official statistics there was no improvement in 1992. The profitability of the whole export was nearly zero in Hungary for 1993 (Népszabadság, October 16, 1993). At the same time, in Hungary, there was an approximately 3-4% improvment in terms of trade, which indicates the selection toward the more competitive exporters.

The recovery proved to be particularly rapid in terms of export, and since 1994, there has been a positive cumulation in this respect. In Hungary, after a 13% fall in export volume in 1993, the increase was about 11% in 1994, 21.5% in 1995 and about 23% in 1996. The first two years of recovery have been mostly characterized by export-led growth in CEE. The domestic demand started to increase in most countries only in 1995. In Hungary, however, due to monetary and budgetary restrictions, the real wages fell by about 10% and the private consumption by 4% in 1995. It meant that in Hungary, the moderate growth of 2% was entirely based on export.

Due to the consequences of transformation and the need for structural and technological modernization, all the CEEcs are characterized by relatively (some extremely) **high import propensity**. This has unavoidably lead to **growing trade and payment deficits**. The value of import of OECD from CEE increased by an impressive 40% between 1990 and 1994, but the export at the same time grew by 80%. While the volume of Hungarian export fell by 20% between 1990 and 1993, the import increased by 5%. The positive or favourable trade balances of CEEcs turned to deficits in 1993-94 in all countries (except Russia), and this deficits seem particularly high in some countries (Poland, Czech Republic, etc.). The CEEcs accumulated growing deficit in 1995 and 1996, except Hungary, which was the only country that managed to cut back its relatively high trade deficit ($3,853 million in 1994 to $2,859 million in 1996) after the March 1995 measures.

As the data indicate, the other East European countries have produced a much unfavourable foreign trade performance than CE. Many countries have suffered seriously of "trade implosion," which means a destruction of trade by lack of monetary relations leading to substantial output collapse. (The term was introduced by G. A. Calvo and F. Coricelli in a 1992 conference material.) These countries have been less successful in compensation of trade losses due to the collapse of CMEA on OECD markets.

One very important reason of recession and sharp drop in the investments has been of **financial nature**. In Hungary, for example, the interest rates were relatively high (about 35-25%) during 1991-93 and they were discourageing productive investments until recently. The high interest rates have been accompanied with high investment guarantees, while most of the companies had to work with negative profit margins, particularly in 1990-1992. The state sector managements have been long proceeding with their "using up" - policies, which meant maintaining un- or non-profitable activities and the financing losses by selling the assets of the company or at least refraining from any investments. The banks have mostly been in trouble (burdened by bad loans) and only after they are cleared, can we expect the reduction of interest rates and the easing of guarantees.

The tax burdens have been gradually increased, and therefore, there have been strong incentives, that the investments have not moved into the legal sectors (first economy), which meant that the suboptimal allocation and utilization of resources remained unchanged. The deficits in the domestic budgets were financed mostly from domestic savings and strong "crowding out" effects could be experienced toward productive investments. In Hungary, while the treasury bonds and securities offered 30-35% returns, one could hardly expect that the financial resources would be channeled to productive sectors.

After 1993-94, the recovery of investments has been based to a large extent on external financing. As the capital flows have been gradually liberalized (as part of convertibility, liberlization in capital account), the domestic companies turn to foreign financial markets, offering credits on much lower interest rates than it was available at home. In Hungary after 1992, while the external state debt increased only because of unfavourable exchange rate changes, about half of the increase in national debt fell on the commercial sector (domestic companies and banks). This debt increased from almost nil to about $6 billion between 1992 and 1996.

In some countries, particlarly in Hungary and Poland, the direct investments of foreign companies also played an important role. This explains the improvement of the structure and competitiveness of exports, particlarly in terms of the rapidly growing manufacturing exports of the Visegrad countries. Therefore, the export boom after 1994 was based to a large extent on the transfer of external financial resources, particularly in CEEcs.

One of the main causes of the recession - according to Professor Kornai - was **the transition from "sellers" to "buyers" market**. The recession was closely connected to the fundamental change from the supply constrained to the demand constrained economy, which needed costly adjustment and reallocation of resources. "In Hungary, the growth of production had slown down long before the system changed, and then it was followed by long stagnation. If we want to transit from over-demand to over-supply under such circumstances, then slowing down of the growth of demand, and particularly its absolute fall (in volume), unavoidably carry along the supply, which in their mutual effects as vicious circles contribute to the deepening of the recession. The postsocialist economy, when it transits from one permanent market regime, the sellers' market, to an other permanent market regime, the buyers' market, then it does not get into an ideal equilibrium situation, but it tips over" (Kornai, 1993).

Another factor of recession, which is strongly stressed by Professor Kornai, was **the "disturbances of coordination."** It took time, until the new rules and pattern of market behaviours were established. Great number of new enterpreneurs were unexperienced, while there was broad "risk aversion," sometimes keeping back people from rational behaviour. "There is a paradox situation. Large amount of liquidity has been accumulated in the banking system, but it remains stuck there. On the one hand, the commercial banks are hesitant to lend them out as credits, but the enterpreneurs are also abstaining from claiming these credits, because they feel that they are too risky" (ibidem: 584).

The old market institutions were only slowly replaced by the new ones, and important acts of legislation have too long been delayed. In some sectors (agriculture, infrastuctures etc.), specific institutions and regulations would have been needed, and in some cases, this had strong enough effects to postpone rapid growth.

There have been several external shocks after 1990, which imposed addititonal costs on transforming CEE economies and hindered the recoveries of their economies. The Gulf War in 1990-91 negatively effected most of the CEE economies by causing a loss of important market or credit repayments and there were only minor compensations to these countries. Most of the neighbouring countries have suffered losses due to the Yugoslav civil war (loss of foreign trade, transit fees or unpaid debt), but the same applies to the local conflict in former SU. Between the June of 1992 and early 1995, the losses of Hungary, due to the Yugoslav embargo have increased to about $2 billion. (Világazdaság, April 13, 1995), which reach about $2.5billion till the end of 1996. Similar losses have occrued for Romania and Bulgaria. Hungarian agriculture was hit by 3 major draughts in 5 years, which have lead to an approximately 150 billion forint loss. The losses for the Czech Republik and Slovakia have been due to the collapse of CMEA (new oil and energy prices), the failure of main debtors of these countries (Romania, Bulgaria, Irak and Siria), and the problems of shrinking arms export. The Gulf war in 1990 cost about $4,7 billion for CSFR.

The transformation in most countries have been **managed relatively peacefully** so far, and **the threats of social tensions, leading to political turmoil, have not been realized** in CEEcs, inspite of high unemployment and worsening living standards. Although, the situation is gradually improving, these dangers, are not totally eliminated by the recovery. In some countries, the governments are coping with a growing number of strikes, which may lead to a wage-price spiral. In Hungary, the number of people leaving under the poverty line doubled (from 800,000 to 1,600,000) between 1989 and the middle of 1992 (about 16% of population), which coupled with high level of unemployment is a threat to the social stability enjoyed so far (Népszabadság, July 20, 1993). Due to the restrictive measures, the real wages dropped by an unprecedented 10% in 1995 and no substantial improvement can be expected even in the following years up to 1996-97 either. That leaves open the possibility of populist, extremist and autocrative forces seizing power, particularly in the Eastern European countries.

Changing imbalances

The crisis has contradictory effects **on the internal and the external balances** of the economies.

Due to the drastic cuts in subsidies and tax reforms after 1989-90, **transitorily there have been great improvements in budgetary balances** in most of the countries. The crisis, however, has lead to rapid shrinkage of budgetary revenues (taxes), and the deficits re-emerged on a greater scale than before in many countries. The increase in the budgetary deficits reflected the costs of transformation and restructuring, and in some countries they proved to be one of the constraining factors of long-term growth and recovery. Paralelly with recovery, there have been slow improvements in budget balances of most of the countries.

Hungary had a budgetary surplus in 1990, which turned to a deficit of 5% of GDP in 1991. The originally planned (and approved by the IMF) deficits have been overpassed and corrective new budgets had to be approved by the Parliament almost each year. The deficit graudally increased above 8% for 1994, which created crisis situation of financing for early 1995. The main aim of the drastic austerity measures (devaluation, introduction of import surcharge, cuts in expenditures, etc.) of March 1995 (Bokros package) was to improve that balance and financially stabilize the country. As result of the tough restrictions (mini shock therapy), the Hungarian budget deficit decreased to 3.3% of the GDP for 1996.

Similar developments characterized many of the other countries. In **Poland**, the 1990 surplus turned to a 4% deficit (in GDP) by the end of 1991 and it further increased to about 5.5% in 1992. Then it was gradually brought down to approximately 3% in 1996. We could experience similar trends in **Slovakia**. Due to lack of restructuring and the increasing debt, the deficit remains around 10% in Bulgaria.

In the Czech Republic the balance of budget went into deficit only during the last quarter of 1992, but a balanced budget has been maintained since that. The balanced budget was maintained in **Slovenia, Estonia and Latvia** and in this respect, these countries can easily meet the Maastricht criteria.

The **budgetary problems** of CEEcs are **complex and diverging**:

The postcommunist "fiscal trap" asserted itself in many countries (Hungary, Poland, Slovakia, Bulgaria etc.) and the budget deficits have spiraled after 1991-92 (cf. Kolodko, 1991; Kornai, 1992). First, these countries have achieved improvements due to cuts in subsidies and increase in taxes in their budget, and some of them could even produced surlpuses. But very soon they suffered gradual worsening due to squeezing state entreprises by recession and growing number of bankruptcies. This have lead to substantial decline of tax receipts, which was coupled by the falling rate of inflation. At the same time, the recession was accompanied by rising unemployment benefits and other social demands and the re-increase of subsidies of some firms in trouble. The costs of restructuring were growing burdened the budgets.

According to András Vértes (director of Economic Research Institute), there was an approximately 100-150 billion forint **"system-related"** deficit built in the Hungarian budget, which was due to the **delay of radical budgetary reform** (still 60% of GDP was redistributed) and the costs of transformation. The reform of state "household" has been postponed and was started only in 1995.

In Hungary, the **interest burdens of accelerating public debt** have grown to be the major factor of budget deficit. These expenditures were around 350 billion forint in

1994, while the whole deficit was only 330 billion forint. The delays in marketization and privatization of banks and the costs of "debt-consolidations" have been the major contributing factors. The Hungarian and Bulgarian budgets are **heavily burdened by the foreign indebtedness**. In Hungary, the debt servicing took about 8% of GDP in 1996, which meant more 4% surplus should be achieved in the primary budget. The deficits in Hungary have been so far financed from high domestic savings, but this may not be the case for the future. This situation has strongly contributed to high interest rates, hindering investments and growth ("crowding out effects").

The increasing indebtedness first external, then domestic, seemed to be one of the major constraints of recovery and particularly of long-term growth. Hungary could have easily been forced into a "stop-go policy cycle." After a 3% growth in Hungary in 1994, only an approximately 2% growth was achieved both in 1995 and 1996.

The emerging private sector is **avoiding** tax to a great extent, while the collapsing state sector is not only cutting drastically its tax payments, but leads to increased social costs (unemployment benefits). The shift of economic activity to a less extensively taxed and taxable private sector means not only a sub-optimal allocation of resources, but it is one of the major source of budgetary imbalances. The tax evasion costs about 150-200 billion forint revenue loss a year in Hungary. The estimated share of black economy is about 1/3 of GDP in Poland and Hungary, and 12% in the Czech Republic.

The crisis have had **contradictory effects on balances of trade and payments**. As shown before, the trade liberalizations (first 1989-90 opening, then EU associations) and the requirements of transformation and modernization have lead to the rapid increase of import, which have only been partly and transitorily compensated by export successes of CEEcs. The balance of payments have been improved by capital inflows (mostly Hungary, the Czech Republic and Poland). Since the end of 1992, the external balances of most of the countries seem to have been deteriorating, and the indebtedness of some of the countries may worsen again. The process may aggravate as the liberalization committments under Europe Agreements come into force for the associated CEEcs in 1995. To defend their balance of payments, most countries have to introduce transitory import restrictions (import surtaxes, increased tariffs) or devaluations.

The main question mark about trade deficits is, how far they are due to **structural weaknesses or results of modernization**. The modernization deficits could be transitory (results of import needs of restructuring investments or simply that of FDIs), and as the export capacities are built (and the local value added increased), the trade balances may improve. If this is not the case, then deficits lead to further aggravation of indebtedness.

The **prospects of a long-term stabilization** even for CEEcs is open for questions. Poland, with its rapid growth rate, may achieve the pre-1989 level in 1996-97. For Hungary, if the moderate growth prevails (2-3%), this could take years beyond 2000. According to the WIFO (Austrian Economic Research Institute), till 2000, most of the

CEEcs will be by about 15% above 1988 levels of GDP (Poland with 25%, but Hungary just reaching), while Bulgaria and Romania will remain 25% bellow, and in Russia and the Ukraine the production level will be only half of 1988 the levels (Figyelõ, July 6, 1995). Some prognozes are optimistic, some less, but it is clear that the prospects depend on many internal and external facors. As the WIIW 1995 Report noted, "there are no tigers in the Central and Eastern European cage." The prospect of a 10% inflation and a 6% growth of GDP is, however, a realistic medium-term possibility for stabilizing CEcs (Finance Ministry of Hungary, Világgazdaság, September 28, 1993). The Czech Republic did already meet that expectation in 1995, others can meet it only later. After long recesssion, according to Anatoly Chubais, former deputy prime minister and architect of market reforms, the growth of Russian economy may reach an annual growth of 10-12%, after 1997. But the full catching up of CEE may take a long time. According to the Rhein Westfalische Wirtschaft Institute in Essen, for the CEEcs, it may take about 50 years to reach the level of EU (Handelsblatt, Világgazdaság, August 1, 1995).

The stabilization is crucial from points of view of joining Euro-Atlantic institutions of integration. Although, **the Maastricht convergence criteria have not been directly set** as conditions of joining EU by the CEEcs, but it is clear, that they have to take them into account. In fact, it is their national interest to make maximal efforts to converge with the EU economies notwithstanding what the realistic prospects of early joining are. The meeting of Maastricht convergence criteria might be subject for competing for accession among the CEcs into EU. The official Czech arguments claim that the country is well prepared for EU membership on those grounds (even more well prepared than the present members). According to the 2000 package, Poland would reduce its inflation to 5%, the budget deficit to 1.5% and unemployement below 10%.

In terms of **budgetary balances and public debt**, most of the CEE countries fare not badly, and they have good chances (sometimes better chances and positions than the present members) to meet the Maastricht criteria. Inflation is, however, another question. R. Dornbusch and S. Fischer speak about a "moderate inflation," which should be between 12-18%, and can be seen as a sustainable and tolerable level, which the countries can live with (The World Bank Economic Review, 1993, No. 1, p. 1-44). Most of the CEE candidates fall already into this category and some (Czech Republic, Slovakia and Slovenia) managed to bring inflation bellow 10% already by the mid-1990s. The prospects of around 10% inflation are not irrealistic indeed, as the stabilization and transformation programs are completed in the near future. According to Nomura Research Institute, the average inflation of CEFTA countries (Slovenia included) will slow down from 21.9% to 18.7% from 1995 to 1996 (Világgazadaság, January 18, 1996). Of course, these countries have a long way to go to achieve the level of inflation required by Maastricht or the "desirable level of inflation," which can be set around 2-3%. Taking into account the about 10-15 years of transition period, which the future CEE members probably could enjoy, the elimination of inflation in these countries is not irrealistic. Of course, it depends on many factors, it would require a fundamental adjustment and a structural modernization.

B. Structural modernization

The CEE countries missed the technological revolution of 1970s (renewal of production bases, rapid innovation, computerization of organization, management and administration, revolution of infrastucture, particularly telecommunication and transport, etc.) and face the tremendous problems and costs of reparation of damages caused by former negligent policies toward environment.

The systemic deficiencies (lack of interest in innovation and technological modernization) have been aggraveted by harsh restrictive policies and the gradual reduction of investment ratios since the end of 1970s. The share of investments in GDP was about 30% (with worsening ICOR already since the 1960s), which gradually fell below 20% to early 1990s (in 1991 it was 19% and in 1992 17-18%) in Hungary. Although, it corresponded to the level of industrial countries, it is insufficient in the light of modernization needs.

Structurally **a complex duality** characterizes the CEE economies (very similar to the DCs):

- developed and underdeveloped sectors and regions in terms of effiency and competitivity;
- high technologies used in certain fields, while outdated technologies with outworn capacities in others;
- the contrast of the dynamic private and sluggish state sectors, illegal and "black" (second and third) economies.

The main problems and directions of structural modernization are:

1. The replacement and renewal of production capacities and technologies.

2. Reduction of the relatively high energy and material intensivity of production and the restructuring of economy accordingly.

3. Modernization of outdated infrastructures, on micro and macro-economic levels as well.

4. Basic institutional reform of the public services sectors (health, education and social systems). This is an important part of the marketization programs.

5. Restoration of the environment, which has been polluted beyond the expectations and previous estimates. (Some believe that this is as important as the whole complex of structural modernization.)

The Copenhagen criteria for CEE candidates sets that they have to "meet competition" on the European market. Structural modernization is a basic pre-condition of that.

C. Role of foreign capital investments in modernization

1. The main characteristics of joint venture developments and foreign investments in CEE

The joint ventures and foreign investments play startegic role in integration of CEE into the global world economy. Therefore, their development, which have been unfolding since the end of 1980s, tells lot about their transformation and integration.

1. Till the end of the 1980s, the interest of foreign capital was limited toward the region, and an acceleration started only after 1989. The big blue chip investors already came to Hungary in 1989-90. The investments have been concentrated mostly to Budapest and Western Hungary (Figyelõ, August 18, 1994). Foreign investments in CEE grew from $2.3 billion to $56 billion between 1990 and 1996. In Hungary, up to 1988 only 50 joint ventures had been set up, only with about $250 million capital. By the end of 1996, the cumulative amount of direct capital invested in Hungary has exceeded $15 billion in more than 20,000 ventures. Between 1989 and 1996, about $12 billion, in Poland and $7 billion in Czech Republic have been invested.

Volume of FDIs in CEE in 1992 and 1996 (million dollars)

	Till 1992	At end of 1996
Hungary	3,300	15,200
Poland	1,500	12,300
Czech Republic	1,570	7,000
Slovenia	880	2,200
Slovakia	231	900
Croatia	-	1,600
Romania	540	2,200
Bulgaria	330	600
Russia	2,850	6,500
Ukraine	480	1,000
Estonia	300	1,500*
Lituania	220	-
Latvia	180	-
Albania	62	262**
Total FDIs in CEE	11,000-12,610	56,000
China		21,300***

*Baltic States together.
**By the end of 1994.
***Till the end of 1993.
Sources: UN, EEC, 1993, Geneva. Business Eastern Europe - Világgazdaság, February 16, 1994. Estimates of WIIW. World Investment Report, 1993, UN, New York, 1993. East-West Investments and Joint Ventures News, UN ECE, Geneva, 1989-93. Világgazdaság, April 4, 1995.

In some other countries, the investments have caught up only after 1990-1991, or some of the troubled regions have attracted only limited interest so far (Southern Europe or some former Soviet republics).

2. The volume of the capital invested in CEE has remained marginal compared with other regions of global economy. Until 1992, from the $1,900 billion global FDIs only about $8 billion (with former SU about 12 billion, i.e. 0.4% - 0.6%) had come to the CEE region (about 80% goes to OECD) and they are far behind some of the NICs. Some big investor countries, like Japan, are still mostly uninterested and reluctant to come. At the same time, in early 1990s, while the share of Hungary in international flows was 1%, its share in world trade was only 0.2%. In per capita terms, Hungary was one of the first countries in the world (equal to Malaysia).

According to the Institute for International Economics in Washington DC, the foreign capital, which would be needed to raise the amount of productive capital per worker in CEE and former SU to that of the West within ten years, would be about $1.5 trillion a year. The most favourable assumption is $90 billion and the "best guess" is $55 billion a year (The Economist, July 6, 1991). So far only half of that has been invested, and in five years.

3. The role of foreign companies in the national economies is still far from the proportions characteristic ot (small) Western countries (25-40% in GDP). For 1995, in most of the countries this share in GDP was around only 1% (Bulgaria, Croatia, Poland, Romania and Slovakia) and it reached 5.6% for Czech Republik and 5.8% for Estonia (EBRD; Népszabadság, April 14, 1997). Even in Hungary, where the share of foreign investments is the highest in the region, it was estimated about 12% in GDP and 24% of employment in business sector by the end of 1995. At the same time, 39% of value added, 38% of investments and more than 70% of exports of Hungary fell to that sector in 1996. The per capita value added of foreign owned companies was 67% above the average (Népszabadság, February 1, 1997).

4. Until recently, Central Europe (Hungary, Czech Republic and Poland) have been the most favoured direction of investments. At end of 1996, these three countries have absorbed about half of all foreign direct investments coming to the region. So far, Hungary has been receiving about 1/3 of foreign investments in the whole CEE region, but this trend is seemingly changing. Hungary was favoured by because of more advanced legislation and banking system, and exemplary debt servicing.

5. The joint ventures are dominated in terms of number of entities, by German and Austrian firms, but in terms of volume of invested capital, the American companies have better positions. The German and the American are the number one investors.

In Hungary, in recent years, a specially balanced diversification of external economic relations has emerged. "One third of direct investments coming to Hungary is American, one third of credits is Japanese, and two thirds of foreign trade is conducted with the states of EC and EFTA. That has a stabilizing effect on Hungarian economy" (Figyelõ, March 17, 1994). Although the Suzuki company has a major investment in Hungary, the Japanese investors have been generally very cautious in CEE so far, but this may change in the future. In Hungary, the "origin" of almost 1/4 of foreign investments is unknown.

By 1995, in Hungary, France have become the third largest investor after Gemany and USA, and about half of French investment to CEE have come to Hungary. The French companies have invested in energy sector, infrastructure (highway construction) and pharmaceutical industry.

6. So far, the flows have had a "one way" character. Investments in the opposite directions have remained marginal. There are only few CEE transnationals (Moscow Narodny Bank, Hungarocamion, Tungsram, etc.). There are, however, more than 1500 Hungarian joint ventures abroad with about $200 million investment. 70% has been invested in the CEEcs. The average amount of invested capital per company is around 6 million forint ($50,000).

7. The volume of the capital invested per company is marginal, particularly if we do not take into account the few number of larger investments.

Although some large investments were implemented, the average foreign capital per venture were only $300,000 in 1991-1992 in Hungary. In 1991, 37% of new ventures was established only with a 1 million forint capital ($12,500). Some of them were considered as "shell ventures" (for exploiting tariff preferences, tax regulations or for exporting capital through profit repatriation etc.). In CSFR, at the beginning of 1991, there were 1,600 companies with foreign participation. 3/4 with less than 1 million krone, and only 28 with more than 10 million krone. Substantial investments have only been made in 3 companies (Skoda-VW, BAZ Bratislava-VW and Skounion Teplice-Glareibel).

On the other hand, large transnationals seek presence in the region. From the 50 largest industrial companies 35 have already invested in Hungary. The 100 leading transnational companies of the world are represented in CEE in some forms.

8. The capital flows have been concentrated on "green field" investments, and in some periods and sectors there has been rather limited interest in privatization, particularly as assets of state firms are growingly devaluated. Some critics claim that the cream of the state sector has been rapidly skimmed by foreigners (tobacco, sugar, paper or beer

industries) and only the ailing sectors were left for the domestic incvestors. In Hungary, between March of 1990 and October of 1993, the proportion of new investments was more than 60% in the whole, and only 40% went to privatization. In Hungary, 1995 was an exception, when from the more $4 billion only $1.2 billion fell on direct investment, and the remaining greater part went to privatization of the huge energy and telecommunication companies. Alltogether, the share of green field investments and privatization has been about 50-50% till the end of 1995.

In the Czech Republic, the approximately $3 billion direct investment was accompanied by the same amount of portfolio investment until the end of 1994. The same proportion was $8 billion to $800 million in the case of Hungary (Világgazdaság, August 9, 1995).

9. Joint ventures and foreign capital investments concentrate on certain sectors (to industry, but trade and services are also favoured targets). Larger scale investments are limited only to certain fields (vehicles, consumer electronics, food processing, energy etc.). In Hungary, 35% of industrial investments went to food processing. The main automobil manufacturers (GM, Suzuki, Ford, Audi, VW and Fiat) set up footholds in the region. Between 1990 and 1995, about $4 billion has been invested into the automobile industries of the region. According to the prognozes of the automobile industry, about 10% annual increase can be expected in terms of car sales in CEE till 2000.

2. The macro-economic effects of FDIs

1. Foreign investments and direct company contacts with Western partners can promote technological progress and the transfer of modern technologies as well as structural change. The technological and structural modernization could help to reap enormous benefits once the market is adjusted. The FDIs tend to create improved and more balanced economic structures. It was stated on invested American capital: "They have introduced new technologies and contributed to the development of Hungarian industry" (Világgazdaság, August 31, 1993). The same applies to the company structures, through investing in small and medium sized companies as well. There were examples, when foreign investors were closing down formerly developed research (pharmaceutical companies), and there was a lack of transfer of technology.

2. In theory, foreign investments generate economic growth. In reality, this depends on several factors. In this respect, the typical example of the contradictory role of FDIs is Hungary, which has attracted the largest amount of foreign investments, but it has produced the lowest rate of growth in the Central European region. The slow Hungarian growth follows from the special circumstances and economic policies (high debt and the related restrictions), but the directions flow of external resources also count. In case of privatisations, the inflow of capital simply buys property or concessions and ends up on government accounts. Sometimes, substantial amount of capital is needed for consolidation of the company or the monies did not flow to productive investments.

According to the Hungarian National Bank, it is difficult to identify to what extent and in what forms, the investments and the profits are recycled through informal channels. "Only about 25-30% of foreign capital has flown into the exporting sectors. The expansion of the Hungarian economy was served mostly by green field investments in vehicle and electronic component manufacturing and by privatised firms in machinary and chemical industries. The new owners of privatised companies often maintained the links to former domestic suppliers, while in case of green field investments, the role of Hungarian contrators is still small" (Népszabadság, November 6, 1996).

3. FDIs have positive effect on employment. Since 1989, the employment in Hungary fell to 87% in general, but at the same time, the number of workers employed by joint ventures increased continously. Part of joint ventures meant licensed work contracts and were based on reserve capacities, when there were no investments, and in fact, the work force was reduced.

4. The FDIs help to create a monetary stability through their positive effects on the balance of payments. In Hungary, it is estimated, that the aproximately $3 billion deficit of balance of payments was in 70% covered by foreign investments in recent years.

5. FDIs promote export, they are more export oriented, and seem to be less effected by the collapse of CMEA trade. In 1992, the companies with foreign participation sell roughly 40% of their products on foreign markets, while the corresponding share for domestic companies was only 20% in Hungary. While the share of foreign companies was 1/3 in industrial output and 1/5 in employment, they give about 1/2 of industrial export of Hungary, in 1994. In the case of Poland, foreign companies concentrate much more on the domestic markets (Világgazdaság, August 9, 1995).

The export generating and modernizing effects can be indirect. In Hungarian Suzuki, share of Hungarian value added (components) increased from 35% to more than 50% till the end of 1993 and with the 10% EC content, Suzuki easily meets the 60% "local content" requirement of the association agreement. At the same time, in the Audi engines, which are manufactured in Győr, Hungary, the Hungarian value added was only 6% in 1996. "So far the Hungarian manufacturing industry has not yet reached the technological level upon which they can become suppliers of engine and component manufacturers demanding extremely high material quality and precision" (Miklós Somai, Autóipar itthon és a világban (Motor industry at home and in the world, VKI, Kihívások, No. 72, World Economic Institute of Hungarian Academy of Sciences).

There are some negative experiences and phenomena, when foreign investors were cutting down the domestic production in order to eliminate the competition and the export is marginal. Several companies have simply bought monopolistic market positions (RFE/RI. Research Report, November 6, 1992). About 1/3 of foreign investments went to monopolistic sectors (construction, food processing, paper indsutry, and some consumer goods). Once settled, foreign investors often press for protectionist measures.

REFERENCES

Ákos, B.P., A magyar gazdasági rendszerváltás finanszírozásáról (About financing the Hungarian system change.), Aula, No. 2, 1992, p. 9.

Aslund, A., Post-Communist economic revolution, How big a bang? Washington DC, 1992.

Ellman, M., Shock therapy in Russia: Failure or partial success? RFE/RL, Research Report. No. 34. 1992.

Kádár, B., Gazdaságpolitika válságban (Economic policy in Crisis), Külgazdaság, No. 8, 1993, p. 6.

Kornai, J., Transformation recession, Közgazdasági Szemle, July-August, 1993, p. 577.