Current account as a structural weakness of the new EU members

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Content:

1 Introduction

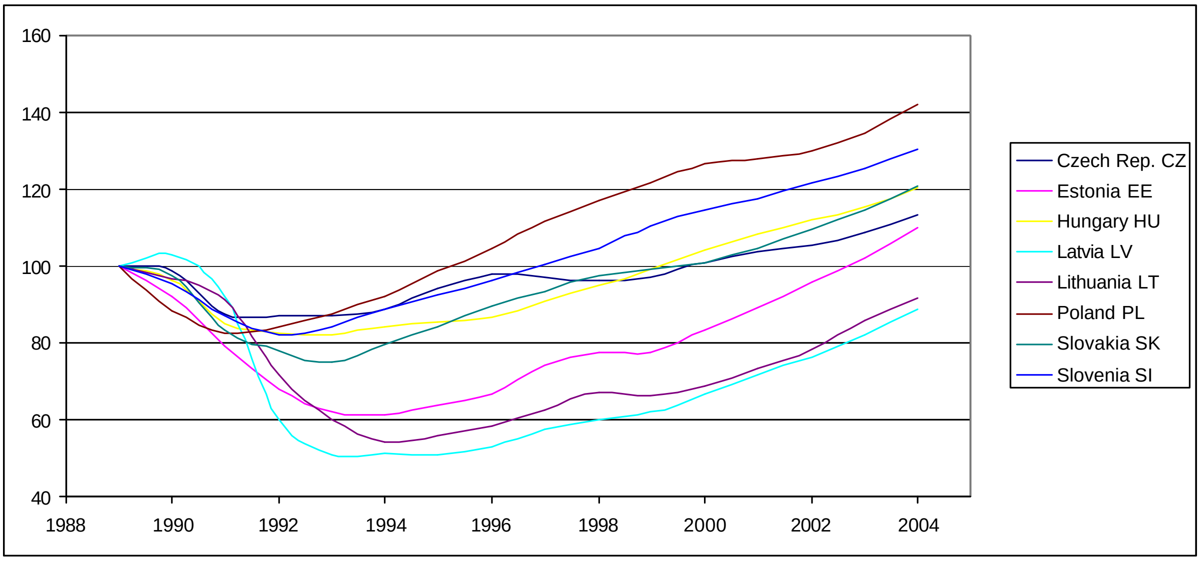
In this paper we concentrate on a particular serious problem impairing most of the new EU member countries. The accession to the common EU market and the final entering into the market opened up the domestic markets of Central and Eastern European Countries (CEECs) to a hitherto unknown extent. Given the insufficient levels of international competitiveness (and other factors to be dealt with), current account balances of the CEECs tend to deteriorate. This poses, of course, a problem in itself. However, using the well-known negative relationship between current account deficits and economic growth (Thirlwall 1979), we argue that external balances restrict economic growth to a level too low to prevent unemployment from rising. Even though the CEEC growth rates seem to be comparatively high from a western European perspective, they are still too low to compensate for the high productivity gains due to the catching-up process in efficiency. As a case study we analyse the development of Hungary and take the findings as point of departure for deliberations of alternative policy approaches.

2 The new EU members

2.1 Growth and productivity

It is well known that the “market-shock” led initially to an absolute fall in production in most of the transition countries for more than one year. Only from the mid-1990s onward growth gained slowly momentum, and some of the countries needed ten years an more to arrive at the 1989 production level (see Figure 1).

Figure 1: Real growth in the new EU member countries 1989-2004 (Real GDP, 1989=100)



Source: own illustration, wiiw databank

Notwithstanding improved growth performances from the mid-1990s onwards, a number of severe economic problems continue to exist in the new member countries, in particular unemployment. Over the six years 1998-2004 only two of the eight CEECs under consideration, namely Hungary and Slovenia managed to keep their unemployment rates below average EU15 levels (see Table 1). The majority of the CEECs experienced higher unemployment than on average in the EU15, with some few years of exceptions in Estonia and the Czech Republic. In the year 2004 unemployment amounts to 19% in Poland and 18% in Slovakia.

Unemployment will not recede quickly. The persistent efficiency reserves and the enormous catching-up process in labour productivity[1] will lead to further increases in unemployment despite considerable real growth. The speed of the catching-up process is clearly represented by the development in the manufacturing industry (see Table 2). During the years 1995 to 2002, (the weighted average of) labour productivity increased annually by 6,5% in the CEECs and by 2,2% in the EU15. Cumulated for this eight-year period, labour productivity grew by almost 80% in the CEECs vis-à-vis just above 16% in the EU15. The downside of this remarkable achievement was not only that real growth was too weak to create additional jobs ('jobless growth') in the CEECs. The cumulated loss of manufacturing jobs accounted to 14% in the CEECs, while the number of these jobs did not fall significantly in the EU15 (-0,9%).

[1] Which is primarily due to the activity of multinationals who settled in these countries and who apply the most advanced technology.

2.2 Current account

However, the growth differential with western European economies, though necessary in the catching-up process, is one of the causes of another most serious problem of the CEECs: the huge and lasting negative balance in current account.

In the period of 1998-2004, current account in per cent of GDP

- has deteriorated from –2% to –7% in the Czech Republic
- has 'improved' to –6% at the end of the 1990s, but then worsened again to –15% in Estonia
- has oscillated between –3% and –6% in Hungary
- moved up and down between –7% and –11% in Latvia
- 'improved' from –12% to –6% in Lithuania
- improved after almost –8,3% (in 2000) to about –3% in Poland
- oscillated between –4% and –9% in Slovakia and
- is only now approaching equilibrium in Slovenia after –4% in 1999.

These deficits are the source of continuous macroeconomic adjustments, of fiscal and monetary austerity measures and of slowing down economic growth. Typical examples are Poland and Hungary, and therefore we will deal with the case of Hungary in more detail.

Table 1: Uemployment rates (total unemployment)

	CZ	EE	HU	LV	LT	PL	SK	SI	EU15
1998	6,4	9,2	8,4	14,3	13,2	10,2	n.a.	7,4	9,3
1999	8,6	11,3	6,9	14,0	13,7	13,4	16,7	7,2	8,5
2000	8,7	12,5	6,3	13,7	16,4	16,4	18,7	6,6	7,6
2001	8,0	11,8	5,6	12,9	16,4	18,5	19,4	5,8	7,2
2002	7,3	9,5	5,6	12,6	13,5	19,8	18,7	6,1	7,6
2003	7,8	10,2	5,8	10,4	12,7	19,2	17,5	6,5	8,0
2004	8,3	9,2	5,9	9,8	10,8	18,8	18,0	6,0	8,1

Sources: Eurostat

Table 2: Labour productivity catching-up in the CEECs vis-à-vis the EU15 in manufacturing industry, 1995-2002

	Growth rate in %		CEECs´ growth differential against EU15 in pp			Growth rate in %	
	cumu-lative	annual average	cumu-lative	annual average		cumu-lative	annual average
CEECs					EU15		
Production	54,0	6,4	38,6	4,3	Production	15,4	2,1
Employment	-14,0	-2,1	-11,9	-2,1	Employment	-0,9	0,0
Productivity	79,1	8,7	62,7	6,5	Productivity	16,4	2,2

Source: Havlik et al. 2003, p. 11

Gross production and productivity in real terms; Central and East European first-round accession countries, weighted average

3 The case of Hungary

We look at the recent economic development in Hungary, and in particular in the period since the regime change. In order to gain a better understanding of Hungary's economic path and her current problems we have to start some time before the transition from plan to market. The first section deals with the development up to the mid-1990s, the second section describes the effects of the reforms in this first period and the policy reaction upon them. Finally, the third section deals with the most recent period focusing in particular on current account aspects.

3.1 Economic reforms before and after transition

Unlike other socialist countries, Hungary carried out a variety of economic reforms already since the 1950s and 1960s[2], the most significant thereof being the reform of the economic control system in 1968. After a longer period of stagnation the reform activity once again accelerated in the 1980s.

On its April 1984 session the Central Committee of the Hungarian Socialist Worker's Party made a decision on the further reform of the economic control system. The principles of the reform were enacted in the VII. (and last) five-years plan, and the two main elements were a tax reform and a bank reform.

The reform proposed the introduction of a value added tax and of a personal income tax, and the reforms were implemented in 1988 with the consequence of an acceleration of price increases to double digit figures. The banking reform followed long debates in the second half of 1985, when a decision was made about the establishment of the two-tier banking system. The commercial banking functions of the National Bank were separated to establish individual profit-oriented banks. The Central Bank kept only the tasks of a bank of issue. The establishing of the two-tier banking system was completed by 1987.

[2] Károly Lóránt, János Hoós, Thomas Morva: Socio-Economic Impact of Structural Adjustment in Hungary. The Hungarian SAPRI studies. Final report. http://www.saprin.org/hungary/research/hun_summary.pdf

Price and wage liberalisation

Price reforms started already in 1968 with gradual liberalization of the “fix prices”. However, the scope of free prices remained narrow until the end of the 1980s. Price liberalisation continued in 1980 by connecting domestic prices to world market prices. A decisive step in approaching Western-type tax and price systems was the above mentioned introduction of the value-added and personal income taxes in January 1988.

The Hungarian economic reforms were strongly supported, sometimes initiated by Bretton Woods institutions (IMF and World Bank). For instance price liberalisation and the reduction of consumer price subsidies were explicit parts of the obligations in Structural Adjustment Loans agreements with the World Bank. By the end of 1990 almost 90 percent of all consumer prices were placed in the free price category. The ratio of consumer price subsidies to GDP decreased from seven percent in 1987 to below one percent in the following four years.

Wage liberalisation was delayed compared to other elements of liberalisation policy, because monetarist policy held that excessive wage increases were the main threat to financial stability. Hence, governments endeavoured to restrict purchasing power and real income (salaries and pensions) and to postpone full wage liberalisation. At the beginning of the 1990s the system of progressive taxation was implemented. Later, in January 1993, central wage control was abolished and replaced by recommendations of a newly established Interest Conciliatory Council. This tripartite forum is a variant of institutionalized labour-relations (employers, employees and government) and is responsible for recommendations to enterprises on the lower and upper limits of wage increases. The recommended margins are not obligatory, but enterprises respect them in practice.

Privatization

All political parties existing at the time of transition supported privatisation, motivated partially by the goal of production efficiency and partially by intentions to create a broad domestic middle class.

The reduction of state ownership started already some time before the regime change. Three important laws made it possible to begin privatisation: 1) the Act on Economic Associations (1988); 2) the Act on Foreign Investments in Hungary (1988); and 3) the Act on Transformation of Enterprises (1989). These laws opened up the way for the so-called *spontaneous privatisation*, where formerly state enterprises continued to exists, but their property and financial assets were transferred to private economic associations, while, in exchange, the enterprises received shares from the limited or stock companies. These transactions were called *enterprise emptying.* The workable parts of the enterprises went into the private associations, while unviable and charged elements remained in the enterprises condemned to liquidation. The essence of the spontaneous privatisation was that managers of state-owned enterprises became owners of those companies. Altogether one tenth of the state property was privatised in this way.

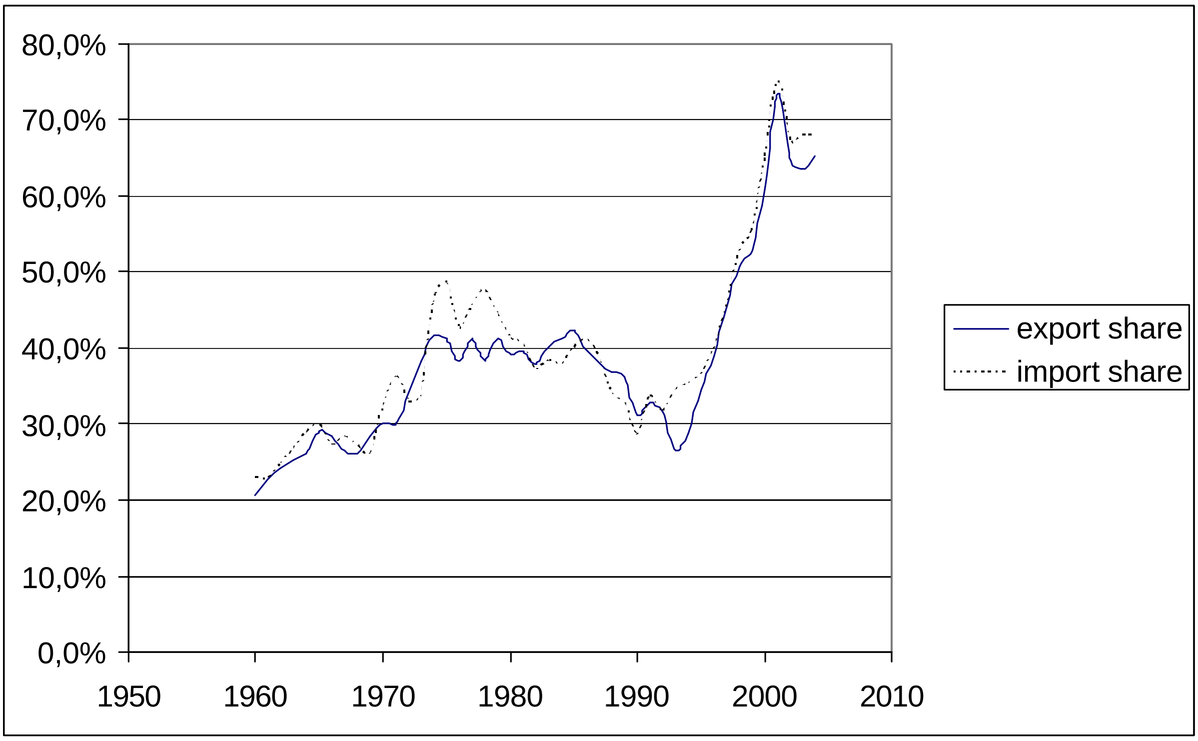
The first (rightist) government that took office after the systemic change established a State Property Agency (SPA) and made the privatisation process better organised. The first step of the organised privatisation was a pre-privatisation program, during which about ten thousand retail shops and restaurants were auctioned off and bought mainly by the former managers. SPA privatised companies mainly by designating specialised organisations that sold the units to the highest bidder.

Another mass privatisation initiative of the SPA was the *self-privatisation program*. The SPA commissioned a consulting firm to transform and privatise around 700 enterprises (from a total of 1856 to be privatised). Ownership rights were transferred to consulting firms, and these firms were remunerated from the receipts from enterprise sales. The program accelerated the mass privatisation of small and medium-sized enterprises. Until 1994, around one quarter of the state property was privatised. During this period, mostly domestic owners bought the privatised assets.

Opening up the economy

Since the 1960s, there have been two marked phases of opening up of the Hungarian economy, the first at the beginning of the seventies and the second in the 1990s. During the first phase the GDP share of exports/imports doubled from about 20% to about 40%, in the second phase this percentage exploded to about 70% (Figure 2). Consequently, Hungary is today one of the most open economies in the world.

Figure 2: Share of exports and imports in GDP, Hungary 1960-2004



Source: wiiw databank

The picture above (Figure 2) suggests that internationalisation began already long before the regime change, namely in the 1970s. However, trade liberalisation proper started in 1988. In the July 1988 meeting of the Hungarian Socialist Workers Party, the Central Committee resolved upon a resolution to implement a rapid liberalization of imports. The liberalization program according to commodity groups was originally planned to be completed in four years, i.e. about 25-30% of tradables should be "liberalized" every year. To speed up the process the whole period was then shortened to three years before the start of the program. By 1992, the final year of the liberalization program, the proportion of liberalized imports reached 90% compared to 35% in 1989. Hence not only the degree of openness of the Hungarian economy is remarkable. It is also the speed of trade liberalisation which is outstanding compared to the time period which was usual for now developed industrial countries in the past[3].

[3] The speed of opening up an economy to international competition was significantly lower in NDCs (Now developed economies). For example, Great Britain, trying to catch up in textile manufacturing technology with the then technologically leading Low Countries in the 15th and 16th century, used what we would call today

The year 1992 marked the beginning of a hitherto unknown process of opening up the Hungarian economy in terms of import and export shares (Figure 2).

A second and no less important change in foreign trade was that the previously used clearing turnover was replaced by dollar accounting, while in 1991 the COMECON dissolved itself. The transition to dollar accounting in Eastern European trade – although it was a Hungarian initiative designed to make use of the balance of payments surplus accumulated within Soviet trade relations – caused a 10% deterioration of the terms of trade, about half as much as in the 1970s, when the oil price shock pushed the country towards indebtedness.

3.2 Macroeconomic impact of the reforms and policy reaction

As a consequence of the radical reforms mentioned above and the liquidation of the COMECON trade, the Hungarian economy practically collapsed. From 1989 to 1993, the absolute bottom of economic decline, the *GDP dropped by some 20 percent* (see Figure 1), industrial production by 30 percent, consumption by eight percent, per-capita real wages by 15 percent. Between 1989 and 1995 employment fell from 5,5 million to 4,0 million, i.e. by 1,5 million and stabilized around 37 percent of the total population and 52 percent related to people of active age, which is a low level also in international comparison. In the statistically observed history of Hungary, including years of crises, world wars and revolutions, there was no other period when *one third of jobs were lost*.

With the introduction of the value added tax system the *inflation* rate rose from well under ten percent to double digits. Price and wage liberalization together with the elimination of subsidies fuelled further inflationary pressures. The inflation rate quadrupled within three years. To curb inflation the ¨financial government", supported by the IMF, carried out a tight monetary policy, which drove up the interest rates well above the profit rate of industries, so money market investments became the most profitable ones and as a consequence the industrial activity remained at low levels.

The changes, especially the import liberalisation widened the gap between exports and imports. While in the years before transition foreign trade was balanced, and in the period of 1988-1990 even a surplus was achieved on average, from 1991 onwards the preceding

infant industry promotion for about one hundred years in order to arrive at a competitive position (Chang 2002, p. 20).

reforms caused a steep fall in the *trade balance*, and the deficit hit bottom at $4 billion, more than one third of the total value of exports in 1994 (see Figure 6). Parallel to foreign trade also the current account balance deteriorated, since the surplus of services was more than consumed by interest payments.

Simultaneously, the *budget of general government* run also deeply in the red. Up until the late 1980s the central government budget deficits averaged around 2,0-2,5 percent of the GDP. The deficit was financed by low-interest National Bank loans (money creating). This form of financing did not cause inflation. As a consequence of bank consolidation and the National Bank Act, however, this situation changed significantly.

In the course of bank consolidation, bad loans were exchanged for government bonds at market interest rates. Since the interest rates on these bonds were extremely high (30 to 35 percent), these bonds (HUF 340 billion) resulted in some HUF 100 billion annual interest payments, equal to 3,5 percent of GDP (!). At the same time the National Bank Act required the government budget to be financed via the money market with high (market) interest rates. This caused a vicious circle between the budget deficit and its financing needs which resulted in a fast growing government debt and budget deficit which increased to 7,6 percent of GDP by 1994.

Policy reaction: the stabilization package

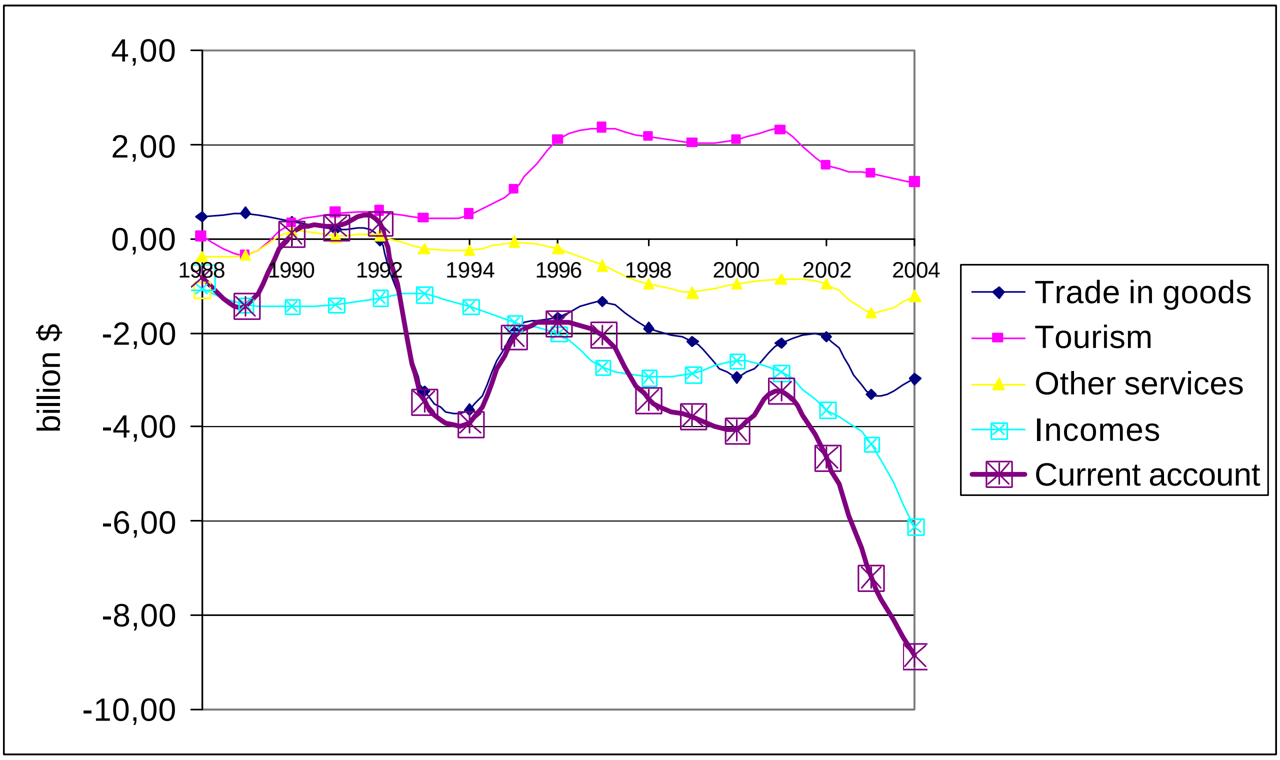
In response to the deterioration of the budget and current account balance the Hungarian government, which was socialist by name but neoliberal by practice, introduced a strict stabilisation program. When the finance minister presented the package two socialist ministers resigned in protest against it, but the government finally adopted the program in March 1995. The national currency was devaluated by 9 percent and a system of crawling devaluation was introduced. As a temporary measure (valid until 1997) an 8 percent surplus import duty was imposed on all products except energy. Salaries were frozen in state enterprises and public institutions, the responsibility for a large proportion of sick pay was transferred to employers, and the zero-rate of personal income tax and of value added tax and after children tax allowances were abolished. Tuition fees were introduced in higher education and the system of social provisions was transformed: the general right to family allowances, child care benefit and child support and pregnancy assistance was made dependent on the social situation of families.

These measures were not accepted without resistance: the announcement of the package set off passionate protests among university students and other affected strata of the population, and the Constitutional Court cancelled one part of the social measures and postponed the introduction of others.

But the stabilisation package – though with huge sacrifices in living standard – was successful in the beginning. The temporary import duty together with devaluation and shrinking domestic demand improved foreign trade and the current account balance. Exports and income from tourism increased while imports fell behind (see Figure 3, 1995-1997).

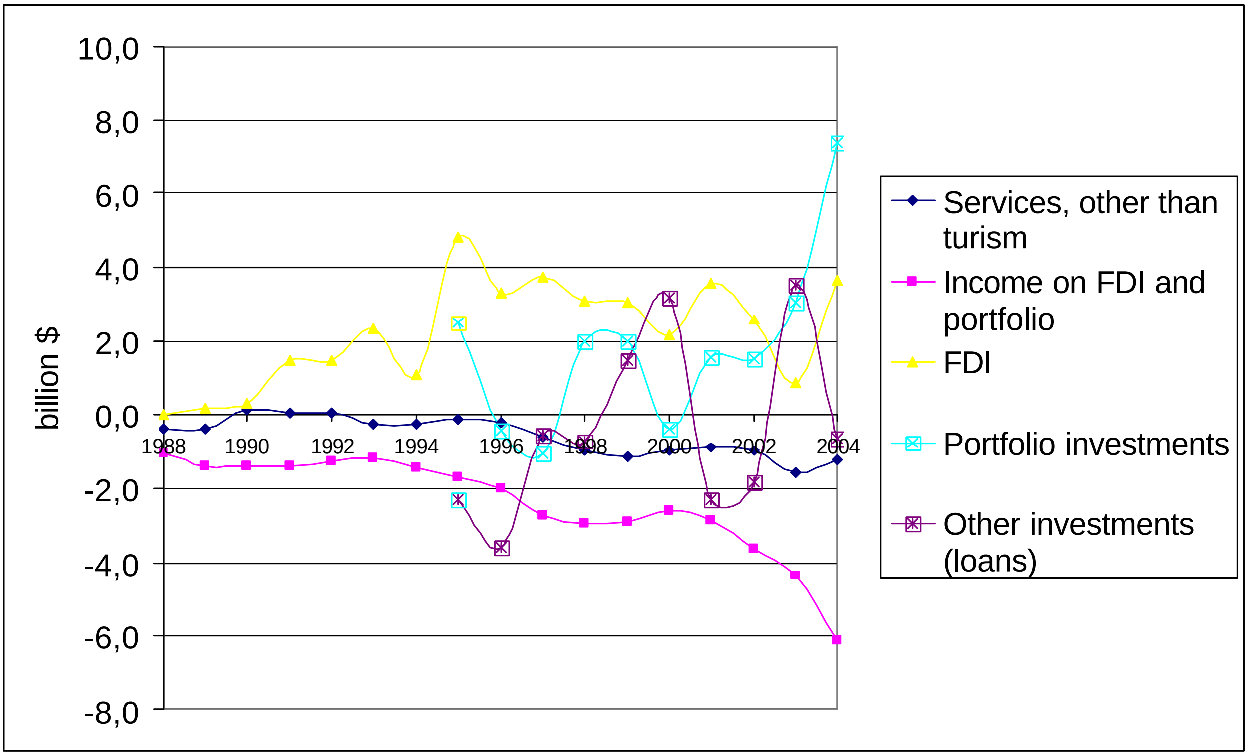
But the most significant change was the huge inflow of foreign direct investments (FDI) and portfolio investments (see Figure 4). The FDI inflow was connected to the privatisation of the electrical energy industry (electrical energy power stations and partly the networks) in the first place, but "green field" investors also showed an increased interest. The portfolio investments were attracted by extremely high interest rates paid on Hungarian government bonds. In the first year after the stabilisation package, the interest rate differential to western European levels was above 10 percentage points.

Figure 3: Main components of current account; Hungary 1988-2004 (billion $)



Source: Hungarian Central Bank

Figure 4: Main component of balance of payments; Hungary 1988-2004 (billion $)



Source: Hungarian Central Bank

3.3 Further developments and the current account

Further privatization and internationalisation

The second (socialist) government that entered into office in the summer of 1994 aimed at accelerating privatisation and finish mass privatisation during the 1994-1998 period of the Parliament. The principles of privatisation changed, with emphasis being placed on cash sales and the income from privatisation ought to reduce budget deficits and state debts. The scope of action was extended to include foreign investors, since these investors were to bring in foreign exchange into the privatisation process necessary to downsize foreign indebtedness. The new conception of privatisation allowed majority ownership by foreigners even in strategic branches, as, for example, in the energy industry and services, or in the sector of large commercial banks.

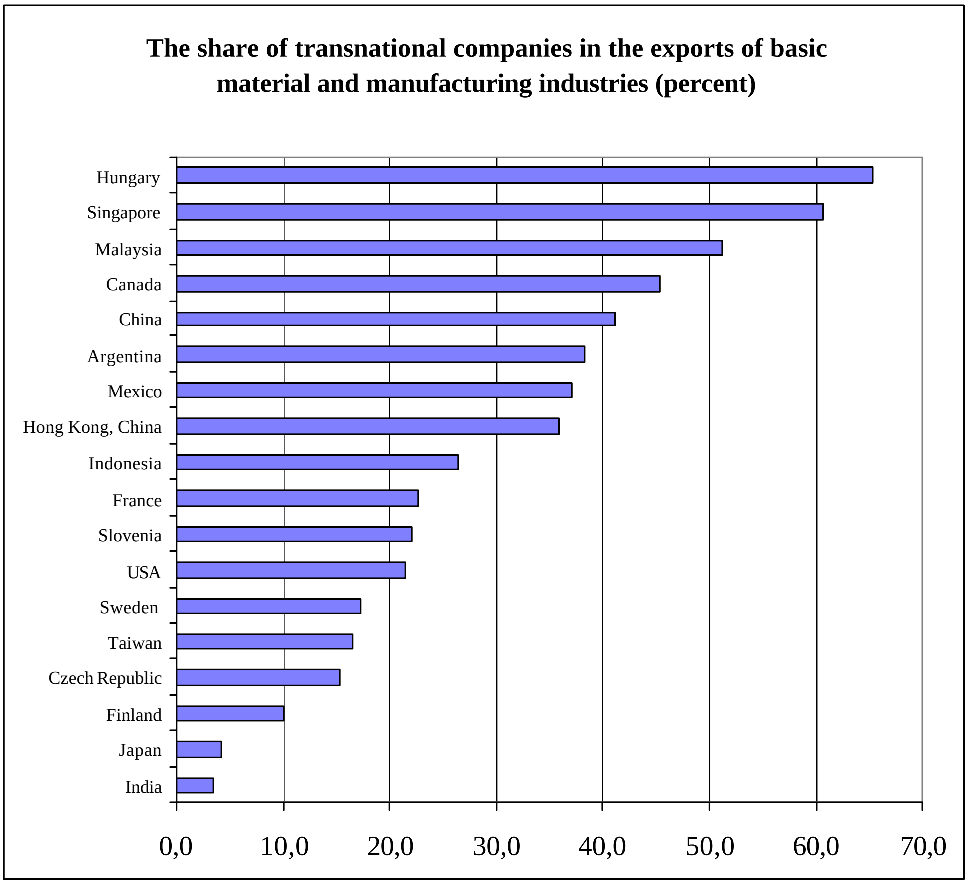
The new government put the bank privatisation also on agenda and completed it by the end of its mandate of 1998. Against the huge sum of money invested in the bank consolidation, the privatisation did not bring in significant budgetary income, and foreign investors achieved the majority position often through capital increases.

The Hungarian privatisation can be distinguished from similar reforms in other countries by a few major characteristics. In Hungary, privatisation for cash played a leading role, instead of distribution by using coupons (on the basis of citizenship). In the first ten years of the transition, *much more foreign capital arrived to Hungary than to other countries of the region*, though it was only partly related to privatisation, and mainly promoted green field investment. Employee shares and concessional credit facilities played only a limited role.

Around *two-thirds of the privatised wealth went into foreign hands*. And foreign participation increased further when foreign owners increased capital and bought shares or in other ways bought the assets of Hungarian owners. The main foreign owners by country of origin are the EU (53% mainly Germany and France) and the United States (13%). The remaining part was sold on international stock markets.

Privatisation together with green field investments resulted in a *ratio of foreign ownership in Hungary that is outstandingly high* in international comparison. According to an analysis published by UNCTAD , the share of transnational companies in the exports of raw materials and processed products is the highest in Hungary with 65%, while the same ratio in countries better integrated into the European Union and comparable to Hungary in size (Sweden, Finland) is only around 10-20% (see Figure 5). The newest UNCTAD investment report shows the same for GDP. The ratio of foreign companies in the manufacturing industry (measured on the basis of contribution to the GDP) is around 65 percent in Hungary while within 15-20 percent in Sweden, the Czech Republic and Finland.

Figure 5: Foreign capital in comparison



Source: World Investment Report 1999, UNCTAD

In Hungary the proportion of foreign property in company ownership exceeds 50% in almost each industrial sector and renders the domestic production chains fragmented (e.g. agriculture – food processing – wholesale and retail trade), resulting in considerable uncertainties in the external equilibrium of the country.

Contrary to expectations privatisation did not help in creating a strong middle class. By increasing social inequalities it rather contributed to the decline of the existing one. The privatisation of public utilities (electrical energy, water, gas supply, concessional road-building) resulted in dynamic price increases that considerably exceeded the average rate of inflation. Because income levels could not keep pace with the explosive price increase of the public utility sector, the gap between incomes and public utility prices contributed to the process of impoverishment after the systemic change.

The emerging dual economy

In the socialist era there was no possibility and sense for a foreign company to invest in Hungary. With the systemic change and especially with the approval of the Act on Foreign Investments in 1988 the legal obstacles to foreign direct investments ceased, and FDIs in Hungary began to grow, but hovered around $1,5-2 billion in the first half of the 1990s. The new government, who took office in 1994, aimed at acquiring as much foreign currency from privatisation as possible. The privatised state companies were usually offered to foreign professional investors who grasped the possibility to acquire Hungarian companies, but even more to take over the market shares of these companies. As a consequence the annual FDI doubled and in the last decade it reached a yearly average of $3-4 billion (see Figure 4) that amounted to some 6-8% of the GDP. With the substantial inflow of foreign capital the foreign ownership became dominant in most parts of the economy. For instance, in the manufacturing industry the average ratio of foreign owned companies (calculating on the basis of the subscribed capital) was around 65% in 2002. This ratio is much higher in the insurance and banking sector (80-90%), but in such services like the wholesale and retail trade or the electrical energy supply is also high (40-50%). In international comparison these data can be taken as extreme (see Figure 5).

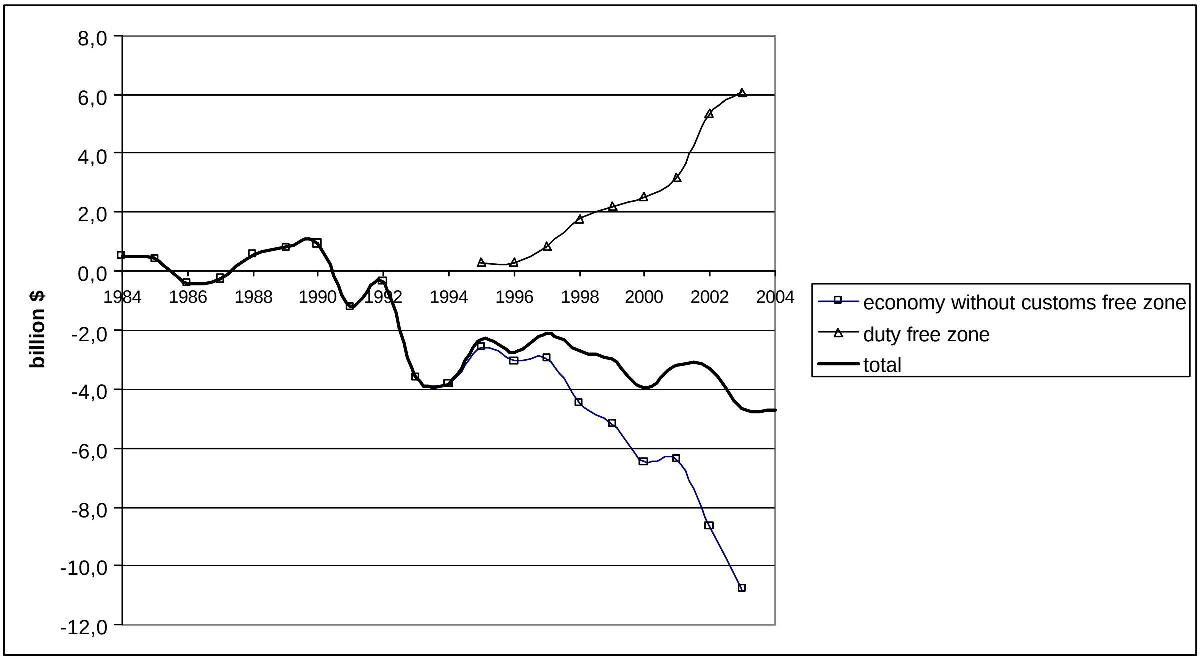
Some part of FDI formed an enclave in the form of *duty free zones (free trade zones)*. The characteristic feature of this sector is that its production is almost entirely exported and its material input comes from import while the labour input is given by Hungarian employees. With other words these are the companies relocated from high-wage western countries to low wage middle-European countries for assembling, where the necessary parts often are produced in and imported from China. These duty-free zone companies employ only 2 percent of the labour force of the competitive sector and have almost no connection with the domestic economy of Hungary, but they produce half of the country's export and therefore co-determinate the growth rate of GDP. The foreign companies in the customs free zones have been showing up a rather fast growth rate in the last decade while the output of the Hungarian companies as a whole was around stagnation in the same time period. With other words, the relative fast growth rate of the Hungarian GDP in the last decade was mainly caused by the performance of the foreign but not the Hungarian companies. From this point of view we can say that the Hungarian economy has a dual character and for this reason the statistical data (which include the performance of the customs free zone and the other foreign owned companies) and also the economic policy built on these data can be misleading. This dual character of the Hungarian economy explains why the Hungarian budget and current account are deteriorating while the country produces relative high economic and export growth. The solution of this puzzle is very simple: the foreign owned companies produce the growth, but they transfer their income abroad, while the Hungarian part of the economy is stagnating and – because of huge losses in market share since the systemic change – has very serious imbalances.

Current account and net foreign debt

The massive inflow of FDI and portfolio investments supplied only a temporary solution for the woes of the Hungarian economy. When the performance of the foreign companies of the customs free zone is separated the imbalances of the Hungarian economy can be clearly seen. Figure 6 shows that when leaving out the foreign trade surplus of the customs free zone, the foreign trade balance has been deteriorating since the systemic change with a stop caused by the stabilisation package of 1995.

The parliamentary elections in 2002 have accelerated the deteriorating tendency, but even controling for the effects of the election budget the growing imbalance is significant. With some approximation the negative trade balance of the Hungarian (non customs free zone) economy can be taken as the market losses Hungary suffered as a consequence of the liberalisation, privatisation, deregulation and the economic policy at large that has been followed since the systemic change. These deficits amounted to $11 billion in 2003 (see Figure 6) and they are increasing with a fast rate.

Figure 6: Foreign trade balance, Hungary 1984-2004 (billion $)

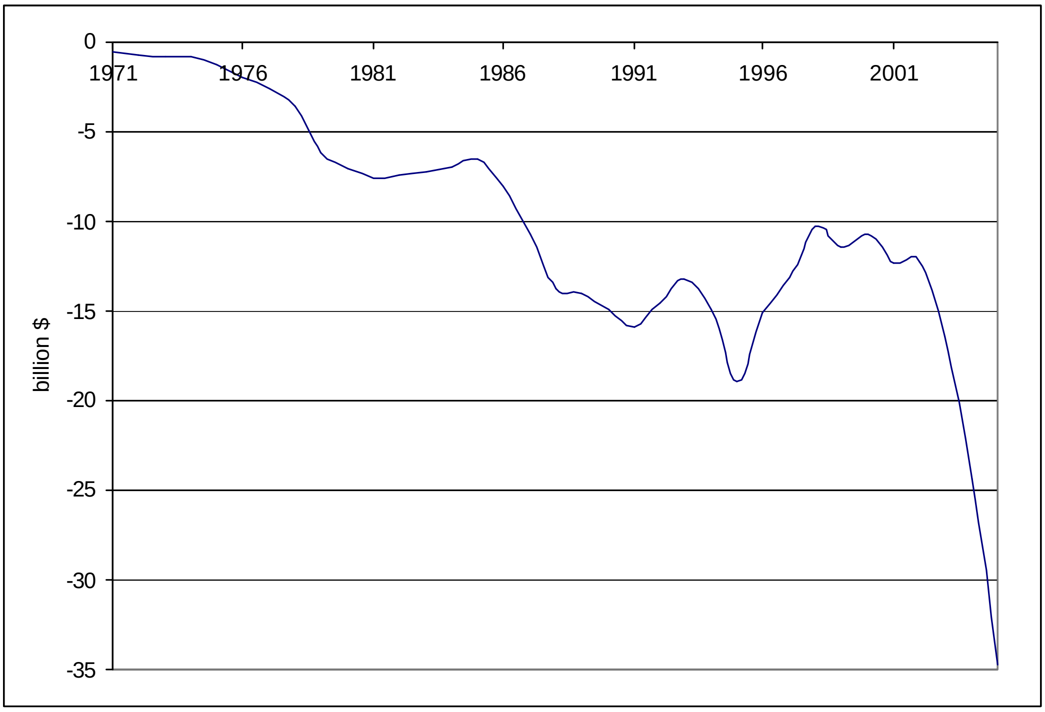


Sources: Yearbooks of the Central Statistical Office of Hungary, Press releases of the Central Statistical Office of Hungary on Foregin Trade

A sober contemplation leads to the conclusion that, if current tendencies continue, the negative current account and the indebtedness will inevitable increase until the country will be insolvent and has to renegotiate its debts, which today have arrived already at about 35 billion $ (see Figure 7).

From this calculation a Latin-American type development emerges which can hardly taken as an inspiring perspective, but at the same time there seems to be no power or movement willing and able to change this tendency. The IMF type stabilisation packages, trying to solve the imbalances by cutting the expenses on health care or education, or the general government reforms, a euphemism for privatisation of government services, can hardly improve the competitiveness of the manufacturing industries. This was clearly brought out by the stabilisation package of 1995 and its effects. On the other hand, the resources that are at the disposal of the Hungarian companies are insufficient to compete with multinational companies.

Figure 7: Net foreign debt, Hungary 1971-2005 (billion $)



Source: Lorant (calculations on the basis of publications of the Hungarian National Bank)

4 Conclusions

In this paper we have argued that one of the major economic problems of the new EU member countries is their current account performance. We have tried to reveal the underlying logic of the problem by means of a case study of an economy where this problem is most crucial, namely Hungary.

We have analyzed and described the institutional development and the subsequent economic performance of Hungary in the recent past focussing in foreign trade aspects. While every (new member) country is quite specific in its own path of development, we believe that there are some conclusions to be drawn from the Hungarian case which might be of a more general interest.

The case of Hungary

The Hungarian economy is a case where neoliberal ideas played an important role already long before transition, but with transition they gained momentum. We may distinguish four policy areas which seem to be primarily responsible for the specific economic path at large and the balance of payments development in particular: free trade, privatization, FDI and financing public debts.

First, both the extent and the speed of *internationalisation* were extraordinary, and they were not supported by industrial policy measures which would have been required for Hungarian companies to eventually approach international competitiveness. The neoliberal concept, that liberalisation and deregulation would increase the performance of the country because the resources would be allocated efficiently and everybody would produce what is most suitable and profitable, in practice resulted in serious imbalances both in foreign trade and current account due to significant efficiency differentials to western competitors.

Second, the two waves of *privatization* did not manage to spread out the means of production evenly to the Hungarian people and to foster the emergence of a broad middle class. Instead, privatization to a large extent was tantamount to selling off Hungarian companies to foreign capital with the consequence of the emergence of a dual economy. Vertically disintegrated transnational enterprises contribute partially to improve Hungarian export performance but worsen current account balances at the same time by profit exports. In the end, privatization (with liberalisation) meant a severe loss of markets, huge unemployment and growing current account deficits. Furthermore, exceptional price increases endanger the living standard of the poorer strata of the society.

Third, the import of foreign capital to Hungary in the form of *FDI* enabled the establishment of internationally competitive plants and of much needed jobs. However, as Mencinger[4] and others have argued, there is not necessarily a positive correlation between FDI and economic growth. This seems to be the case also in Hungary, where many TNCs are too separated from the domestic economy to bring about a net benefit to the economy and to the balance of current account.

Fourth, neoliberal ideas suggesting that *budget deficit* shall not be *financed* with national bank loans, have been also applied in the management of Hungarian public finance. However, with high inflation rates, financing the budget deficit via the money market results in fast growing interest payments which crowds out financing of government services on the one

[4] See Mencinger 2002, p. 62, Fig. 2.

side and increases the deficit itself on the other side, and this has caused growing budget deficits and indebtedness in Hungary.

Hungary, or more exactly the influential economists supported by Bretton Woods institutions and later by the European Commission, have been carrying out neoliberal-minded economic policies since the middle of the seventies. The applied policies never delivered the promised results. On the contrary, some policy measures made the situation worse than before. After thirty years of neoliberal attempts Hungary is in a desperate situation first of all as a consequence of lost markets and the growing current account deficit and there are no forces on the horizon to change this situation.

Alternative policies for the new member countries

It is generally proposed that there is no alternative to the neoliberal philosophy. However, there is growing awareness that there are alternatives derived from a much more sound theoretical basis than neoliberalism[5]. Referring to the Hungarian case, but possibly with some relevance for the new EU member countries at large, one might suggest[6]:

- Leaving industrial development completely to market forces is a theoretically false and historically disproved strategy. When an economy is opened up to global competitors within a very short period of time, selective interventions in industrial policy (e.g. infant industry promotion) are the sine qua non in order to give domestic companies a fair chance to catch up technologically. These interventions should be guided by a clear design of a "development vision" for the economy.
- Privatization in itself is neither economically good or bad. Historically, countries with large sectors of state-owned companies (e.g. France, Austria, Norway) have exhibited high and superior rates of economic growth. Hence governments should consider carefully the rational for privatization, and in particular the costs of privatization. Alternatively, there are a number of ways to improve the efficiency of state owned industries (without privatization).
- FDI is not the "Mother Theresa of capital inflows" (Gabriel Palma), and FDI and other TNC activities have been associated with numerous problems for the receiving economies. For example, sometimes FDI may cause substantial *outflows of capital*. FDI stands the best chance to contribute to a positive macroeconomic development if

[5] See among others Chang/Grabel 2004; Huffschmid 2005.
[6] Chang/Grabel 2004, Part II.

firmly tied to national growth strategies, which in turn must be based on the country's endowment and industrial policy regime.

- There is no empirical evidence that greater central bank independence reduces inflation and improves macroeconomic performance. But central banks, embedded in national macroeconomic growth regime can and do play important roles in fostering economic growth.
- Finally, the negative foreign trade and current account balances of the new member states mirror the fact that these countries have given more market room to the EU-15 than they received. To reach a dynamic equilibrium, which is a necessity according to the Constitution, the EU-10 countries need a growing market share of the EU-15 market. In order to determine the fields where the market share of the EU-10 can be increased an industrial policy for the whole Union is urgently needed. Such a policy has been outlined by former Commission President Romano Prodi and the Enterprise Commissioner Mr Erkki Liikanen and others (Industrial Policy In An Enlarged Europe January 21, 2003 – Brussels Charlemagne Building – room S3 CONFERENCE-DEBATE. Minutes).

This list of suggestions could, of course, be enlarged and detailed. Its role is merely to indicate the directions for economic strategies which have been theoretically well established and historically proven to be superior to neoliberal ideas.

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Abbreviations

CEEC Central an Eastern European Countries

CMEA (COMECON) Council for Mutual Economic Assistance

CZ Czech Rep.
EE Estonia
HU Hungary
LV Latvia
LT Lithuania
PL Poland
SK Slovakia
SI Slovenia