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## Hungary

### *The Janus-faced Success Story of Transition*

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#### 12.1 Introduction

In this chapter, we refrain from presenting a very long-term statistical analysis, for no other reason than the fact that Hungarian political and economic structures have undergone truly fundamental changes in the past ninety years—that is, since the disintegration of the Habsburg monarchy. Each event, but most recently the collapse of the Soviet empire in 1989–90, and the related economic and power structures have created new circumstances. In the following, we attempt to summarize primarily the post-1989 era, a period of two decades during which almost everything has undergone a change in the process of Europeanization and globalization.

In general, we also refrain from the detailed, and by its nature ephemeral, analysis of the ups and downs of specific years, as descriptions of such individual phases and their related analyses are available from a number of regional overviews. Instead, we adopt a developmental perspective—that is, the long view—and therefore approach the Hungarian experience from the perspective of global political economy of reforms, focusing on facts that could be of relevance for other countries in managing their institutional and structural change. This is a unique, and in some ways a narrow, perspective, but it follows the themes of the present project.

<sup>1</sup> Comments from Vladimir Popov, Augustin. K. Fosu, and three anonymous referees are appreciated, with the usual caveats.

## 12.2 Is Hungary to be considered a success at all?

Hungary in 2010 was a country with a population of fewer than 10 million people and a per capita gross domestic product (GDP) of €15,800 on purchasing power parity (PPP).<sup>2</sup> This was roughly 63 per cent of the EU-27 average, comparable with Estonia (€15,900) or Poland (€15,300), also in PPP, two countries that used to be traditionally lower in terms of their levels of development. In terms of economic structure, Hungary stands out, with a relatively high share of industry in GDP. This activity contributes 29.4 per cent to overall GDP, or 5 percentage points over the average of the European Union (EU). By contrast, farming, the traditional powerhouse during the monarchy and even in the inter-war period, contributes to a mere 3.3 per cent to GDP and about 7 per cent to employment. This is about twice the share of the EU average of 1.7 per cent, but is still by no means dominant. Correspondingly, the share of services accounts for only 67.3 per cent of GDP. In other words, while Hungary is truly a post-industrial country, its tertialization lags behind EU average by about 7 percentage points. Seen differently, frequent claims in the transition-related literature on deindustrialization and overtertialization do not seem to apply to this country.

In terms of dynamics, the following trends can be observed. Following the transformational recession in 1989–93, when GDP dropped by about 20 per cent, growth resumed in 1994, but pre-crisis levels of GDP were regained by 1999 only. In terms of living standards—and related societal perceptions, not susceptible to structural and qualitative aspects of growth—this seemed to be a lost decade. However, following the harsh adjustment programme of 1995, GDP grew 4 per cent per annum during the years 1996–2000; it grew to 4.3 per cent in 2001–05, but dropped to 3.9 per cent in 2006. In 2007, growth decelerated partly because of the harsh fiscal adjustment measures included in the Convergence Programme of August 2006 adopted for the 2007–09 period,<sup>3</sup> but did not come to a halt. In 2007, GDP grew by 0.9 per cent and, in 2008 by a mere 0.8 per cent. Then, in the crisis year of 2009, GDP contracted by as much as 6.3 per cent against the EU average of -4.2 per cent; in 2010, it recovered by 1.2 per cent, the EU average being 1.8 per cent.

In short, similarly to the delayed and forced first adjustment of the previous decade (Kornai 1997; Antal 1998), the second major fiscal adjustment of 2006 has taken place without a recession, albeit that the expansionary effects for which many had hoped on the basis of more theoretical literature also failed

<sup>2</sup> The data source, unless otherwise indicated, is the *ECB Statistics Pocket Book*, May (ECB 2011).

<sup>3</sup> Various versions of the programmes, as required by the EU rules, are being elaborated and updated, usually in March, August, and November of each year. With the introduction of the European semester in 2011, the relevance of these documents as commitments of the government increases. They are available on the website of the fiscal authority at <http://www.ngm.gov.hu>

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to materialize. Moreover, reflecting the cumulation of weaknesses and the delays in structural reforms in 2005–08, the third consecutive fiscal retrenchment, introduced under an International Monetary Fund (IMF)–EU/World Bank standby package between October 2008 and May 2010, was already textbook—that is, it ended up in contraction of overall output. This was brought about by the response to the global financial crisis in 2009. In the final account, this recession has proven more severe than the EU average: 6.3 per cent in Hungary, compared with an EU average of 4.2 per cent.

But it is certainly not the 2007–11 period that is representative of when and why Hungary can be considered a success story. During the fifteen-year period since the 1995 adjustment package under review, growth tended to be significantly above the eurozone average: 2.7 per cent in 1996–2000 and 1.4 per cent in 2001–05. Exports, a major component of sustainable external finance and thus lasting growth, expanded rapidly. Starting from a mere US\$9 billion in 1989, exports had grown to US\$15.7 billion by 1996 and US\$30.5 billion by 2001, expanding to US\$93.8 billion by 2007 and peaking with US\$107.2 billion in 2008—a level to be recovered only by 2011 (EIU 2011). With regard to foreign direct investment (FDI), Hungary has long been the champion in per capita terms as far as stocks are concerned, although the inflow peaked in 2005 and 2006 at €6.2 billion; the figure for 2007 is around €4.2 billion, while the 2008 figure is €5.6 billion.<sup>4</sup> Still, foreign ownership accounts for approximately 40 per cent of Hungarian assets and 80 per cent of its exports. Dynamic inward FDI has contributed to a major upgrading of Hungarian exports, with machinery and equipment accounting for 61.7 per cent (*ibid.*), or double the Spanish or Italian equivalent.

In short, Hungary has been a success on a number of accounts. First, the country managed the transition from communism to democracy peacefully, without any of the political turmoil witnessed in a number of countries in Eastern and south-east Europe. Second, it managed its accession to the EU in 2004 in a gradual and organized manner. Adoption of policies and institutions has been incremental, whereas opening up the domestic market was swift and irreversible. In so doing, Hungary was able to benefit from competition and structural adjustment, and around 1996 inward investors were already factoring in the impacts of EU membership, including improved regulatory framework. Third, Europeanization—adjustment to EU structures and institutions—speeded up and directly shaped institution-building, with the Commission checking developments on the ground during the so-called *acquis* screening procedure in 1995–2002. This has lent additional credibility to new institutions, such as the competition agency, the financial supervisory agency,

<sup>4</sup> These figures are from the Ministry of National Economic Development (<http://www.ithdh.hu>); the stock of FDI put at €60 billion by end 2009.

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or environmental agencies. Fourth, global processes had an impact in terms of revolution and deregulation in information and communication technology (ICT). In terms of mobile phone use, Hungary ranks among the first in Europe. In terms of liberalization, such as in airlines, insurance business, and any other trades, the global processes have fostered change for the better and created sizable consumer surplus, as prices started to come down to single-digit levels during a number of years since 2001. All in all, Europeanization has been working both top-down, by setting up new organizations, and bottom-up, through inter-firm contacts and massive movements of students, as well as business executives and tourists. Stagnation of the formal institutional level of the EU has by no means slowed down the growing interaction at the micro level.

One of the toughest challenges is to define to what extent the above-mentioned outcomes are the result of conscious policy that could be described with the term 'strategy', as has become customary in the political economy of policy reforms. More probably than not, conscious and forward-looking decisions at some critical juncture were needed and these, indeed, were taken. But at other times, particularly since membership in the EU in 2004, drifting and improvisation have prevailed over any conscious conduct of policy.

The first major conscious decision was taken in 1989 when the Communist government adopted a three-year liberalization plan and legislated for various forms of privatization (Szamuely 1990). The second major decision was taken by the newly elected Conservative government, which, in fact, continued with liberalization. Moreover, ongoing legislative and political processes had culminated by 1992 in the adoption of a series of laws that made life for corporations much harsher. These four laws, concerning central banking, financial institutions, bankruptcies, and corporate taxes, actually included most of what was by 1992 known as 'second-generation reforms'. This accounted for an institutional shock therapy (Bokros 1994), which contrasted these measures with radical liberalization, as practised in Poland and Russia at the time. Finally, in March 1995, fiscal adjustment and reform measures were introduced, with major expenditure cuts, surprise inflation, and the introduction of a crawling devaluation of the currency.

No further radical measures, other than fiscal rebalancing, have been taken since then. However, it is beyond any doubt that, until December 2002, when the enlargement decision of the EU was taken at the Copenhagen Council, a fair degree of consensus existed across the various fractions of the ruling elite on the need to comply with all or most of the Union's entry requirements. These entry criteria covered political freedom, legal harmonization, institution-building, and introduction of policies that were not high on the domestic agenda, but which had been prioritized by the EU. These last included issues on environmental protection, gender equity, cooperation with neighbouring

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states, and the improved transparency of legal and political decision-making processes. Thus there can perhaps be justification in considering the entire 1989–2004 period as a single continuum, as the commonalities obviously outpaced the dissimilarities. As a consequence, improved economic performance and solidification of democratic arrangements, taken together, do allow Hungary to be classified as a success story for the period under review.

### 12.3 The changing interface of external and internal factors

The strategy of global and European integration has evolved through trial and error during the socialist reform period. Hungary stands out among the Communist countries of the period with respect to a few unique factors.

#### 12.3.1 *A classical socialist system*

The classical socialist system as described by Kornai (1992) lasted for a mere four-year period (1949–53). Previously, it had been commonly expected that, with reunification with Austria (and eventually with Germany, which actually happened in 1955, but which had been anticipated as early as 1947),<sup>5</sup> Hungary would become ‘Finlandized’. Thus it was believed that a non-Communist government majority, as well as the equally important dominant private sector, would create a path to development comparable to that in Italy, Britain, or France. In these countries, despite the financial sector being curtailed and state management extended, economic and political pluralism was sustained. Finlandization, in this perspective, would have implied security guarantees to the Soviet Union, as well as a tolerance of Russian interference in various domestic affairs in exchange for economic liberties at large.

The outbreak of the cold war thwarted these hopes, but the pluralist system was maintained until mid-1949. Already by June 1953, with a ‘new course’ initiated by Stalin’s heirs in Moscow, the reformist government, under the leadership of Imre Nagy, launched a series of changes, phasing out the command economy over a decade and a half.<sup>6</sup>

#### 12.3.2 *Limited pluralism*

The second oddity of the country was triggered by the fact that political liberalization in Hungary, similar to Poland, went out of control and culminated in the Revolution of 1956. Despite the presence of occupation forces, the

<sup>5</sup> See Fülöp and Sipos (1998) for more details.

<sup>6</sup> For more details, see Berend (1988).

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totalitarian system collapsed in twelve hours, and this signalled that it could be replicated any time. Therefore the new Communist regime of János Kádár, installed in two weeks by the Soviets after crushing the Revolution, made every effort to find a *modus vivendi* with the population, who had also learned that geopolitics limited freedom.

Interaction between the leaders and the population created a continuously evolving set of interrelationships and change that developed into a model of limited pluralism in all walks of life.<sup>7</sup> The economy was only one dimension of this gradual change, which, of course, fortified the regime as long as the geopolitical predetermination lasted. But simultaneously and obviously at odds with official creed, it undermined its legitimacy by allowing for a series of practical options, such as existence of the irregular economy from the late 1960s, particularly its large-scale forms after 1982.

The limited, but continuously expanding, liberalization created the training ground for various forms of market activity. Moreover, it helped the Weberian ‘commercial spirit’ to survive at the grassroots levels—that is, millions working in small businesses, household plots, auxiliary and servicing activities outside the state controlled large-scale operations in trade, farming, industry, banking, and even intellectual activity. The emergence of a ‘second society’, second publicity, second value set, second career path in the private and informal sectors, respectively, coexisting with the still predominant formal/official structures of communism, obviously eroded the old regime. How it happened and why so peacefully requires a monographic discussion (for details and a review of related literature, cf. Csaba 1995).

### 12.3.3 *Social learning in matters of the economy*

Most importantly from our perspective, this long trial-and-error period (during which the concept of how capitalism could be restored without capitalists) promoted large-scale social learning in economic matters. As this chapter is not the place in which to replicate these intriguing details, a summary should suffice at this point: social learning implied that much of what later became known as the ‘Washington consensus’ had been emerging through ‘learning by doing’ and through local dialogue on the controversial reasons for the minimal success of the limited reforms. From a long-run perspective, it is particularly relevant to note that a broad professional consensus emerged over the need to reorient trade from the east to the west, to conduct an open-door policy vis-à-vis FDI, and to support private property as it emerged in an organic process rather than through legislative action. It

<sup>7</sup> Compare the collection of papers by Szabó and Majtényi (2008).

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became a deep and shared professional conviction that individuals assuming governmental responsibility observe a kind of professional minimalism and that experimentation in general is to be avoided (Kádár 1994).

This applied *a fortiori* to the wholesale transformation projects proposed by the offices or academic departments of various agencies. To use the parlance of the Wolfensohn presidency of the World Bank, the ‘domestic ownership of reforms’ has never been in doubt. For this reason, a fair degree of continuity in terms of policy could indeed be observed and maintained, despite recurring pressures from democratic political processes that could have easily derailed the overall operation, especially during the push for immediate redistributory justice and other populist measures. This is a well-known phenomenon in any established multiparty democracy not applying rules-based fiscal policy.

### 12.3.4 *Sustaining policies on structural reforms*

Continuing policies on structural reforms, mainly of the second and in part of the third generations, had thus become politically feasible. As long as successive governments modified only the emphasis of the overall strategic direction, not the strategy itself, these measures had time to be internalized and applied, and to produce results. For instance, it goes without saying that privatization, although vitally necessary, is by no means sufficient for improving efficiency, allocative and static alike. But if time and other scope conditions (competition, trustbusting, adjustment of administrative pricing, and ensuring market entry for new participants) are secure, privatization can become effective. Present examples abound: from mobile phones to airline and insurance markets, not to mention the food industry or tourist services. However, this required time and patience, as the first results—as also with liberalization—were painful in terms of prices and redistribution.

The above observation can also be validated through indirect reasoning. In some areas in which such policies have not been sustained, outcomes have been less convincing. For instance, Hungary was among the first in terms of introducing a partially funded pension scheme in order to overcome the problems of an ageing society and a massive evasion of public dues (partly caused by the tax system supporting small businesses). However, the 1997 privatization scheme was gradually phased out and cancelled by successive governments over the period 2001–08 in efforts to court current pensioners, who are among the most active participants in national and municipal electoral processes. Consequently, because of modifications to the system, much of the gain in terms of implicit debt reduction was undone, without resorting to an even partial nationalization of the pension funds (Orbán and Szapáry 2006). In turn, the fiscal burden of the pension system alone has increased to about 2.5 per cent of GDP per annum and is likely to grow despite timid

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measures introduced in 2007–08 to curtail early retirement and disability pensions. Unsurprisingly, the actual nationalization of private funds in January 2011 has, however, contributed to alleviating short-term fiscal strains; in the meantime, it has aggravated the problem of implicit debt in a country with shrinking population and widespread tax evasion.

Similarly, the decrease of market capitalization and the increase of governmental intervention and spending during 2001–08 have clearly have been at the root of the overall structural slowdown of economic growth. No new entries can be observed on the Budapest Stock Exchange and all major privatization efforts (such as Budapest Airport in 2005 or Malév Hungarian Airlines in 2006) have evaded capital market deals in favour of policymakers' hand-picking strategic investors. As a result, it is perhaps realistic to say that the local capital market has already lost its window of opportunity. Supporters of this line of thought (Pálosi-Németh 2008) note that large multinationals are already in the habit of funding themselves through global capital markets in New York or London, while small- and medium-sized enterprises (SMEs), because of their inherent features, tend not to be suitable for floating on the capital markets.

In summary, Hungary may be qualified as a relative success in the first fifteen years of transition, in terms of institution-building, positive restructuring, policy consensus, and successfully joining regional and global integration processes, at the levels both of transnationalizing firms and of joining major organizations. In terms of the former, evidence is seen in the surge of outward FDI, by such corporations as MOL (oil industry), OTP (banking), and Richter (pharmaceutical), as well as of the private pension funds acquiring western corporate bonds; in terms of the latter, joining the Organisation for Economic Co-operation and Development (OECD) in 1995, the North Atlantic Treaty Organization (NATO) in 1999, and the EU in 2004 are the milestones of accomplishments.

### **12.4 The role of professional and social consensus**

#### *12.4.1 Social roots and broad-based approval*

The short summary above provides some (albeit partial) answers to rather intriguing questions in the search for the reasons for success in managing transition—although not of sustaining growth and convergence to EU-15 levels. In short, no simple, single-factor explanations can apply.

It would be difficult to attribute success to policies and institutions only. This is, of course, the customary textbook answer provided by analysts in the first instance. We have already alluded to what competing interpretations in

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political science have called ‘embedded neoliberalism’ (Greskovits and Bohle 2007). This denotes the social roots and broad approval of most of the major measures that have not only been contemplated, but also implemented. However, it is also true that, over the past two decades of economic reform, a series of structural and policy measures were attempted or contemplated, but could not be implemented or sustained. For instance, among the better-known samples, we could cite the introduction of local taxes (*teho*) in 1987, the attempts to introduce a value-based property tax in 1996 and 2007, experimentation with a wholesale introduction of tuition fees in 1995 and 2007, and centralization of the management of all public finance funds through the introduction of the Treasury Office in 1997.

While there was a rather sound economic rationale behind each of the measures, they were all somewhat contrary to the implicit ‘social contract’. It is hard not to describe the 2006–07 period as a series of failed, but serious, attempts at reform, despite the recognized characteristics of social contract and the ensuing resistance to these, especially in health care and the reorganization of territorial administration. The landslide victory of the opposition in the referendum of 9 March 2008 and the ensuing split of the ruling coalition left the minority socialists without room for manoeuvre. One of the most palpable consequences of this was the ongoing lack of consensus with respect to the size and nature of reforming public dues. As noted by an insightful analysis by the chair of the Roundtable on Competition, a Socialist government-convened expert body, the lack of professional consensus and adversarial political climate in 2005–08 mutually reinforced the debilitating outcome (Török 2008)—that is, Hungary was the only new EU member that had attempted no serious tax and expenditure reform during the years of 2000–08. This had a dampening effect on growth, particularly from 2004,<sup>8</sup> but the impact was much less on the country’s competitiveness owing to the predominance of transnational corporations.

### 12.4.2 *The behaviour of foreign investors*

A second major component, usually overlooked by macro-scene analysts, is the behaviour of foreign investors. These are not always impressed by the changing moods of the rating agencies, the quality press, or even of the international institutions and academic fashions. Foreign investors have tended to qualify Hungary as a fundamentally good location, despite its well-known and publicized shortcomings in terms of policy incalculability,

<sup>8</sup> According to conservative estimates, fiscal expansion during 2004–06 must have contributed at least 1 percentage point to the growth rate of 4.3 per cent per annum. But such an expansion was obviously unsustainable in Hungary, as in any small open economy.

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legal imprecision, or red tape and non-transparency. While the complaints on these accounts seem endless—and many are well founded—major investors have generally considered Hungary and its environment in a broad sense to be hospitable and profitable. The first had to do with the continuing insight—namely, that the paucity of foreign savings and investment lowers current consumption, and that only a much slower pace of modernization is attainable. Thus successive governments have maintained lavish investment incentives and the low corporate tax rate (currently only 10 per cent) is also an incentive to realize profits locally for reinvestment rather than repatriation abroad through transfer pricing. Moreover, outward investment during the current decade started to grow, reaching the US\$3 billion margin in 2007, highlighting the gradual maturing of the country as an investment locality. In the later years, this trend slowed down, not least owing to the defensive reaction to the global crisis of major Hungarian firms. The latter applied primarily to MOL, the Hungarian oil corporation, which struggled against hostile takeover attempts first from Austrian, later from Russian, buyers. With the help of successive Hungarian governments ensuring control via the golden share, the story ended by the Hungarian government buying itself into MOL in May 2011, ensuring national majority ownership of shares. But the company, in its years of struggle, obviously slowed down its expansion. In Croatia, its major market, the local government follows a line of national ownership, thereby curtailing MOL's role in the Croat oil company INA. In short, expansion has proven to be a bumpy road for Hungarian flagship firms.

### 12.4.3 *The structural upgrading of production and exports*

A related consequence of the foregoing two factors has been the structural upgrading of production and exports. As more foreign and domestic investors increasingly adopt a long-term perspective, the more they invest in research and development (R&D), in their organizations, in training, marketing, and linking with international production and sales network across the board. The predominance of intermediary manufacturing, intra-industry, and even intra-firm trade in Hungarian exports made it resistant to cyclical fluctuations and made possible the tenfold increase (from US\$9 billion to US\$107 billion) already noted for the period 1989–2008. This is a major difference from the decades of the 1970s, 1980s, and even the 1990s during which external financial disequilibria was a recurring event among the major, but mostly unexpected, constraints that dominated all aspects of economic policymaking.

It was a major policy blunder on the side of the government when, preoccupied with domestic politicking, it shrugged off the warning signs of an emerging major international financial crisis in 2008. Already after the collapse of Lehman

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Brothers, the government submitted to legislation a fiscal plan calling for over 3 per cent growth of GDP, obviously disregarding the crisis that was already well in the making. This was asking for trouble, which was not slow to hit, coming in less than a month. The massive speculation against the forint could be warded off only by a then unprecedented jumbo bailout package of €20 billion, orchestrated in days by the IMF, the EU, and the World Bank, in a previously unheard-of concerted rescue action. In turn, fiscal and monetary tightening followed, and output indicators declined sharply by 6.3 per cent, while unemployment rose to over 11 per cent. Fighting for financial survival has become formative for the 2008–10 period, with export markets—and thus foreign sales—collapsing in 2009 and recovering only gradually by 2010. Notwithstanding this derailment, the generally export-led feature of Hungarian growth has not given way to seclusive, protectionist tendencies, not even in the short run.

### 12.4.4 *Cumulative processes*

Last, but not least, the role of cumulative processes needs to be underlined. This means that instead of applying the usual analysis of comparative statics, longer-term developments may be understood better through multiple causalities. Interaction among various market players and regulators may turn out to be crucial, because such interactions can solidify, modify, or even correct the outcomes and/or its unintended side effects.

Within this perspective, the strategic role of foreign investors, especially in the banking sector and in the process of Europeanization, which is perceived as a two-way social learning process between Community and domestic players, might have been decisive. Ultimately, the decisive transnationalization—or, according to its critics, extreme transnationalization—of financial intermediation might have anchored the rest of the process. Privatization of the banking sector already in the mid-1990s was a bold step, given the ongoing protectionist practices in much of continental Europe—France, Spain, Italy, and Germany included. Furthermore, the practice of multinational corporations relying on parent-company financing or directly tapping the global capital markets has had two major ramifications. First, it helped to bridge the novel and largely inexperienced domestic banking and financial services industry, and to iron out the shortcomings that could have easily become a major bottleneck to industrial restructuring and economic expansion in general. Second, it substantially constrained the ability of the government to pick winners along the more traditional lines, as in East Asia or France. Thus it enhanced the role of capital market financing and diminished the role of government-inspired allocational decisions. This helped to sustain a market-led line of restructuring, which is by no means a one-shot event in

the contemporary world economy, but rather a process of continuous adjustment and renewal.

## 12.5 Strategies: learning and unlearning

As we have tried to sketch above, foreign actors—as the result of strategic options—have had a major lasting influence in shaping decisions. However, it would be wrong to neglect the role of local policies and regulations, both in terms of their favourable and unfavourable implications.

### 12.5.1 *The role of local policies and regulations*

Domestic policies have fallen short of providing a truly sound macroeconomic policy environment during the entire period under scrutiny. Despite recurring attempts to streamline public finances, general government deficits, when adjusted for cyclical items and occasional creative accounting, tend to be around 6 per cent of GDP. In comparative terms (Bönker 2006), this seems to be a peculiarity of Hungary and should not be attributed to general trends in transition or to various one-off effects relating to EU accession. Even following IMF-style austerity, general government deficits in 2008 were 3.7 per cent in 2008, 4.5 per cent in 2009, and 4.2 per cent in 2010, despite recurring tightening by the fiscal authority during each calendar year.

It would perhaps require a separate study to decipher how and why recurring budget deficits continue to emerge. In the 1990s, most analysts would have attributed the recurrence to the ongoing dominance of state administration, extension of the welfare state, and changing forms of redistribution stemming from the social contract (Antal 2007; Muraközy 2008), but the 2000s obviously mark a new era. In this period, the anchor role of the EU has been lost, while ‘normal politics’—understood in most continental OECD countries in terms of myopic policy stances and refraining from major restructuring of the welfare state—have become the defining feature. This general trend is influenced by a level of extreme distrust among major political agents that translates into ever-shorter horizons and the tendency to inflate populist promises (Györfy 2007a). Expectations of basic improvement—that is, swift alignment with the eurozone—were widely shared by both investors and analysts alike, but the derailment, which in theory could have happened any time after 2004, has not materialized. However, in the longer run, crowding out and the ensuing insufficient investment in all areas except manufacturing have led to a deceleration of growth.

Similarly, according to the European Central Bank (ECB 2011), Hungary’s inflation record has been dismal. Inflation reached a high of 15.1 per cent

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during 1996–2000, dropped to 5.8 per cent by 2001–05, then to 4 per cent in 2006, but reverted to 7.9 per cent by 2007 and 6 per cent by 2008. Reflecting the crisis and overall uncertainty, it was still 4 per cent during and despite the deep recession in 2009—which was a warning sign. And in 2010 the very sluggish recovery of 1.2 per cent coexisted with an inflation rate of 4.7 per cent. Also in 2011 the growth of about 2.5 per cent coexisted with an inflation rate exceeding 4 per cent, reflecting the unfinished nature of disinflation (in terms of EMU requirements).

### 12.5.2 *External borrowing*

The role of external borrowing has changed politics. Whereas external finance in the Communist period served primarily to bridge imbalances triggered by macroeconomic policies, the majority of financing since 1995 has gone to the private sector and investment. Hungarian growth remains export- and investment-led. For this reason, even the softening of policies during the next decade has not translated into serious external financing difficulties, as robust export growth and the continuous inflow of direct and portfolio investment have helped to overcome this problem. The overall picture, however, is modified if we consider that much of the portfolio investment in the 2000s was used to cover fiscal deficits. Once the exchange rate<sup>9</sup> stabilized and started to appreciate, the high nominal interest rate on forint claims translated into a real rate of interest for foreign investors. In other words, external financing came, even during the golden years of cheap external funds, at a considerable cost (Erdős 2008). To put it differently, the room for manoeuvre could well have been utilized for launching third-generation reforms because entry in the EU, particularly in the EMU, could have created an anchor for social forces and for expectations. This opportunity, however, seems to have been wasted.

### 12.5.3 *Joining the Euro-Atlantic structures*

Joining the Euro-Atlantic structures in 1999–2004 has had a stabilizing influence. Alignment with NATO at a time when it was at war with Yugoslavia on the borders of Hungary was a bold step, and put an end to a decade of uncertainty with regard to military strategy and neighbourhood policies. Membership in the EU also played a predominantly favourable role already during the accession process by anchoring expectations, shaping institutional

<sup>9</sup> Exchange stabilized around 250–60 forints per euro for the entire 2003–07 period. During the 2008–09 crisis, a temporary depreciation of 10 per cent helped to cushion the economy from even more shock, then a gradual appreciation to 260–65 forints took place in the first half of 2011.

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change, and lending credibility to the newly established, or even directly duplicated, regulatory agencies. However, it is equally obvious (Györfy 2007b) that EU membership and the prospect of a swift introduction of the single currency was loaded with moral hazard. While markets expected politicians to act in the best interests of the nation, politicians took advantage of the advances in trust and credibility, misusing these for their own party-political games.

Since then, the EU has been faced with its worst implementation crisis: large member countries flouting the Stability and Growth Pact and two founding members rejecting the Constitutional Treaty. Consequently, existing procedures already could not ensure compliance in public finance years before the financial crisis and the de facto Greek default. This is not an attempt to shift the blame on external factors instead of internal issues. However, it goes without saying that any country outside the perceived safe haven of the EU would have been severely punished by global capital markets for such continued misbehaviour, as was witnessed in Hungary in 2002–08. While the punishment, as detailed above, did come in 2008–10, it also remains a mystery why the allegedly efficient markets tolerated recurring and manifest transgressions for much of the decade.

### 12.5.4 *Open economy and open society*

Lastly, we have repeatedly referred to the favourable conditions created by an open economy and open society for sustaining and deep-rooting modernization. In short, it is not only a question of substantial inflows of FDI and portfolio investment, nor is it only about formal membership in the EU; what really matters is what could be justifiably termed the ‘microfoundations’ of change. These include broad access to information, the spread and ever-cheaper use of Internet facilities, large numbers of students being involved in exchange programmes such as Erasmus and Socrates, and faculty mobility programmes, as well as the spread of mass tourism, all of which constitute a form of on-the-spot training of how other societies work on a daily basis. Large-scale employment of foreigners in local firms and of Hungarians working in international firms and institutions also contributes to this experience. In short, Europeanization and globalization, as explicated above, have become factors of life that shape expectations (of earnings, discipline, quality of services) and career paths, as well as geographical mobility. The exchange of academics, businessmen, and students creates an environment conducive to adaptive strategies on all layers of the economy and society.

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### 12.6 Causes and consequences of post-EU derailment

Sustainability is a pet notion of modern economics and for a good reason. Borrowed from biological sciences, it addresses a point often missed in earlier economics analyses fixed on maximizing attitudes—that is, that the maximum at a given point of time can lead to loss or even damages later. Furthermore, success should be measured in a continuum rather than through a comparison of discrete points in time.

In answering the intriguing question ‘what precisely went wrong in Hungary?’, perhaps the first issue to which we can point is a lack of sustaining commitment of subsequent governments to sound policies, be that fiscal discipline or supporting private initiative. The second is myopia—that is, a *carpe diem* approach and disregard for even medium-term consequences. This led to missing the single currency in 2006–08, and later to the nationalization of pensions in 2010. Third, there has been a continuous misreading of signals coming from the global economy, be that the bubble of the US housing market or the nature of intra-EU infights. Fourth, there has been an erosion of elite consensus over the broad lines and priorities that anybody in government should follow, including the need to lay the groundwork for the viability of future generations, in terms of sustainable welfare systems, including education, health, environment, and pensions.

This consideration is obviously relevant to our assessment of the Hungarian development strategy. As could be forecasted years ago (Csaba 2007), EU membership created only the option—but not the certainty—of further reforms and institution-building. As the EU increasingly stagnates in terms of institutional and policy renewal, immediate incentives fade for the political class to introduce the reforms that are needed for sustaining high growth rates and for achieving a real convergence to the EU-15 average in terms of per capita GDP. In 2010, per capita GDP in Hungary was only 54 per cent of the EU-15 average and only 63 per cent with regard to the average of the EU-27 (ECB 2011).

Even the rudimentary data cited at the beginning of this chapter indicate that Hungary has entered a longish low-growth phase, because of repeatedly missed opportunities to consolidate public finances and the ensuing impact of a crowding-out of deficits. The level of public debt is a synthetic indicator of the mismatch between growth and financing: public debt has gone up from 52 to 66 per cent over the years 2001–07, and peaked at 67.5 per cent in 2008 despite a major fiscal consolidation effort in 2006–08, then climbed to 80.2 per cent by the end of 2010, reaching the EU average of 80.2 per cent, but being still below the eurozone average of 85.2 per cent (ECB 2011). Meanwhile, growth was close to 4 per cent, declining to 3.9 per cent, then declining to 0.9 per cent in 2007,

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and 0.9 per cent in 2008, thereby preceding the contraction of 2009 discussed above. Furthermore, this also implies that the annual burden of amortizing public debt had stabilized around 4.5–5.0 per cent of GDP in 2006–11. In other words, the scope necessary to tackle structural reforms such as privatizing pensions, supporting infrastructural development, and financing the streamlining of the overblown public administration<sup>10</sup> is already restricted by the need to pay for the costs of ‘yesterday’s party’, an issue known only too well in Europe.

Other factors of growth also seem to be in poor shape. With real wages stagnant, personal savings are unlikely to grow while capital markets, as we have indicated, remain sluggish. Governmental savings are contingent on tough implementation of additional reforms, following the ambitious project of the Széll Plan of March 2011 (see in detail Ministry for National Economy 2011). Finally, the corporate sector, a net saver during several years of the decade, may not be in such a position once the economy expands.

Enhancing labour market participation to align with the Europe 2020 strategy would certainly be a must, as well as a possibility. When people work instead of collecting various social transfers, they are also contributing to social security rather than merely drawing on its services. The Scandinavian example is quite convincing for ensuring higher participation rates and a subsequent steady, sustainable decline in public spending and deficits. By contrast, analyses by the Ministry of Finance (Ohnsorge-Szabó and Romhányi 2007) have shown that measures triggered by purely electoral politics, such as reduced tax rates to low- and lower-middle income stratas or discretionary pension increases above the statutory levels, contributed to about half of the 2006 deficit of 9.2 per cent.

Reversal of these measures in 2006–08 was not sufficient for a sustainable improvement, while in 2009–10 firefighting dominated any broader structural considerations. Furthermore, the contraction of output, brought about by the spillover of the global financial crisis has aggravated the situation, with unemployment soaring over 11 per cent and labour market participation rate remaining around 56 per cent, a long way from the 70 per cent EU target. It is hardly surprising to see the centre-right government put job creation in the focus of its agenda. However, instead of the projected 300,000 new jobs for 2010–14, a decrease of 90,000 materialized in 2010–11, not least owing to the

<sup>10</sup> While labour market participation declined from 5.5 million to 3.9 million over the 1989–2007 period, the number of individuals earning from public-sector payrolls has remained around 1 million. While this number had declined to 720,000 by 2011, and additional 3.3 million were receiving pensions. According to conservative estimates, any streamlining would free at least 200,000–300,000 individuals. The rate of unemployment has risen, during the phase of high growth, by 2 percentage points to 7.5 per cent over the years 2001–07, and to 7.8 per cent by 2008, even peaking with 11.2 per cent by mid-2011, exceeding the EU average of 6.7 per cent for the earlier and 9.5 per cent for the later periods (ECB 2011).

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above described layoffs in the public sector and the sustaining contraction of domestic markets. The latter is well illustrated by the shrinkage of retail trade by 3 per cent in 2010.

This is a problem in its own right, but even more so for the public coffers, as substantial portions of the population are supported through transfers, rather than being converted into employees, either as self-employed or part-time workers. By contrast, as estimates of the independent research team Central European Management Intelligence (CEMI 2006) have shown, a 10 per cent increase in the activity rate could by itself eliminate half of the deficit. Likewise, the suggestion to broaden the tax base from the current 2.1 million full-time taxpayers to 4 million (the total employed)<sup>11</sup> would result in an improvement of an additional 3–4 percentage points at the macro level in terms of GDP. In sum, the combination of better enforcement and more employment could create the opportunity for further employment and lower tax burden. And we have not yet mentioned the option of cutting expenditures, which at the end of 2010 ran at 49.8 per cent of GDP, smaller only than to Finland, Sweden, Belgium, and Austria, the big spending states of the EU. In a way, what is needed is not a brand-new strategy, but a correction of the derailments of 2004–08—in other words, going back to basic strategy could work miracles. The latter could include deregulating and simplifying the current non-transparent system of public dues, improving the rule of law, enforcing existing laws of disclosure, and introducing rules-based fiscal arrangements in line with international experience (Kopits 2004). The centre-right government has started to move in this direction in 2010–11, not least owing to the pressure to raise revenues while introducing, in two steps, a flat tax rate of 16 per cent from 2012.

### 12.7 Lessons for global political economy of reforms

From a global policy reform perspective, perhaps the most pertinent lesson from the experience of Hungary is the importance of sustained and conceptually anchored strategic interchange between governmental policy/institution-building and spontaneous development/learning by doing. The Hungarian experience underscores the limitations of ‘pragmatic’ and ‘non-ideological’ approaches in managing longer-term processes, given that the number of

<sup>11</sup> In 2007, an individual earning more than 1.6 million forints was taxed according to the highest rate, 38 per cent. In contrast, 1 million people, registered as small-scale farmers, are tax-exempt for earnings up to 6 million forints per annum. Further, 600,000 people earn, at least on paper, the statutory minimum wage, about double the estimate of the Labour Market Agency.

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tasks to be managed is infinite, and the pros and cons of each option are value-loaded and tend to be contradictory at any moment of time.

At certain critical junctures, no orchestra, not even the best and smallest chamber orchestra, can play a complex piece by Bach, Mozart, or Bartók without the guidance of at least an informal chamber master. On the one hand, at certain points of time, public choices—for example, with regard to solidarity and incentives, fiscal sustainability, or adhering to the rules of international agreements—need to be institutionalized. On the other hand, it is at least as important for longer-term development, as well as process management, that the cooperation of millions of players, both domestic and foreign, be assured of the persuasion, transparency, and internalization of these objectives and merits of the goals to be attained. This seems to have worked in the 1988–2004 period during which stabilization, liberalization, and EU accession were on the agenda. In contrast, failure in 2006–08 has largely been attributable to the misconceived attempt to introduce structural reforms through *putsch* (cf. Martin 2008; Szakolczai 2008). The danger that this is going to be replicated under the centre-right government is real, given its avowed commitment to ‘nonconventional economic measures’.<sup>12</sup>

It would be wrong to deny that, under even normal times without any imminent crisis scenarios, it could be politically difficult and require more innovative solutions than customary to orchestrate a professional and social consensus around a few well-defined objectives. Adopting the single currency could perhaps be one such intermediary objective; creating sustainable pensions is perhaps another. And providing acceptable livelihoods for regions outside the political centres might be a third objective, with environmental sustainability the fourth.

The quality of education at primary, secondary, and university levels needs to be mentioned. It is highly unlikely that without additional efforts and targeted development of skills, lifelong learning can become nothing more than a slogan. As practical skills tend to become devalued in five to ten years’ time in all walks of life, except perhaps the infamous hamburger job, action is needed even though the outcome will not be obvious for a decade or more. Traditional arrangements, such as universities and standardized secondary schools, have proven inadequate to combat the foremost problem of the entire 1980–2011 period in continental Europe. Thus Hungary’s current educational policy of copying existing arrangements from other countries with reference to EU standards has quickly proven to be a dead

<sup>12</sup> These included the imposition of sector-specific crisis taxes and the nationalization of private pension funds in 2010, and the single-handed raising of retirement ages for a number of professional groups in 2011.

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alley, as documented by the constantly low labour market participation rates and increasing youth unemployment reported in the preceding section.

It is perhaps an inevitable by-product of the FDI-led strategy that a substantial degree of dualism has emerged in the economic, but even more so in social, structures. The transnationalized sector is booming, its benefits multiple, and the trickle-down effect is palpable. However, in social terms, a large part of the small business sector, partly intertwined with the irregular economy, continues to stagnate under a backward system. Since the transnationalized sector, with its Western-type wages and lifestyles, offers employment to only 15 per cent, social inequality manifests. Also, the 3.3 million pensioners out of a population of 10 million tend to benefit little, if at all, from the dynamic components of these processes, even though members of this age group are the 'kingmakers' of any election. Therefore social conservatism, well known from the continental welfare model, is likely to be sustained.

Finally, it is perhaps important to acknowledge the need for continuous reform, which is likely to take the shape of reform waves. As one of the oldest insights in politics confirms, one electoral cycle is usually sufficient for only a single major reform agenda to be implemented, even if managed by fervent reformers like Margaret Thatcher, Leszek Balcerowicz, or Domingo Cavallo. Thus it may make sense to work out a strategy of reforms and to update these continually with feasibility studies, cost estimates, and the introduction of sequencing propositions, as is done in large corporations. Given that the two unique events of the recent past—the collapse of Communism and membership in the EU—are history, normal politics, interest-group politics included, allow only for piecemeal progress. But if we take labour market reforms, for example, which were successfully managed by such diverse countries as Switzerland and Denmark adopting different strategies, this might be a tall order, as it cuts across society. Likewise, pension reforms may require a decade or longer. Healthcare reforms may need more trial and error, while sustaining the calculability and access of citizens. The Semmelweis Plan adopted by the right-wing government (MTI 2011), by contrast, is confined to more administrative interference, command, and controls, thus stepping in the footprint of its ill-fated predecessors.

Our broad political economy focus follows from the need to set up and actively reorganize reform coalitions on a regular basis. This observation radicalizes the age-old insights of the global experience of policy reforms: without social, political, ideological, and media support, structural reforms and institutional change are unlikely to endure long enough to produce palpable outcomes, even in the 'single issue areas'. Furthermore, it goes without saying that pro- and anti-reform interests, dispositions, and convictions may vary among citizens of different generations, levels of education, or even places of residence, to name only a few of the more trivial components. Therefore none

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of the overarching broad coalitions may qualify as singular agents of change, irrespective of their relative strength in legislation. The more the traditional left-wing parties are being penetrated by business interests and the conservative parties with petty *bourgeoisie*, the less relevant the traditional assumptions about pro- and anti-reform forces may prove to be.

The experience of Hungary also highlights the limitations of external anchoring. As long as the stick-and-carrot influence of EU membership was present, it helped to form and sustain the needed political and professional consensus around all major strategic issues, regardless of the issues concerned (disinflation, respect for minority rights, or longer-term environmental concerns). Once such leverage is gone, lack of internal commitment could lead to perverse outcomes. This means the misuse of soft external financing to fund non-reforms and old-style populist policies,<sup>13</sup> rather than financing the transition to sustainable pension and fiscal systems. The grandfatherly approach of international markets has allowed non-sensical policies to survive much longer than the theory of efficient financial markets would have assumed. In reality, soft external financing, although by no means the trigger of misconceived policies in 2001–08, certainly contributed to their cover-up, just as much as was the case in 1972–78. More specifically, EU membership and the prospect of a fast adoption of the euro have proven elusive, for policymakers and market participants alike. The introduction of the euro has not materialized; still the related expectation was so general that it has added to a disorientation of the markets. Furthermore, the EU's current implementation crisis has prevented this being rectified through direct fiscal surveillance mechanisms.

In summary, Hungary can provide samples of both well-timed reforms (that is, advantages of early-bird action, as witnessed during the years 1989–96) and poorly sequenced, haphazard measures (those of the 2004–08 period). In particular, the 2006–08 years indicate how radical projects can be thwarted, inter alia, by poor preparation and design. But, more importantly, the experience of this period underscores the need to separate and sequence different reforms according to the length of time needed and the technical difficulty and complexity of social implications. While it is a relatively straightforward procedure for a government to attempt to streamline taxation or fiscal affairs, it is an entirely different matter with the more elaborate, value-loaded issues, such as the socially and intellectually divisive areas of health care<sup>14</sup> or environmental protection. Frontloading the healthcare and regional reforms, each with a time span in excess of fifteen years, must be seen as a major conceptual

<sup>13</sup> These policies were truly unique from a regional, as well as a broader European, perspective (Csaba 2009).

<sup>14</sup> For an enlightening account of why these failed, see Mihályi (2008).

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and sequencing error that immediately led to the reversal of most reforms planned by the socialist government, irrespective of their merits.

The consensus from policy reform literature about the relevance of sequencing measures, or frontloading these with immediate returns and improvements, was confirmed once again. Thus it is somewhat ironic to have seen the right-wing government in 2010–11 replicating the same mistakes, in terms of poor, if any, professional preparation, lacking social consultation, as well as launching attacks on all ‘fronts’/sectors, rather than sequencing individual measures along a longer-term master plan.

The broader lesson from the good and bad Hungarian experiences can be simply drawn in normative terms. It is the need for an integrated intellectual and analytical framework, a vision-cum-operational strategy that could be combined with tactical skills, persuasive power, and coalition-building—the vital ingredients of any reform policy for surviving under a democratic and pluralistic environment for one or two election cycles. Trust and social consensus are the most essential ingredients, albeit the most difficult to accomplish in practice.

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