

OTTO HIERONYMI

PRIME MINISTER JÓZSEF ANTALL
AND THE REGIME CHANGE IN HUNGARY
1989–1993

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VERITAS

Történetkutató Intézet és Levéltár

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TABLE OF CONTENTS

INTRODUCTION

1. Why this book? What is it about?	9
2. Background, sources, personal experiences	11
3. Current and future relevance	16
4. Acknowledgements.	17
5. Chapter Overview.	18

PROLOGUE

The Personality and Historic Role of Prime Minister József Antall

1. József Antall: the greatest Hungarian statesman of the 20th century	21
2. Antall and the Hungarian regime change	23
3. Hungary's place in Europe and the world	27
4. The Euro-Atlantic community	29
5. The objective of the social market economy	30

CHAPTER ONE

The Economic, Monetary and Social Crisis of Hungary in the Late 1980s

1.1. Inheriting a structural and imminent crisis	32
1.2. The "Hungarian Reform": part of the big lie	34
1.3. The external and domestic monetary crisis	37
1.4. The "real economy": phony privatization	38
1.5. Corporate debt and impending bankruptcy	39
1.6. The reality of the Communist welfare system	40

CHAPTER TWO

Regime Change and the Social Market Economy: the Objectives of the Antall Government

2.1. Avoiding economic and social collapse	41
2.2. Why the "social market economy"?	43
2.3. Germany, Switzerland and the rest of Europe	47
2.4. Domestic and external constraints	52
2.5. A valid but forgotten objective	53

CHAPTER THREE

The European and World-wide Models of Regime Change

3.1. Revolutions: a mixed record	57
3.2. What happened after the First and the Second World Wars?	64
3.3. Decolonization and the “planned economy”: betting on the wrong model ..	65
3.4. The international debt crisis: “marketization and structural change”	67
3.5. The collapse of the Communist system: the fallacy of the “shock therapy” ...	68
3.6. The failure of the “Arab Spring”: Was it the fault of “Liberal Democracy”? ...	74

CHAPTER FOUR

The 1990 Program of Hungarian National Renewal

4.1. A complex drafting process	79
4.2. The central economic issue: growth or austerity?	83
4.3. Mastering the bureaucracy: a classic challenge for all new governments ...	85
4.4. Issues of communication and of substance	87
4.5. How was the program implemented?	89

CHAPTER FIVE

External Debt, Resource Shortage and Crisis Management

5.1. Resource shortage: the central problem of regime change	92
5.2. The magnitude and nature of the Hungarian debt	98
5.3. Antall’s refusal to default on the external debt: a correct decision	105
5.4. No easing of the debt burden: the political incompetence and indifference of the OECD countries	113
5.5. Foreign direct investment in Hungary	115

CHAPTER SIX

Bank Reform and Monetary Policy

6.1. From Communist “banks” towards a “real” banking system	125
6.2. The structure of the Hungarian “two-tiered” banking system	129
6.3. The Bank Reform Commission	131
6.4. Tensions between the Ministry of Finance and the Central Bank	149
6.5. The controversy about cleaning up the banks’ balance sheets: who shall pay the bill?	153

CHAPTER SEVEN

Privatization and the Strategy of Bank Privatization

7.1. From nationalization to privatization: a global trend	155
7.2. A broad range of approaches: from the German <i>Treuhand</i> to “coupon privatization” and to “market privatization”	160
7.3. Hungarian privatization policies and institutions (<i>ÁVÜ</i> , the Office of the Minister of Privatization)	165
7.4. The special case of bank privatization	173
7.5. The Antall government’s record on privatization	182

CHAPTER EIGHT

The Conditions of Sustained Growth: the Working Group on Economic Policy Strategy (GAM)

8.1. Recognition of the need to create the conditions for sustained growth	192
8.2. December 1991: the appointment by Prime Minister Antall of a Working Group on Economic Policy Strategy (<i>GAM</i>)	194
8.3. The principal aspects of the Working Group’s Report – a strong emphasis on institution building and strengthening	204
8.4. The group’s recommendations become government policy	215
8.5. How important was <i>GAM</i> ?	217

CHAPTER NINE

External Relations: Joining the European and Atlantic Communities

9.1. The collapse of the Communist empire and the peaceful end of the Cold War	224
9.2. A unique historic opportunity to join the Euro-Atlantic Community	226
9.3. József Antall: a great international statesman	230
9.4. Securing Hungary’s place and role in the new post-Cold War world	235

CHAPTER TEN

The First and Second Battelle Reports

10.1. How did I get involved: the opportunity of a lifetime	241
10.2. The Office of the Prime Minister’s Advisers	243
10.3. Commitment, friendship and hard work	244
10.4. What was the first “Battelle Report” about?	246
10.5. Growth and institutional reform: the Second Battelle Report	264

CHAPTER ELEVEN	
<i>The White Paper on the Legacy of Four Decades of Communism</i>	
11.1. The Prime Minister's suggestion and sense of history	268
11.2. A large and dedicated group of participants	269
11.3. Time pressure, computer and software complications and changing priorities for some (" <i>isn't the draft too critical?</i> ")	276
11.4. Spring of 1994: too late for publication (?)	277
11.5. With hindsight the study was not only relevant but also original and to the point	278
CHAPTER TWELVE	
<i>The Values of József Antall</i>	
12.1. A modern thinker and man of action	279
12.2. Western and Hungarian framework	281
12.3. A liberal-conservative internationalist	285
12.4. Idealism and realism, patriotism against nationalism	287
12.5. The values of Antall: a legacy for Hungary, Europe and America	288
CONCLUSIONS	290
EPILOGUE	294
SELECTED BIBLIOGRAPHY	298

INTRODUCTION

1. Why this book? What is it about?

This is a highly personal book. I have been thinking about the topic and planning to write about it for more than 30 years now. In fact, the current structure and chapter titles very closely resemble the first draft Table of Contents that I had prepared a long time ago. Over the years more and more has been written about the Antall government, about the Antall years, and about Antall as a person. It is not that Antall is a “fashionable” topic; a designation he would have disliked and rejected. It is rather that Antall’s personality and work were very important at a crucial time in the history of Hungary, Europe and the world. His legacy should and will last not only in Hungary but across the world among people who believe in responsible politics, in the public good, in peace and international cooperation, in the accountability of political leaders and in the future of liberal democracy.

The end of Communist domination in Europe, the relatively peaceful end of the Cold War and the ensuing opportunities for fundamental political, economic and social regime change were the most important turning points for the better in the tragedy and crisis laden history of the 20th century. The victory of the model of democracy and freedom over authoritarianism and totalitarianism and the opportunity to build new liberal democracies was real, not a temporary illusion, as was the opportunity to broaden the geographic and virtual borders of the Western Community while those of the authoritarian regimes were shrinking.

The dissolution of the Soviet Union and its network of satellites was an important starting point on the road towards a “better world”, as had been the defeat of Nazi Germany and of the other Axis powers at the end of the Second World War. Since the end of the Cold War many hopes for a better world could and were fulfilled, just as much as after 1947–49. But the more than three decades since the end of the Cold War have also witnessed numerous failures, internal conflicts and humanitarian and political crises as well as the re-emergence of political oppression and authoritarianism. Today, the world is suffering from the most dangerous crisis provoked by a bloodthirsty autocrat that we have witnessed in the last 70 years, a crisis that represents a combination of armed aggression and of the threat of the destruction of international order.

At the time I am writing these lines, the outcome of Putin's criminal policies cannot be ascertained. What is certain, however, is that the Russian "strongman" must not be allowed to impose his will on Ukraine, on Europe and the world. Not if we want to live in peace and freedom also in the future. Thus, the story I am trying to tell in this book is relevant for our time and for the future. It is relevant because it deals with the lasting consequences of oppression and about the efforts to overcome them. Those of us who were fortunate enough to witness these efforts from close up have a duty to tell their story. Fundamentally this is the objective of my book.

What then is my story? Why have I been convinced for the last 30 years that I have something to tell that is different from the analyses and memoirs about the same period that the present book covers written by other people, including my friends? The answer to this question is quite simple. As discussed in chapter 10, which deals with the First and Second Battelle Reports, the current book is in a certain sense the third concluding volume of my analysis and views of the transformation of the Hungarian economy, from a run-down Communist planned economy into a "normal" European market economy.

There are two common threads that link the three studies. The first one is that all three deal with the regime change in Hungary. The first one was prepared shortly before the regime change started. The second was the by-product of my participation in the unique intellectual and political process that was the regime change itself, and which was completed in the middle of the period indicated in the title of this book. The planning of this current third volume, as indicated above, was started after the 1994 elections at a time when the regime change had been *de facto* completed.

The second common thread has to do with the three different but complementary perspectives from which the studies were undertaken and completed. The first one was a "view from the West", as indicated in the title of the Hungarian translation of the study, and the report looked primarily at the future. The perspective of the second one was both from the West and from Hungary, and dealt with both the present and the future. Finally, the perspective of this book is also both Western and Hungarian, but it deals definitively with the past. In a sense my reflections have come full circle.

What is the book about?

This book deals with the replacement of the Communist one-party authoritarian political system by a liberal, democratic parliamentary regime in Hungary and the role of Prime Minister Antall in this process. This book is neither a complete and systematic history of the regime change in Hungary nor is it a biography of the late Prime Minister.

The specific issues dealt with were selected on the basis of the following criteria (or preferably of a combination of these criteria): (1) the importance of the issues, the challenges and the opportunities; (2) my direct knowledge about the questions and whether or not I was close to the discussions about them; (3) the extent to which I was aware or not of the thinking and decisions of the Prime Minister and of his government; and (4) the issues on which my contribution can be identified.

Regime change has multiple aspects – economic, political, social, institutional and ideological, domestic and external. While thorough regime change – especially if it is successful – involves an entire nation and country, some individuals play an exceptional role in the process.

The term “regime change” has several interdependent meanings. It can be used to describe an objective: the hope and desire for a different, a better, freer system under which people would like to live. When thinking of or speaking about regime change people may refer to both the negative features of an existing (as a rule an oppressive, unfree) political order and to the positive aspects of a system that is meant to replace the existing one. Most of the time people know more about the first one – the one they hope will be abolished – than about the regime that ought to replace the old one. This, however, is not always the case. It may happen that people are keen to adopt a system that has some specific new well-defined features but are much less clear about which features of the old one must be abolished if a regime change is to be completed. “Regime change” also refers to a process during which an entire country undergoes a complete and lasting transformation, and to the outcome of this process.

As it is clear at a first glance at the Table of Contents, economic issues tend to dominate the narrative. This is, however, due not only to the fact that I am an economist and that my work as an advisor had to do with economic questions. It is also because the state and the future of the Hungarian economy was the most important issue in the process of regime change – second only to the opportunity to end the dictatorship and to establish a functioning democracy. The focus on the economy does not mean that I underestimate today, or that I underestimated at the time, the importance of the political dimension in the regime change and in the thinking and unique achievements of József Antall.

2. Background, sources, personal experiences

Important to the background of this book is that from January 1990 until December 1993 I was a Personal Advisor of József Antall. From 1970 until 1995 I was a Senior Research Economist at Battelle’s Geneva Research Centers. The Battelle Memorial

Institute, with headquarters in Columbus, Ohio, was and remains the world's largest independent not-for profit research organization. My field of work was economic analysis and forecasting. Battelle-Geneva was for many years the most international component of the entire Battelle organization. We all worked on a project basis, and most of our research was interdisciplinary. Battelle is essentially a science and technology based organization, but at the time economics and techno-economics represented a significant share of its activities, especially of Geneva. Given its size and long history relatively few people are even aware of Battelle's existence let alone know about the scope of its work. The reason for this is quite simple: unlike university-based researchers, Battelle staff members as a rule do not publish the results of their work. It is up to the "sponsors" of the projects to decide whether the results should be diffused beyond a relatively narrow circle of direct users.

During the more than a quarter century that I spent with Battelle I was responsible for many projects with a wide-range of topics, methodology, geographic scope and type of sponsor. The main geographic scope was Europe (essentially Western Europe), but I also did extensive work in America (especially the U.S.), Asia (mainly Japan), Australia and the Middle East. Forecasting, scenarios and model building were also important aspects of our work and experience.

I was born in Hungary and left the country in December 1956 when I was 18 years old. I had been enrolled for a few weeks as a student at the Institute of Central Asia of the Eötvös Loránd University in Budapest but my real interest was international relations. For that field of study I could not qualify because my family did not have the required (Communist) background. After leaving the country, I was accepted to study at the University of Geneva in Switzerland, where I was able to start courses in Economics and International Relations in May 1957 already with the help of a scholarship, as so many of my fellow refugees. It was at the University of Geneva and the Geneva-based Graduate Institute of International Studies (IHEI) that I earned my *licence* and doctorate.

Economic systems, economic policies and economic order were among the areas of my professional interest both at Battelle in Geneva and during the years I had worked as an international economist in New York. Although I never worked during the Communist years on a project in Hungary or for a Hungarian organization, following events in Hungary and in the "Soviet camp" was part of my personal and professional interest for many years, in fact ever since my student days. Thus, in 1988–1989, like many other people, I was also aware that changes were happening. How far these changes could go, I did not know. In the fall of 1989, after a series of discussions I managed to start a research project with Swiss support on the economic situation and outlook of Hungary and the relevant economic policy implications. It was during

the research for this project that I had the opportunity for the first time to meet József Antall in the company of the Swiss Ambassador. During the conversation at this breakfast meeting the Ambassador, who knew Antall well, told him about Battelle and the kind of independent research it was engaged in. In response Antall told the Ambassador what he knew about my great-grandfather, Károly Hieronymi, and about his historic contribution to the development of the infrastructure and the modernization of Hungary during the last decades of the 19th century¹. I in turn described my professional experience and my student days in Geneva as a disciple of the late Wilhelm Röpke, one of the “fathers” of the concept of the social market economy.

The research project, which also involved the inputs of about 15 Western experts, was completed by January 1990, and the final report was distributed to experts, officials and opposition politicians in Budapest. It was designated by the Swiss Ambassador in Budapest as the Swiss contribution to the debate on the on-going transformation in Hungary. A key recommendation was that a free Hungary should try to develop a “social market economy”. The conclusions and recommendations of our report differed significantly from another report that was carried out, as I later learned, with the participation of several experts from the other side of the political spectrum.

Sources for the current book

Throughout the book footnotes contain references to published or unpublished books, articles and other documents used in the respective chapters. The Selective Bibliography at the end of the volume contains a collection of the principal sources used. Especially of interest were books and articles written and published by Péter Ákos Bod² and Géza Jeszenszky who were not only particularly close to Antall during

¹ Károly Hieronymi, (1836–1911) was a prominent liberal Hungarian politician and engineer, a follower of Kálmán Tisza. In 1892–1895 he was Minister of the Interior and in 1903–1905 and 1910–1911 Minister of Commerce. For an illustration of his role in Hungarian politics, see his electoral duel with Vilmos Vázsonyi in: Csergő, Hugó and Balassa, József, Editors (1927): “A Vázsonyi–Hieronymi választás,” in *Vázsonyi Vilmos beszédei és írásai, Országos Vázsonyi Vilmos Emlékbizottság*, Budapest, volume one, part three, chapter one, pp. 295–313

² Bod, Péter Ákos (1998): “*Hol tart ma a három ország, hol tart a rendszerváltozásuk?*” in Blejer, Mario I. and Coricelli, Fabrizio, Editors (1998): *Három ország, három történet, három szereplő: rendszerváltozás Kelet-Közép Európában, ahogy Leszek Balcerowicz, Bod Péter Ákos és Václav Klaus látta*. Széphalom Könyvműhely, Budapest, pp. 128–214. This is an enlarged version, in Hungarian, of an earlier work: Blejer, Mario I. and Coricelli, Fabrizio, Editors (1995): *The Making of Economic Reform in Eastern Europe. Conversation with Leading Reformers in Poland, Hungary and the Czech Republic*. Edward Elgar, Aldershot.

the entire period covered by this book, but have continued to write about Antall and re-publish the late Prime Minister's writings.³ There are numerous other writings by my friends and members of Antall's team that I have enjoyed reading and used in my analysis, even if they are not mentioned in the footnotes in this section.

One of my principal weaknesses is that not only do I like to read but I am also an incorrigible paper collector: books, newspapers, published and unpublished texts, drafts, history, literature, economics, poetry, travel, not to mention old and more recent encyclopaedias. The physical and psychological weight of this habit is considerable, especially since I had interests and experiences in many countries, cities, languages and cultures. However, it also has indisputable advantages: it opens one's mind, it prepares one for new and unexpected subjects and challenges. It was "reading ahead" that had prepared me for many future tasks, challenges and opportunities: curiosity and the passion for "paper" have led to many fascinating encounters with people and ideas in the course of my life.

All this is to say that during the four years that I was intensively involved with issues related to Hungary I had amassed a considerable amount of paper: a collection that has to compete for space with material related to many other subjects. The material is heterogeneous, most of it is in Hungarian, but a substantial portion is in English and a small part in other European languages. There are books, articles, research reports, newspapers, speeches, memoranda, as well as drafts for the various chapters of this book.

Personal Experiences

What were my most important personal experiences during the four years of the Hungarian regime change? What was the most satisfying? What was most frustrating? What do I remember most clearly?

In this section I can indicate only a few of the key aspects of my work and experience. In the rest of the book there will be more detail under this heading but not too many "anecdotes". Unfortunately, I am not one of the many Hungarians who are born storytellers.

³ Jeszenszky, Géza: "Introduction: József Antall and the World" in Jeszenszky, Géza, Editor (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antall Foundation, Budapest, pp. 15–48; Bod, Péter A.: "József Antall, Prime Minister of Hungary", in Jeszenszky, Géza, Editor (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antall Foundation, Budapest, pp. 49–65; Jeszenszky, Géza, Kapronczay, Károly and Birnanczky, Szilárd, Editors (2006): *A politikus Antall József – az európai úton*, Mundis Magyar Egyetemi Kiadó, Budapest; Jeszenszky, Géza, Editor (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antall Foundation, Budapest

There is no doubt that the greatest, most satisfying experience I had, the greatest experience of a life time, was to be able to see from close up and participate in the process of Hungarian regime change and to be part of Antall's team. This also allowed me to develop a great appreciation of Antall's personality, of his human and leadership qualities and of his achievements.

I was not an employee of the Hungarian government; I did not receive a salary from Hungary. My position as an advisor could be ended on short notice at any moment. The feeling that my experience and work could be useful was shared by Antall. This was the basis of my presence and activity. An important dimension of this experience was the close contacts with Antall's associates: being part of a team with a common and important purpose. In many cases these contacts developed into lasting ties of friendship.

I had no personal or professional ambition to stay in Hungary permanently. In terms of duration the most I hoped for (and achieved) was to be part of the team until the end of the parliamentary cycle, until the next elections in the spring of 1994. This I knew from the start. This knowledge helped me secure my independence and also, I believe, improve my ability to judge people, the state of the country and various situations as well as policy choices as objectively as possible given the complexity of those times.

One of the experiences that I enjoyed greatly – as has been the case throughout my professional life – was meeting people and discussing questions related to their work. A lesson that I had learned during my student days when I was doing research on my doctoral dissertation in the United States, and a lesson that was confirmed time and again during my years as a professional researcher, was that people in all positions, including at the highest levels, like to talk about their work. They will also tell you about issues, problems and successes that may show new perspectives, and about what they have never put into writing and even less have published. To conduct this type of conversation – even with people you may meet for the first time – requires discretion and trust on both sides. I have respect for good journalism and I am greatly saddened by the decline of good journalism and good reporting in the age of electronic mass social media, but even in the old days journalists had a hard time in conducting this kind of conversation with experts and decisions-makers. Even if they had a reputation for respecting their “sources” their professional objective was to diffuse information and not just to learn.

I also met many people, young and not so young, with whom I had informal talks that had nothing to do with politics or economics or with their or my work. Talking about books, theatre, movies, languages, travel or food is as interesting in Hungary as it is in Brazil, Japan or France. People's everyday life is a country's foundation, and these conversations can tell you as much about the future as about the past.

On a less positive note, I would like to mention a recurring frustrating experience, hearing criticism of Prime Minister Antall and the government by people who had been much more tolerant and understanding towards the Kádár regime⁴ than they were towards the first freely elected post-Communist democratic government of Hungary. I knew that this type of criticism is part of the freedom of speech in a democracy. Still I had a hard time understanding some of my close friends in Geneva, who were of Hungarian origin like me, when they expressed unfounded criticism about the Antall government and refused to give credit for the government's efforts, or listen when I tried to explain to them the complexity and difficulty of dealing with the legacy of the Communist regime. Not all of them were like that – still it was a somewhat bitter lesson about both friendship and about understanding political reality.

3. Current and future relevance

As already noted, I believe that the story in this book, the analyses and conclusions that it puts forward, have gained relevance in recent years and may remain of interest also in the future. This view is based on a reading of today's situation both in Hungary and in the rest of the world. It is supported by arguments and encouragements I find in the recent writings of like-minded friends.

The dominant feature of today's political environment is the tension between liberal democracy and international cooperation, on the one hand, and the growing nationalism and authoritarianism, on the other hand. This is not only an open conflict at the level of ideas and theories and of political systems but increasingly also a military conflict brought about by Russian aggression and by the countries that condone or support Russia's criminal behavior.

Many politicians and journalists and other observers in the Western democracies have been expressing their fears that we might be facing a "new Cold War". In fact, we are already in the midst of a Cold War, at the core of which the bloodiest, most brutal and destructive war is taking place on European soil since the end of the Second

⁴ János Kádár was a Hungarian Communist leader and the First (General) Secretary of the Hungarian Socialist Workers' Party (HSWP) for 32 years. His leadership was characterized by unrelenting Realpolitik. During the Hungarian Revolution in 1956, he took part in Imre Nagy's revolutionary government. In November 1956, after the suppression of the Revolution, he came to power as First Secretary of the Party. In 1958, he ordered Imre Nagy to be executed. Kádár's regime has been described as a dictatorship of the proletariat. He played a key role in Hungary's transition from the anti-Soviet government of Imre Nagy to the pro-Soviet regime that followed. Kádár's longevity as the Communist ruler of Hungary was due to his skill in combining concessions to Hungarian consumers with unshakable loyalty to his masters in the Kremlin.

World War. Not only is there no just and peaceful way out in sight, the perpetuation and possibly the expansion of the geographic scope of wars of aggression against democracy could be waiting for us.

Communists (and not only “Stalinists”) and their numerous “fellow-travellers” used to pretend that the original Cold War was the fault of American (Western) imperialists, or at least there was equally shared responsibility for its outbreak and long duration between “the East” and “the West”. Hungarians well know and must always remember how wrong this interpretation of one of the principal developments of the 20th century was from the start and remains today.

The Cold War started because of the legitimate reaction to the imposition of Communist totalitarian ideology and oppression by the Soviet Union on countries it had occupied at the end of Second World War, including Hungary. NATO, the OECD, and European integration aimed at building and defending democracy and to provide effective collective security for the members of the emerging Western Community. The crushing by the Red Army of the Hungarian attempt to gain freedom from Communist oppression and to join the community of democracies clearly demonstrated Russian-Communist refusal to tolerate political freedom in the area under its domination.

The actions and rhetoric of Putin’s Russia are motivated by the same kind of ideology and strategy that had initially robbed the population of the Soviet Union and the Soviet satellites of freedom and self-determination and in particular from building a stable democratic political order. As was the case in the second half of the 1940s, threats from tyranny led to a positive reaction by the democracies. If today, once more the world is divided into two sides – those who want to destroy democracy once and for all, and those who are ready to provide help to resist tyranny – it is not the fault of the West.

At the time of the Hungarian regime change it was clear what the consequences of the actions of Communist Russia were for Hungary during the preceding 40 years. The difficulties that the Antall government and the entire country had to cope with were the legacy of Communist rule.

4. Acknowledgements

The four years described in the present volume have been for me a unique human experience. At its center, of course, there were József Antall and the work and ideas and values that were linked to “regime change”. Beside Antall, I am grateful to many people for having been able to participate in a transformation of the world that I never expected to happen during my lifetime.

For the last 30 years the idea of this book project has been almost constantly on my mind. I am grateful to members of my family who kept encouraging me to keep this memory alive and finally to complete the manuscript of this book.

The following short list contains the names of both family members and of people whose name brings up particularly close memories related to the subject of this book. This list is far from exhaustive and I hope no one will be offended by not being included.

Rudolf Andorka, József and Klári Antall, Iván Bába, Gusztáv Báger, Miklós Bányai, Ádám Batthyány, Péter Ákos Bod, Katalin Botos, Zoltán Cséfalvay, Imre Csuha, Gábor Czakó, Ambassador Dahinden, Géza Entz, Csaba Ferencz, István Forrai, György Granasztói, Ibolya Hegedüs, Andrew Hieronymi, Catherine Hieronymi, Charles Hieronymi, Gábor and Josephine Hieronymi, Pál and Magda Hieronymi, Christianne Humbert, Géza Jeszenszky, Béla Kádár, Michael Kaeser, Csaba G. Kiss, József Koblenz, Gyula Kodolányi, Éva and István Laczay, Alexander Lámfalussy, Alexis Lautenberg, Ferenc Mádl, János Martonyi, György Matolcsy, Tamás Mellár, László Nagy, Zoltán Nagy, György Osváth, Tibor Pongrácz, László Ódor, Ernő Pungor, Ferenc Rabár, Jean-Pierre Roth, György Szabad, Iván Szabó, Tamás Szabó, Miklós Pelsöczy-Szabó, Gyula Takácsy, Charles Thomas, Hajnalka Tóth, Robert Triffin, Pál Tar, Erzsébet Várnai and György Vukovich.

Among the friends who also believed that the book should be completed Péter Bod, Tamás Szabó, Géza Jeszenszky and Gyula Kodolányi stand out. I am particularly grateful to Tamás Szabó and Péter Bod for their help in the publication of this volume. Without them the book certainly would not have been published.

Finally, I am also deeply grateful to the publisher and its staff and to those whose support has made this project possible.

5. Chapter Overview

Along with the Table of Contents, the present section ought to give the reader an overview of the structure of the book. The paragraphs on each of the following chapters are kept short. They aim at giving a hint of the key issues and conclusions but in terms of volume of information do not compete with the chapters themselves.

Prologue. The main aim of the *Prologue* is to define József Antall's historic role and his principal merits with respect to the regime change in Hungary and his stature as one of the outstanding international statesmen of our time.

Chapter One presents the economic, monetary and social crisis of the 1980s that was the legacy of the Communist regime, a legacy with which the Antall government

had to cope in order to prevent a domestic and external monetary and economic collapse.

Chapter Two provides a discussion of one of the principal objectives of the program of Prime Minister Antall and of his Administration: the adoption of the European model of the social market economy in Hungary.

Chapter Three discusses the success and failure of regime change in European countries and in the world at large in our time and in a longer historical perspective.

Chapter Four describes the complex process of the drafting and adoption of the 1990 *Program of National Renewal* and the implementation of the program.

Chapter Five deals with some of the most important problems for which the government had to find solutions: the general resource shortage, the country's large external debt and very low external reserves, and the lack of financial assistance from the leading OECD member countries.

In **Chapter Six** the transformation of the banking sector, the shifts in monetary and banking theory and practice, as well as the work of the *Hungarian Bank Reform Commission* appointed by Prime Minister Antall are discussed.

Chapter Seven also treats one of the central issues of regime change: the strategies of privatization and the encouragement of the expansion of the private sector. In contrast to several other countries, Hungary opted on the whole for a market approach in privatization. One of the problems encountered not only in Hungary but in the entire former COMECON region was the over-supply of assets to be privatized and the shortage of private savings and thus of capital available for the purchase of companies to be privatized.

Chapter Eight. In order to develop a systematic strategy to reduce the various obstacles to sustained growth, Prime Minister Antall set up a high-level *Economic Strategy Task Force (GAM)*. According to a recent comment by one of the leading members of this Commission, "the *GAM* report and recommendations can be seen as the economic policy strategy of the regime change".

The theme of **Chapter Nine** is regime change and Hungary's external relations. The key objective was to become a full member of the European Community and of NATO as early as possible.

Chapter Ten deals with the two "Battelle Reports" on the Hungarian economy and economic policies, of which I was the main author. The first study was completed in January 1990 and the second one in late 1990, i.e. towards the end of the second year of the Antall government.

Chapter Eleven. In the spring of 1993 Prime Minister Antall asked me to organize and lead a group of high-level experts to prepare a study on the *Economic and Social Legacy of Forty Years of the Communist Regime in Hungary*. The draft of this detailed

and ambitious project was completed by early 1994 but unfortunately for various reasons it was never published.

Chapter Twelve. The title of this chapter is: “The Values of József Antall”. This chapter is about trying to understand the complex personality of the late Prime Minister, who was a modern thinker and a man of action, in the Western and Hungarian framework. He was a liberal-conservative internationalist, an idealist and realist, a patriot rather than a nationalist. The values upheld by Antall will remain an important legacy not only for Hungary, but also for Europe and America.

Conclusions. The conclusions are briefly presented under two headings: (1) the role of policy-making and ideas in economic and societal regime change and (2) the lasting impact of the regime change achieved by the Antall Administration.

Epilogue. The volume concludes with a question about the future: should we be pessimistic or optimistic about the future of liberal democracy in Hungary and the world in the light of the lessons that can be drawn from this book and from the changing environment in the world?

PROLOGUE

The Personality and Historic Role of Prime Minister József Antall

1. József Antall: the greatest Hungarian statesman of the 20th century

Biographies and autobiographical writings have been favorites among readers as far back as written history exists. Virtually in all civilizations there is an abundant literature on the life and times and achievements of great political leaders. In Western antiquity one may mention for example the comparative biographies of Plutarch or the story of Pericles by Thucydides. Up until recently these texts had been at the core of educational programs shaping the worldviews of many generations of children.

For Hungarians the list of great national leaders includes names like Rákóczi, Kossuth, Széchenyi, or Ferenc Deák. (Needless to say that under the Communist regime new names were added to the list and the lives of the traditional ones were adapted to suit the party's ideology.) Who is on the list of the great leaders of the past is not only a question of effective historical achievement but also of fashion or worse of ideological censorship. As we have found out recently censorship can exist, or at least be advocated, not only in authoritarian regimes but also in modern democracies. For many of us it is a bewildering thought that according to some, for example, Thomas Jefferson or George Washington should be removed from the list of "great men" and cease to be universally recognized as founders of the American Republic and of free, constitutional government, and be degraded to "enemies of equality".

Guglielmo Ferrero was an Italian historian who wrote a five-volume history of the Roman Empire in which he extensively criticized the conventional views in the 19th century, which idolized Cesar and his obsession with power. Ferrero was a convinced democrat. After the end of the First World War he became an outspoken critique of Fascism and Mussolini. He managed to escape from Italy and to find refuge in Switzerland. He continued his academic career as Professor of History at the Graduate Institute of International Studies, a safe haven for academics who fled from the persecution of liberal thinkers by Hitler and Mussolini.

I never met Ferrero since he had died many years before I became one of the Hungarian refugee students welcomed by the Graduate Institute in the wake of the 1956 Hungarian revolution. However, the writings and the spirit of Ferrero were still present at the Institute, and one of the lessons I retained was a critical view of

idolizing politicians who amassed increasing power and who continued to cling to power past their time of retirement. With Ferrero I developed a healthy scepticism of what is called the “great man theory of history”.

These introductory remarks are necessary to dispel the impression that I might put József Antall in the category of the “great men” who are the subject of hero worship during their life or thereafter. Why do I still believe that it is correct to call Antall “the greatest Hungarian statesman of the 20th century”? In my view this is not an expression of lofty hero worship but a way to understand both Antall and the chequered history and statesmanship of Hungary during the last 100 years, as well as the circumstances before and during the time he exercised the highest office in the country.

The list of 20th century Hungarian politicians whose names are familiar not only to historians and other specialists is quite long. Some of them were highly talented, while others had a questionable character and record. Even if one leaves aside the worst ones, who were part of the bloody-handed dictatorships on the left or the right, the regimes that were part of the Hungarian tragedy of the 20th century (a variation of national tragedies that were taking place in the rest of the region and in other parts of Europe), the life story of virtually all politicians was marked by the legacy of out-of-date, or out-of-order, political doctrines, decisions, events, mistakes or simply by the fact that they were unable or unwilling to overcome what they rightly or wrongly perceived as the inalterable burden of their country’s geography and history. Some of them bravely tried to resist or even to reverse domestic or external developments, but in the end they failed.

“Historical determinism” is not a very commendable ideology or tool of political and historical analysis or forecasting. Nevertheless some of the unattractive features of the Hungarian political system – of which the sharp swings between right-wing and left-wing oppressive regimes and the failure to establish a modern democracy during the sparse periods of good times should be mentioned – were not entirely the fault of the leading politicians.

Does all this mean that the competition for the “greatest Hungarian statesman of the 20th century” was not a difficult one to win? My answer is yes and no.

It is highly probable that Antall would not have agreed to take such “competition” seriously. Also his discretion and good intellectual manners would not have allowed him to accept this flattering designation. I decided to use this definition not in order to add to a posthumous glorification and mystification of the late Prime Minister, nor to add to the still raging controversy about the sins and virtues of the political elite of the inter-war period, starting with Horthy, Bethlen, Teleki or Kállay.

I would like to sum up Antall's merits and achievements under six headings. It is the combination of these six points that leads to my conviction that Antall stands out as truly exceptional in the gallery of modern Hungarian political leaders.

1. A deep understanding of the structure and workings of the two main opposing political systems of the 20th century: Western liberal democracy versus authoritarian regimes based on various totalitarian ideologies.

2. A thorough understanding of how a modern democratic parliamentary system works and how it can be established on the ruins of a one-party dictatorship.

3. A strong sense of the importance of social issues and for the need to balance the competition in a market economy with protection of the less privileged; hence his conviction that the "social market economy" was the best societal model for Hungary.

4. A full awareness of the close interdependence of the domestic and the international political order, and of the importance of patriotism and the rejection of nationalism which he recognized as a threat to peace and democracy.

5. A belief that history was offering Hungary, and the other Soviet satellites in the region, a unique opportunity to join the community of European and other Western democracies. Furthermore, that Hungary must not hesitate and miss this moment. It must make sure that there will be no reversal and it will not be squeezed out of the West where it truly belongs.

6. A masterful leadership and understanding of the goal and process of regime change, an innate feeling for differences and similarities of political and human situations, those where compromise was necessary and where firmness was required.

2. Antall and the Hungarian regime change

There is an extensive literature on the life of Antall under the Communist regime and on the path that led him to become the leader of the Hungarian Democratic Forum, the party that he led to victory in the elections of spring 1990. The collections of Antall's speeches and interviews in Hungarian, English and also in German are also useful sources of the late Prime Minister's thinking on both Hungarian and international developments.

The values, knowledge and personal convictions that Antall inherited or acquired throughout his life differed fundamentally from the Communist and National Socialist or similar ideologies that held sway in Hungary at various times. He was a liberal democrat with a strong social consciousness. He was also deeply tied to both Hungarian and European and Western culture and history. Antall was aware of the importance of public service and the responsibilities of political leaders, yet he also

knew that as long as the Communists were in power he could not and would not want to play an active political role.

Antall was not alone to hope in the 1940s and then again in 1956 that Hungary would become a Western type modern democracy. Thousands and thousands of people who shared these hopes and values tried to leave Communist Hungary to seek freedom and democracy in the West, even at the risk of severe prison sentences if they were caught at the border by the members of the State Security Forces (ÁVO and later ÁVH). It was a difficult decision – to stay or to flee. Antal decided to stay both in 1948–49 and after November 4, 1956. Of course, some members of his extended family and some of his close friends decided to join the flow of refugees. For many years travel to the West was *quasi* impossible, and the refugees could not visit Hungary unless they renounced the safety of their new home countries. The correspondence between Hungary and Western countries was subjected to the systematic control of a bloated censorship apparatus. Nevertheless, letters and sometimes books and newspapers did pass and provide contacts even if in-person meetings were virtually impossible for a long time.

After the suppression of the 1956 revolution, many people in Hungary developed a certain resentment against the West. They thought that the Western countries should have provided help against the Russians even if this would have provoked a large war in the heart of Europe. There was also the erroneous belief that the world was indifferent to the fate of Hungary and that people had forgotten what had happened in October and November 1956 in Budapest. Spreading this misconception as broadly as they could was one of the tools of the Kádár regime in its efforts to make itself palatable to the population and to discourage expressions of resentment or of popular resistance.

In fact, the world had not forgotten Hungary. Years and decades after 1956 not only in Europe but on all continents and in most countries it was enough to tell anybody on chance encounters that one was a “former Hungarian refugee” to be told: “yes, we remember 1956 and the Russian tanks that crushed the Hungarian youth and workers who were fighting for their country’s freedom”.

Antall was keen to maintain regular contact and to exchange news and views of how people lived with his friends in Hungary as well as with those who had left. One of Antal’s most remarkable intellectual features was that he was both an idealist and a realist. This combination helped him understand the way people lived both under Communism and in the free world in the West.

During the entire Cold War period, the ups and downs of the relations between the Soviet Union and the Western Community had always affected the conditions within the satellites in Eastern Europe. This was also the case during the 1970s and 1980s. The Nixon opening to the Soviet Union and the ensuing period of “*détente*” and the Helsinki process and the 1975 Helsinki Final Act contributed to a limited easing of the

tight ideological restrictions in the cultural area, on trade and borrowing from Western banks, as well as on travel outside the Communist bloc. Poland and Hungary were the prime examples. However, most of the beneficiaries of the somewhat less rigorous censorship and of the possibility to travel to the West belonged to the *nomenklatura* (privileged) or to their children. Antall obviously did not belong to this group. Nor was he one of the *szamizdat* (underground) authors. However, his knowledge of and sympathies for the political systems of the Western democracies were known both to the police and the members of the opposition groups that began to emerge in the course of the 1980s.

Antall was convinced that the Communist regime was profoundly alien to the aspirations of the Hungarian people and contrary to the country's Western traditions. He not only hoped but also believed that one day a Western type of multiparty democracy would replace the Communist dictatorship, but he generally refrained from predicting when or under what circumstances, except that free elections would have been a part of this process.

Antall did not participate in the first "Lakitelek meeting" but he knew many of the participants who kept him informed of the sense of the meeting.⁵ After thorough reflection about the strengths and weaknesses of the various opposition groups that emerged or re-emerged in 1988–1989, Antall decided to join the Hungarian Democratic Forum (*Magyar Demokrata Fórum*) – a popular movement that at the time was still not a political party. Antall felt that this movement represented a broad range of the Hungarian population in terms of geographic, social and professional background and had the best chance to turn into a major and successful party once the one-party regime came to an end. Antall also thought that the MDF – because of the broad range and diversity of its membership – was the most likely to survive if there was a tightening of the power of the existing regime and if the Communist one-party rule were to continue.

Another group that had hoped that Antall would join their ranks was the resuscitated Hungarian Smallholders Party (*Független Kisgazda-, Földmunkás- és Polgári Párt*). However, Antall felt that the Smallholders represented the past more than the present and future of Hungary. The Smallholders Party became a member of the three-party coalition that Antall formed after the elections in the spring of 1990. However, it became a significant political headache for the Prime Minister because of the character and behavior of one of its leaders, József Torgyán.

⁵ On the first Lakitelek meeting see the publication of the papers presented at this important meeting in September 1987: *A magyarság esélyei. A találkozás hiteles jegyzőkönyve. Lakitelek 1987. szept. 27.*, Antológia – Püski Kiadó, 1991 Budapest.

Antall did participate in the round-table negotiations of the summer of 1989 between the opposition groups and the representatives of the Hungarian Socialist Workers' Party (*MSZMP*). Antal's wide-ranging knowledge of constitutional issues and of Hungarian and world history and his negotiating skills allowed him to play a major role in drafting the final document accepted by both sides. This was the essential document that defined the constitutional rules for the democracy that was to replace the Communist one-party state and paved the way for organizing free elections and for the full change of regime under the Antal Government.

György Szabad and Imre Kónya, among others, recognized Antal's decisive competence and knowledge in the discussions about the constitutional issues during the Round Table negotiations and thus his role in shaping the political system of the new democratic Hungary. Also, it was thanks to the qualifications shown by Antal during these negotiations that he was elected President of the Hungarian Democratic Forum, which he led to victory.

Was the Hungarian regime change a success or a failure?

The principal conclusion of the present book is that the regime change in Hungary was successful and that Antal had an essential role in this outcome. I believe that this conclusion was correct at the time and remains correct today 30 years later despite various counter-arguments and negative developments and deliberate policies to undermine the values of Antal and the objectives his government had pursued.

One of the arguments suggesting that the regime change was not a success was based on the fact that the four years of the Antal government were followed by a return to power during several election cycles of the members of the previous regime. The Prime Ministers Horn, Medgyessy and Gyurcsány and their cabinets could be viewed as valid illustrations of this thesis. The orientation and the actions of the governments that replaced them also moved further and further away from the values and accomplishments of the Antal years.

In the list of unfounded anti-Antal allegations was that the Prime Minister was not a "true son of the people" and that he was a pretentious descendant of the semi-feudal social class that used to govern Hungary with disastrous results until the end of the Second World War. Part of this accusation was that he was nostalgic of the past and tried to restore in Hungary a semi-authoritarian political system on the model of the Horthy regime, seeing himself in the role of the Admiral who was the Governor (*kormányzó*) of Hungary for a quarter century between 1920 and 1944. Despite their obvious absurdity some people believed in them. Like today's "fake news" they served the purposes of the anti-Antal demagogues.

The toolbox of distorted affirmations and vicious attacks against the Prime Minister's interests and competence contained numerous further items. The following are some of the most erroneous and thus the most poisonous ones. Their effect can be felt even today in the popular view of Hungary's first freely elected Prime Minister.

The first and most ludicrous one was that Antall was not interested in economic issues and that this alleged lack of interest of the country's political leader in the economic dimension of the regime change was responsible for the failure of the regime change and for the country's ensuing poverty. The truth is that Antall was fully aware that economic and social issues and political issues were equally important and constituted an inseparable whole. He also knew how extensive work, consultation and the consideration and balancing of the advantages and disadvantages of various policy options were required from the head of a modern democratic government. He also knew that the most important decisions were his responsibility.

In his speeches and interviews, in his Government Program presented to the Parliament, in discussions with members of his cabinet and staff, as well as with his advisers, Antall showed continued concern about the economic situation and extensive knowledge of the multiple aspects of the complexity of the decisions to be made in order to avoid an economic collapse and to manage the economic and financial dimension of the transition. He kept reminding people of the numerous weaknesses of the Communist state dominated economic system and pointed out time again that even in Hungary the various reform measures never changed the basic nature of the economic system. He knew well that the difference between a real modern market economy and the Hungarian reality was much greater than what the regime pretended it was and what many Western experts, including the staff of international organizations such as the Bretton Woods Institutions or the U.N. Economic Commission for Europe had assumed.

As is well known, one of the principal consequences of the "Potemkin-like" policies of the Kádár regime was the country's heavy international debt. Part of the international borrowing served to finance imports and consumer spending in order to bolster Hungary's image of a "reform-minded" socialist country.

3. Hungary's place in Europe and the world

The question "Where do we belong, to the East or to the West?" is a question that has been raised time and again over the last one thousand years by scholars and by monarchs and other political leaders.

History seems to tell us that “Hungarians” came from the East, but decided to become part of the (Christian) West more than 11 centuries ago. However, the question has also been raised and a mixed or uncertain answer is often given because, during the centuries of Hungarian history, Hungarians were time and again attacked, occupied and dominated by powers from the East, or powers from the West, and sometimes simultaneously by both, up to the 20th century.

As a historian and as a politician, József Antall knew well the threats that could come and did come in the past from the East and the West. He was, however, convinced that from the middle of the 20th century the West chose the path that guaranteed freedom, peace and prosperity, whereas the East meant the opposite, violence, oppression and loss of national identity.

The fall of Communism and the possibility of regime change seemed to end this dilemma. Yet, even if the Russians withdrew from their European satellites, and the Cold War came to an end, Hungary’s future, its peace, freedom and prosperity would always depend on its being firmly anchored in Europe and the Western Community. The wisdom of Antall’s vision was confirmed by the early 21st century.

In this context I would like to mention a conference that was jointly organized by Webster Geneva and Corvinus University of Budapest under the title *Hungary, Central Europe and the Future of the Western Community*. The presentations and the discussions covered the following major themes: (1) the achievements, the role and the future of the Western Community; (2) the relevance of the Western Community for small countries in general and for Hungary in particular; and (3) the possible contributions of small countries in general and Hungary in particular to strengthening the Western Community.

This meeting was especially timely and topical, firstly because of the paradoxical position of Hungary with respect to the Western Community. On the positive side one should point out the historic contribution of the 1956 Hungarian uprising to the worldwide cause of freedom and to the ultimate unravelling of the Communist rule in Europe. It is also important to remember the merits of the first freely elected post-Communist Prime Minister, József Antall, in the birth and consolidation of a new, dynamic liberal parliamentary democracy, faced with the legacy of two totalitarian regimes, and in guiding Hungary into the “Euro-Atlantic Community” (his term). On the negative side, by the middle of the second decade of the 21st century, it became increasingly clear that the democratic achievements of the regime change of the Antall years were being gradually eroded from the “left” and from the “right”.

4. The Euro-Atlantic community

The “Western Community” has been the broadest and most successful experience of democratic community building of nations and states based on liberal political principles. In a sense the term “Western” is a misnomer. This Community is neither a geographic concept, nor does it refer to the historic concept of “Western” or “European” civilization. From the beginning in the post-war period to the present day it has been an open-ended community based on shared and convergent values (the most important of which are freedom, tolerance and the respect for human rights and dignity) and interests in peace, international cooperation and stable democratic political order. The “Western Community” has been characterized from the start by pluralism and diversity, competition and solidarity. One of its main organizing principles has been the reconciliation of the respect for national identity and independence, and the rejection of extreme forms of nationalism within and outside this community.

The achievements of the “Western Community” have been impressive indeed. Three of the most important ones should be mentioned here: (1) the unprecedented prosperity and social progress through the process of economic integration; (2) the development and consolidation of free, democratic political regimes across the entire Western Community, and last, but not least, (3) the realization of the centuries old “utopia” of “perpetual peace” – today, war or the use of force between small or large countries belonging to this Community has become simply unimaginable.⁶

The Western Community is both a community of values and of common interests. These values include humanitarian values. These latter comprise the respect of the rules of the international refugee order. Antall’s understanding and respect of the rights of refugees were based not only on his general humanitarian inclination and his commitment to the principles of international law. It was also anchored in his family tradition and his father’s personal experience with refugee protection.

József Antall, Senior (Antall’s father) was a high-ranking civil servant and politician who was opposed to right-wing extremism and to Hitler’s wars. At the end of the 1930s, managing refugee issues was included in his duties, as the number of people taking refuge in the country had started increasing significantly in 1938. Political refugees of Jewish origin set out primarily from Romania, Austria, and Czechoslovakia. Most of the people coming to Hungary were Polish: in autumn 1939, 70,000 civilians and soldiers fled Poland when Germany occupied it. In addition to aiding thousands of

⁶ Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

Polish people as a government commissioner for refugees, Antall, alongside Polish diplomat Henryk Ślawik, rescued more than 5,000 Polish Jews between 1939 and 1945. In 1989, he was chosen to be one of the Righteous among the Nations by the Israeli Yad Vashem Institute. A tree was planted in his honour in the garden of the institute in the presence of his son, József Antall Junior, the future prime minister.

5. The objective of the social market economy

The competing models and schools of economic and social order

One of the principal choices in the electoral program of the Hungarian Democratic Forum and in the Antall government's program for the regime change in Hungary was the introduction of a Hungarian version of the "social market economy".

The following were the principal competing schools and models actually implemented at various times in Western European countries since the late 1940s: (1) the welfare state; (2) Keynesianism; (3) indicative planning; (4) monetarism; (5) post 1970s neo-liberalism (to be distinguished from the original concept of neo-liberalism that had been part of the theory of the social market economy) and the (6) social market economy⁷. All six models were essentially variations of the market economy, with

⁷ From the literature on the social market economy see the following examples: Hieronymi, Otto (2002): "Wilhelm Röpke, the Social Market Economy and Today's Domestic and International Order", in Otto Hieronymi, Chiara Jasson and Alexandra Roversi, Editors: *Colloque Wilhelm Röpke (1899–1966), The Relevance of His Teaching Today: Globalization and the Social Market Economy*, HEI-Webster University, Cahiers HEI, Geneva; Hieronymi, Otto (2005): "The 'Social Market Economy' and Globalisation: The Lessons from the European Model for Latin America", in Emilio Fontela Montes and Joaquín Guzmán Cueva (Eds): *Brasil y la Economía Social de Mercado*, Cuadernos del Grupo de Alcantara, , pp. 247–300; Hieronymi, Otto and Lo Cascio, Martino, Editors (2016 a): *A New Social Market Economy for the 21st Century* Emilio Fontela: Economist and Global Researcher, ARACNE Editrice, Roma; Hieronymi, Otto (October 2009): "Rebuilding the International Monetary Order: the Responsibility of Europe, Japan and the United States", *Revista de Economía Mundial*, Madrid, No. 29, pp. 197–226; Lenel, Hans Otto and Others, (Editors) (1997): *Soziale Marktwirtschaft, Anspruch und Wirklichkeit Seit Fünfzig Jahren*, ORDO, Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft, Band 48, Lucius und Lucius, Stuttgart; Müller-Armack, Alfred (1946, 1990): *Wirtschaftslenkung und Marktwirtschaft*, Kastell Verlag, München; Müller-Armack, Alfred (1949): *Diagnose unserer Gegenwart*, C.Bertelsmann Verlag, Gütersloh; Müller-Armack, Alfred (1971): *Auf dem Weg nach Europa, Erinnerungen und Ausblicke*, Gemeinschaftsverlag Rainer Wunderlich, Tübingen und C.E. Poeschel, Stuttgart; Müller-Armack, Alfred (1974): *Genealogie der Sozialen Marktwirtschaft, Frühschriften und weiterführende Konzepte*, Verlag Paul Haupt, Bern; Posluschny, Myra (2006): *Walter Eucken und Alfred Müller-Armack: Ein Vergleich ihrer Konzeptionen des Ordoliberalismus und der Sozialen*

different degrees and types of government controls and responsibilities. Under all six systems governments play an active role – this was also true for monetarism, neo-liberalism and the social market economy and not only for the first three approaches listed in the preceding paragraph.

Since the end of World War II the most successful European model has been the so-called “social market economy”, that had provided a balance between market competition and social responsibility. The importance of the “social market economy” was recognised by the authors of the draft Constitution of Europe and of the subsequent Lisbon Treaty:

“The Union shall work for the sustainable development of Europe based on balanced economic growth, a *social market economy*, highly competitive and aiming at full employment and social progress, and with a high level of protection and improvement of the quality of the environment...It shall combat social exclusion and discrimination and shall promote social justice and protection...It shall promote economic, social and territorial cohesion, and solidarity among Member States...”⁸

Marktwirtschaft, GRIN Verlag GmBH, Norderstedt; Röpke, Wilhelm (1950): *Mass und Mitte*, Eugen Rentsch Verlag, Erlenbach- Zürich; Röpke, Wilhelm (1951): “Austerity”, reprinted in Röpke Wilhelm (1962): *Wirrnis und Wahrheit*, Eugen Rentsch, Erlenbach-Zürich; Röpke, Wilhelm (1958): *Ein Jahrzehnt Sozialer Marktwirtschaft in Deutschland und Seine Lehre*, Verlag für Politik und Wirtschaft, Köln–Marienburg; Schlecht, Otto (1990): *Grundlagen und Perspektiven der Sozialen Marktwirtschaft*, J.C.B. Mohr (Paul Siebeck), Tübingen; Wünsche, Horst Friedrich (2015): *Ludwig Erhards Soziale Marktwirtschaft – Wissenschaftliche Grundlagen und politische Fehldeutungen*, Lau Verlag, Reineck, München.

⁸ “Article 3: The Union’s Objectives”, Draft Constitutional Treaty, in Norman, Peter (2003): *The Accidental Constitution. The Story of the European Convention*, EuroComment, Brussels, pp. 352–353, emphasis added.

CHAPTER ONE

The Economic, Monetary and Social Crisis of Hungary in the Late 1980s

1.1. Inheriting a structural and imminent crisis

The origins and nature of the severe economic, monetary and social crises that the first freely elected Hungarian government had to face fell into two major categories: “short-term crises” and “structural crises”.

The crises that fell under the first heading had both domestic and external origins. They were the results of policy errors, of sudden events and of systemic shortcomings. The outgoing Reform-Communist government was partly aware of the intensity of the actual or impending crises. They tried to hide or minimize the importance and consequences of these crisis situations. Also, some of the policy measures adopted by them aggravated the crises and increased the burden of the tasks of the incoming Antall government.

The crises in the second category – the structural crises – were essentially the results of the very nature of the Communist economic system. The disequilibria, the waste and inefficiency that characterized the Hungarian economy did not start in the second half of the 1980s. They were the direct results of the nature and the structure of the economic and political regime. Without a complete regime change, partial reforms could not provide a solution. Implementing a complete economic regime change was not an easy task either. The relative advantage was that the Antall government had opted for a balanced approach to achieve this objective.

Political and economic regime change

The regime change was first and foremost a political process. Without the profound and unexpected changes at the political level in the Soviet Union and in Hungary, and subsequently in the whole Soviet empire, the regime change could not have taken place – certainly not in the beginning of the 1990s. Until the very end of the Communist regime there were legitimate fears that the hardline elements of the Soviet leadership would succeed in reversing the political reforms brought about by Gorbachev and Yeltsin, two leaders who both wanted change but at the same time had become fierce

competitors and opponents. When the backlash did come it was fortunately too late, the coup misfired and a Stalinist type regime could not be recreated.⁹

This brief reminder of the key importance of politics and of the disintegration of Soviet Communism without the ability or willingness of the rulers to keep alive the most complete tyranny the world has ever known, does not belittle the importance of the economic and social dimension both in the imposition and functioning and in the ultimate collapse of the regime.

An economy completely under the domination of the top leadership of the Communist party was considered as the essential instrument for securing total control over the entire population in countries and areas where Communists had seized power. Thus, as discussed also in later chapters of this book, government ownership of productive and other assets and central economic planning of production, and all other aspects of the economic process, aimed not to achieve economic efficiency but to deprive people of the freedom of initiative and of all resources that might be used to oppose the will of the absolute rulers.

In fact, the alleged precision and efficiency of Communist economic planning compared with the “messy give-and take” in a market economy (a comparison that even many non-Communist experts got wrong) was in fact a hoax. Among the countless aspects of Communist economic planning that illustrated this point I would like to mention two.

The first one has to do with information and communications, the life lines of the proper working of markets and of business planning in a private economy. However, under Communist “planning” virtually all economic information was treated as a state secret and passing on information even within the government, let alone to the public, about what was actually planned, produced, consumed in an enterprise or in the economy as a whole could be equated with spying and treason punished by severe prison sentences or even by death. The ownership of and access to simple typewriters were closely controlled since they were considered to be potential instruments for spreading “dangerous” ideas and information. Getting a telephone line was an extremely complicated process. Even the offices of central planning were seriously under-equipped with telephones and other communication instruments.

The second point that can be mentioned in this context has to do with the role of money and prices in a planned versus a market economy. It is well known that in a

⁹ On the August 1991 the failed coup against Gorbachev and on its aftermath see: Gorbachev, Mikhail (1996): *Memoirs*, Doubleday, New York; Matlock Jr., Jack F. (1995): *Autopsy of an Empire, the American Ambassador's Account of the Collapse of the Soviet Union*, Random House, New York; and Gessen, Masha (2017): *The Future is History, How Totalitarianism Reclaimed Russia*, Riverside Books, New York.

market economy two of the three main functions of money are (1) as an instrument of exchange, (2) as a measure of value and (3) as a store of value. This means that money and the whole monetary system are the basis of the “price system”. The absence of “correct” price distorts all economic information and thus the whole economic process. Artificially high or artificially low prices send the wrong signals and are one of the principal sources of waste and of shortages and make most statistics virtually useless. Of course, money and prices also exist in Communist “planned” economies. The problem is that they are deprived of their main regulatory functions and thus are useless for providing reliable guidance in the planning process. In trying to overcome this problem Communist planners would use “quantitative” targets in their projections and commands, a method incompatible with the need to understand the structure of costs, and what should or should not be produced.

1.2. The “Hungarian Reform”: part of the big lie

The peaceful victory of the “West” over the Communist system was the victory of the model of the free society over the authoritarian regimes built on a “big lie”. Manipulating information, restricting freedom of speech and thought have been the common features of all oppressive regimes. In the 20th century this reached an unprecedented degree of cruelty and effectiveness. Imposing the “big lie” through the most ruthless means on all aspects of individual and community life was the common key feature of both right-wing and left-wing totalitarian ideologies.

Under the Communist totalitarian system it was important for everyone, for members of the party and for non-members, for high-ranking party and government office-holders, for ordinary people whatever their profession, to whatever official societal category they belonged to, to fully respect the smallest part of the official (Marxist–Leninist) ideology and the decisions and opinions of the rulers, i.e. the “party line”. Ignoring or “misquoting” or “misinterpreting” the basic texts or the correct opinions of the moment were sins of revisionism or of deviationism to be severely punished. The minimum punishment was the obligation of self-criticism in public, in front of party members.

The leaders of totalitarian regimes fear that the smallest tear in this web of lies can endanger the very survival of the regime itself. These fears are not groundless; time and again they have proven to be self-fulfilling: the more complete these systems of lies, the more rapidly the regimes built on them can be brought down even by small elements of truth. Tyranny and disinformation have been intimately linked throughout history. During the last hundred years, this connection has reached unprecedented

dimensions with equally unprecedented consequences in terms of human suffering. The greatest manipulators – the greatest liars – of the 20th century were Lenin, Hitler and Mao. They also founded the most oppressive and murderous political systems of the 20th century.¹⁰

The principal characteristics of free societies include free debate, free differences of opinions, freedom to seek and tell the truth. In un-free societies there is no freedom to know, no freedom of opinion and speech, no freedom to tell, and there is a distorted view of the “truth”. Those who define and control the ideology also determine who may know what and the punishments for those who do not respect these restrictions. In all un-free societies there are severe sanctions against telling the truth (including torture and death) that clash with the ideology. Fully totalitarian ideologies are the invention of the 20th century as were the political regimes built around them: the totalitarian regimes of the “left” (Communism from the Soviet Union to China and Pol Pot’s Cambodia and Castro’s Cuba), and of the “right” (Fascism, National Socialism) – all built on the “big lie”.

How did the Hungarian reforms relate to the “big lie”?

In the history of Communism Hungary and the Hungarian question played an important although fluctuating role. It may be argued that over the years both the rulers in Moscow and the Western world focussed more attention on what and how the Communists were doing in Hungary than the country’s size and material strategic weight alone would have warranted. Without going as far back as the short-lived Hungarian Soviet Republic after the end of the First World War and the dissolution of the Austro–Hungarian Monarchy, one can illustrate this point with a number of examples from the post-Second-World War period up to the end of the 1980s, such as: (1) the full take-over of all control over the country and the creation of one of the most oppressive Communist regimes in the 1940s by Rákosi and other “returnees” from exile in the USSR; (2) the show trial of Cardinal Mindszenty; (3) the temporary fall from grace of Rákosi and of other hardliners, and the short-lived easing of the fear and terror and promises of somewhat higher living standards by Imre Nagy in the wake of the death of Stalin; (4) the end of the Imre Nagy “experiment” and a renewed tightening of the ideological and political controls; (5) the outbreak of the Hungarian revolution on October 23, 1956, which created the hope for freedom – liberation from

¹⁰ See: Hieronymi, Otto (2012): “The Enemies of Freedom: Manipulation of Information by Oppressive Regimes in the 20th and 21st Century”, Paper presented at the 2012 Security Forum of Webster University, Geneva.

Soviet occupation and the end of the Communist regime once and for all – and its brutal repression by Soviet troops; (6) the installation of János Kádár as Head of the Party and his campaign of bloody revenge that included the trial and execution of Imre Nagy; (7) the main task entrusted by Moscow to Kádár to make sure that Hungarians would never try to break away again from Soviet rule and attempt to replace one-party dictatorship through political freedom and democracy; (8) Kádár's faithful and successful carrying out of this objective until the end of his life in the late 1980s.

As a skilful tactician Kádár from time to time allowed limited “reforms” of the economic system, the primary condition being that the essence of the Communist economic regime remain untouched, and that the “reforms” and other measures of “liberalization” could be reversed at any time to avoid provoking the collapse of the Communist economic order. In order to assure the perpetuation of the Communist dictatorship and his own position as one of the longest-serving dictators in history, for years and decades he managed to disguise the true nature, scope, hard limits and actual and potential consequences of “Hungarian reforms”.

Kádár and his close associates succeeded in creating different perceptions by different groups of people in Hungary, in Moscow or in the “enlightened” Western world about the Hungarian reforms and the differences and similarities between the “Hungarian model” and the basic, traditional version of the Communist planned economy.

For many years – *de facto* until the end – the members of the Politburo in Moscow had to be convinced that Hungary was safely anchored in the “bloc” and Hungarian reforms were not a way to smuggle capitalism into a country that had the 1956 record of unreliability. At the same time foreign creditors of an increasingly indebted economy had to believe the opposite, i.e. the Hungarian reforms meant that Hungary would become as productive and flexible as a true market economy. The experts and officials in international organizations in their turn had to accept the promises of Hungarian officials that ultimately the objective of the Kádár regime was to fulfil all the requirements set by organizations like the GATT (People's Republics entry in 1973) or even IMF and the World Bank (entry in 1981) for the policies (including supplying reliable statistics) of the members that were true market economies. Finally, the Hungarian people were expected to believe that the more plentiful supply of consumer goods in shops in Budapest than in Moscow or Leningrad were an expression of *de facto* liberal economy rather than of a fragile system on the edge of bankruptcy.

The entire history of Communist regimes, ever since the 1917 October Revolution in Russia, has been marked by fluctuations in arguments, influence and power between “orthodox” and “reformist” leaders and factions. With very few exceptions,

the orthodox won out over the true or alleged reformists. Sometimes these latter and their supporters lost their lives, at other times and under different circumstances the defeated were only deprived of their power and position in the party and in the state.

These types of virulent political and ideological conflicts, often with violent outcomes, occurred across the Communist world. However, those that took place in Russia were of particular importance. This was because of the concentration of ideological, economic and military power in the Politburo of the Communist party of the USSR and the reverberations throughout the Communist countries of decisions taken in the Kremlin.

1.3. The external and domestic monetary crisis

The 1980s – the last decade of Communist rule in Hungary – were characterized by four decisive developments: (1) a deep and worsening economic and financial situation, (2) vain attempts by the Communist rulers to stop and reverse the downward trend through more or less traditional measures, (3) a final recognition that the socialist economic system could not be saved, (4) a persistent hope even by the so-called reform wing of the leadership that even if the move towards the market economy and a multi-party political system power became inevitable, both economic and political power would remain in the hands of the members of the Communist ruling class.

Hungary's situation was truly paradoxical. There was a widely held opinion that "Hungary was different from the other COMECON countries" and if any of the members of the Eastern bloc could successfully navigate between the orthodox planned economy and the Western liberal market economies, it would be Hungary. Yet, the monetary and financial indicators increasingly showed the difficulties of managing the "Hungarian model".

For private and official international officials and observers, four interconnected categories of indicators were a growing source of preoccupation: (1) the rate of inflation, (2) the balance-of-payments situation, especially in convertible currencies, (3) the large external debt and the heavy debt service and (4) the low level of the country's foreign exchange reserves.

The domestic monetary and financial situation was aggravated by the financial problems of Hungarian companies. The so-called "standing in line" problem (waiting to be paid) drove through a financial domino effect into bankruptcy. The erratic exchange control system, an inherent feature of all collectivist economic systems, contributed to the inefficiency of Hungary's domestic and external financial system.

The Communist government was hoping that the country's membership in the Bretton Woods institutions would be a sufficient safeguard against the risk of an external payments crisis. However, the external payments situation continued to deteriorate to the point that when the Antall government came into office Hungary was close to running out of international means of payments. Under the socialist regime the true state of both external and domestic monetary conditions was a tightly kept secret, with information withheld even from the highest levels of the party bureaucracy. Thus, János Fekete, Deputy President of the Hungarian National Bank, reported only to First Secretary János Kádár.

Fekete, who for many years was the principal architect and manager of Hungary's external debt strategy, was an orthodox Communist and a slick international public relations strategist. As a good client of Western international banks, he managed to become a member of the so-called Group of Thirty, an informal discussion body of leading bankers and monetary experts.

1.4. The “real economy”: phony privatization

The “real economy” was not in better shape at the time the socialist economic system ended than the monetary and financial system. The 1970s and 1980s were a period of multiple challenges for each of the major groups of countries in the world economy: the Western market economies (OECD countries), the developing countries (including the group of so-called newly industrializing countries, the *Schwellenländer* in German), and the socialist planned economies.

There were some major external shocks as well as some positive developments. There was a double starting point: (1) the collapse of the Bretton Woods system of fixed exchange rates and the explosive growth of short-term capital movements, and (2) the so-called oil crisis and a radical shift in the international structure of terms of trade in favor of the oil-producing countries. The global effect was the first major worldwide recession since the 1930s. Pessimism about the future of economic growth was amplified by the new concern about the environment (“Club of Rome effect”). An important additional side effect of the prevailing “stagflation” was the international debt crisis.

There were, of course, serious misinterpretations of what was in store in terms of structural and technological and ultimately also of political changes. Thus, those who believed that technological progress had come to the end by the 1970s could not have been more wrong. In fact, the 1970s and 1980s saw the take-off of the IT and digital revolutions, as well as the start of a new wave of international economic competition

with a tremendous impact on the comparative strength of small and large economies across the globe. The emergence of the four “Asian tigers” was only one illustration of this trend. In many respects this was not only the period of intensification of the various aspects of globalization, but also a moment of the growing loss of competitiveness of the socialist economic system that led to the collapse of the Soviet empire by the end of the decade.

The “Hungarian model”, just like the “Yugoslav model”, was not immune to these worldwide developments. The phony tolerance of small-scale private firms, the imitation of the Yugoslav ownership and management methods (that later contributed to the disintegration of the Yugoslav Federation and to the death of hundreds of thousands people) and the phony measures of privatization that consisted in passing on state property to members of the *nomenklatura*, did not turn Hungary into a competitive market economy.

1.5. Corporate debt and impending bankruptcy

In the analyses and theories of economic systems, “production” occupies a central role. While issues like “income distribution” or “foreign trade” are also essential features of an economy, “production” is what creates “wealth”. This is also reflected in the modern estimate of the global activity of the modern economy: “gross domestic product” (or in its widely used abbreviated form: GDP).

This emphasis on “output” or “production” has been one of the main features of the theory and practice of socialist economic planning. In fact it has proven to be one of its principal shortcomings. Early critics of the Soviet economic system pointed out that the neglect of the price system and of money and monetary *equilibrium* would lead to wrong decisions about production and thus to waste and inefficiency. These issues were already analysed by the monetary economist Ludwig von Mises in the early 1920s in his pioneering book entitled *Die Gemeinwirtschaft*.

The example of Hungary in the 1980’s showed that half-hearted “reforms” were not sufficient to turn a system originally built on planning production volumes into a functioning market economy. There was until the very end of the system something wrong with company structure, with decisions made in industry and the service sectors, with old large state-owned firms and with small new enterprises. Even if the managers were competent and enterprising they could not succeed fully.

One of the main manifestations of this situation was the “shortage” of funds. This shortage was the result not only of a macro-economic shortage of capital, but also of the lack of proper (price and monetary) indicators for scarce resources in

the “production process”. This explains why the widespread corporate debt crisis provoked a wave of bankruptcies beyond what would have been normal even under a weakened economic situation.

1.6. The reality of the Communist welfare system

In the decades following the Second World War there was a competition between the Western liberal market economy and the Communist planned economy that received widespread attention and propaganda on both sides of the Iron Curtain. As it became more and more visible to the naked eye that the Western market economy was superior in terms of both freedom and material income and wealth to the Marxist–Leninist Russian model, the spokespeople of the Eastern party line and their Western fellow travellers resorted to the phony argument that “in the West people have more and larger cars, but under Socialism we have a better welfare system”.

This argument was totally disproved by reality. In terms of health care, of nutrition standards, of educational facilities, in general working conditions, in length of life expectations, even Hungary, which was considered to be ahead of countries like Romania or Czechoslovakia, was losing in comparison with the Western social market economies. Thus, one of the main challenges facing the Antall government was to deal with the inefficiencies inherited from the socialist welfare system and stop Hungary backsliding also in this important respect.

CHAPTER TWO

Regime Change and the Social Market Economy: the Objectives of the Antall Government

2.1. Avoiding economic and social collapse

The economic regime change was to be carried out – similarly to the fundamental transformation in the political system – in one government cycle. The most immediate task of the new government was to take stock of the state of the economy. What the Communist government left behind was much worse than was imagined even by the most realistic critics of the regime. In all honesty, I also have to admit that the so-called Battelle report also erred on the optimistic side. Although the report contained a severe and detailed critique of the Kádár regime and insisted on the need for the complete transformation of the economic system, on some points our report overvalued the validity of the “Hungarian reforms” and their direct utility for the process of building a true, dynamic market economy in Hungary.

Thus the stock-taking *quasi* automatically led to the need for systematic and well-organized crisis management. While there were voices – in Hungary and abroad – in favor of allowing the monetary, fiscal and economic system to collapse, based on the argument that it would have demonstrably been the fault and responsibility of the departing Communist rulers, this approach was totally alien to the thinking of József Antall and to the members of his government.

For Antall, and for all of us who were close to him, it was essential to ensure the viability of the economy and to prevent a scorched earth approach to economic and social regime change. Under the heading of crisis management, restrictive macro-economic (especially fiscal and monetary) measures, as well as specific micro-economic measures, had to be adopted. From that start, there was a recurring debate within the government and between international bodies like the IMF whether the fiscal and monetary policies were sufficiently restrictive or, conversely, too restrictive.

There were, in fact, several of us who believed that excessive monetary and fiscal restrictions could hamper the successful transformation and the return to growth of the Hungarian economy. It was in fact clear that too much “austerity” would be counterproductive. It would slow down the reconstruction efforts and would also have a major negative psychological impact on the Hungarian peoples’ perception of what

the market economy was about. There is no doubt that the “IMF view” of economic regime change and of reconstruction had an important dampening effect on both economic growth and on the popularity of the market economy. These factors have certainly contributed to the former Communist elite’s return to power after the first electoral cycle, at least in Hungary.

The Antall government had three important economic policy objectives. In the short term, of course, maintaining the functionality of the economy and avoiding its collapse. The second medium-long-term objective was to build a model of the social market economy. The third was the creation of the institutional and legal framework of the market economy. József Antall considered that it was not enough to simply repeal the institutions and laws of the Communist system. It was crucial to build the framework for the institutions of parliamentary democracy and of the market economy. The first parliamentary term was to be dedicated to this task.

This objective was not really appreciated or understood by many of the Western officials and experts. A director of the World Bank actually admitted at a seminar that in the first three years after the system change, the World Bank’s experts and managers underestimated the relevance of the construction of the legislation and institutions required for the success of the regime change. As discussed in the previous chapter and chapter five, which deals with the severe resource shortage and the burden of the foreign debt, at end of the government of Miklós Németh (1988–1990) Hungary was on the brink of monetary and financial collapse.

From the start, Prime Minister Antall made it clear to the Hungarian people and to international observers that his government would undertake all the steps necessary to prevent a general breakdown. The sharp austerity measures – restrictive fiscal and monetary policy and cutbacks in subsidies and social spending – depressed investments, consumption and employment and the hardships experienced by the population tarnished the image of democracy and the market economy and had a negative impact on the popularity of the government. Many people, instead of blaming the previous Communist regime that had been responsible for the catastrophic economic and financial situation, believed or pretended to believe that the situation was the fault of the new freely elected government that had in fact saved the country from economic collapse.

By the end of 1990, the fiscal and balance-of-payments indicators showed an improvement. The economy moved away from the danger zone, but, as was expected, at a lower level of activity and employment and a lower living standard.

2.2. Why the “social market economy”?

The Prime Minister felt that both in the short and in the long term the central objective of the economic regime change was the adoption of the model of the “social market economy”, adapted to Hungary and to the conditions of the 1990s. This had also been the central recommendation of the Battelle Report completed in January 1990.

The search for economic and societal models

One of the most important and challenging political and intellectual questions has to do with the interdependence of three factors: (1) economic and social theories, concepts and objectives; (2) economic and social policies and institutions; and (3) the working of the economy, quantitative and qualitative results, i.e., economic growth and social progress. What is the weight of theories and policies and how do they shape the actual conditions of life at the level of individuals and of larger communities?

As noted in the Prologue, the following were the principal competing schools and models actually implemented at various times in Western European countries since the late 1940s: (1) the welfare state; (2) Keynesianism; (3) indicative planning; (4) monetarism; (5) post 1970s neo-liberalism (to be distinguished from the original concept of neo-liberalism that had been part of the theory of the social market economy) and the (6) social market economy.

All six models were essentially variations of the market economy, with different degrees and types of government controls and responsibilities. Under all six systems, governments play an active role – this was also true for monetarism, neo-liberalism and the social market economy and not only for the first three approaches listed in the preceding paragraph.

The social market economy is essentially a continental European phenomenon, both at the level of theory and that of practical implementation and policy experience. The development of European and Western economic and political integration was one of the best guarantees against the threat of the imposition of a totally state (and single party) controlled economy.

Implementing the model of the social market economy

The model of the social market economy required fiscal and monetary discipline but not at the price of squashing growth and the prospects of future prosperity and social progress. This liberal economic model was not to be confused with the libertarian and monetarist ideology whose followers were advocating a so-called

“shock therapy”, in particular in terms of exchange rates policy and international capital movements.

Hungary was interested in economic and financial integration in Europe and in the broader international context. This included welcoming foreign direct investments and other non-debt-creating long-term capital imports. However, Hungary was cautious about the full-scale liberalization of short-term capital movements (capital exports and imports) as well as about adopting unchecked floating and excessive fluctuations of the exchange rate of the Hungarian currency. This caution was fully justified in the light of past experience (accumulation of external debt by Hungary) and the successive international financial crises before and after 1990 (Britain, France, Poland, and of course, Russia). It should also be remembered that even France introduced full-scale liberalization of short-term capital movements only in the beginning of the 1990s and that the choice for the new monetary system to be developed (Maastricht Treaty) was not freely floating but (permanently) fixed exchange rates.

As pointed out by Professor Bod, a leading member of Antall’s economic team (first as Minister of Industry and Trade and subsequently as Head of the Hungarian National Bank), at the micro-economic/enterprise level Hungary pursued more radical policies of transformation and market discipline than the other former Communist countries. The Hungarian government was also in favor of trade liberalization, resisted protectionist pressures, and rejected suggestions to create a closed regional trade and payments system.

Protectionist ideas originated not only from Hungarian sources, but rather paradoxically at times also from representatives of great trading nations such as Japan or free trade groupings such as the European Community. This can be illustrated with two examples. One had to do with the Japanese car manufacturer Suzuki, which had negotiated an extremely protectionist deal with the Hungarian Communist government. According to the terms of this agreement Suzuki would be given a very high level of protection from other international competitors, if it set up a production facility in Hungary, the output of which was destined to be sold both in Europe and on the Hungarian domestic market. When Suzuki learned after the regime change that under its policies and the international trade rules, the new non-Communist government of Hungary could not uphold this bizarre agreement, the Japanese company tried to obtain a large monetary compensation from Hungary for the loss of discriminatory trade measures in its favor.

The second example has to do with the inward looking attitude of some of the officials of the European Community. During one of my bilateral meetings and in depth discussions with the Head of the Permanent Mission of the European Community in Budapest, as I was trying to explain Hungary’s economic situation and problems, as

well as asking how the European Community was planning to help Hungary overcome its economic difficulties, I received the following answer: “If Mr. Antall is really such a good European, how is it possible that there are so many Japanese cars in the streets of Budapest?” This statement was baffling, but obviously deniable and off the record. This was not a “negotiation” for which, in any case, as an Adviser I had no brief. For the record I would like to add that the aging Head of Mission was a German bureaucrat, and, of course, there were more German-made cars in the country than Japanese cars.

*Building a new social market economy:
the main features of the original model*

The “social market economy” was one of the most successful economic, political and societal models in modern history. The term was coined to describe the objectives, theories and policies related to the reconstruction of the German economy and German society after the horrors of the National Socialist regime and the destruction of the country’s economy during the Second World War. Some of its key features were inspired by the experience of Switzerland. There is no doubt that the “social market economy” also played an important role in the orientation of European integration.

As mentioned in the Prologue, the importance of the “social market economy” was recognised by the authors of the draft Constitution of Europe and of the subsequent Lisbon Treaty:

“The Union shall work for the sustainable development of Europe based on balanced economic growth, a ***social market economy***, highly competitive and aiming at full employment and social progress, and with a high level of protection and improvement of the quality of the environment... It shall combat social exclusion and discrimination and shall promote social justice and protection... It shall promote economic, social and territorial cohesion, and solidarity among Member States...”¹¹

At the start the concept of the social market economy was far from uncontested. However, in the light of the rapid recovery and the economic and social success of the policies of the Federal Republic, the “social market economy” was increasingly recognized as one of the most successful “models” of reconstruction and of economic policies in general, not only in the post-war period but in modern times as well.

The principal features of the original model of the social market economy can be summed up in the following 10 points:

¹¹ “Article 3: The Union’s Objectives”, Draft Constitutional Treaty, in Norman, Peter (2003): *The Accidental Constitution. The Story of the European Convention*, EuroComment, Brussels, pp. 352–353, emphasis added.

- 1) The market economy is a liberal economic and societal model – it is superior to the state-controlled models (socialism) both in terms of economic efficiency and of political freedom.
- 2) However, the market economy also requires appropriate government policies and in particular effective social policies.
- 3) Thus, the 19th century (Manchester) model, as well as the ultraliberal (“libertarian”) approach advocated in the latter part of the 20th century, was rejected by both the original authors and the practitioners of the social market economy.
- 4) Competition is an important dimension of the market economy. However, “social Darwinism” is rejected in the original model of the social market economy. Social policies have multiple objectives: to support the losers in the competitive process, to encourage political acceptance of the market mechanism and to fulfil common tasks that cannot be dealt with through private initiative (“public service”).
- 5) The price mechanism is an essential part of the market economy. One of the tasks of government policies is to assure the appropriate working of the price system and to handle necessary price controls and price interventions in the least intrusive way.
- 6) The social market economy is not only an economic but also a political and societal model. One of its most important features is the recognition that there has to be an informed and open debate about the division of tasks between governments and markets and the private economy. The encouragement of small and medium-sized enterprises is necessary for political and economic reasons.
- 7) Monetary stability is a key condition for the success of the social market economy. Inflation is perceived as a threat to both economic efficiency and social stability. Also, sound fiscal policies are important both for political and economic reasons. Systematic “austerity policies” are, however, the sign of a failure of government policies and lead to a dangerous “vicious circle” of stagnating or falling living standards and pressures on output and productivity.
- 8) The overall objectives of the social market economy are sustained growth and social and economic progress for all. All should benefit from expanding output. A constant widening in income and wealth among the few and the lower classes is fundamentally wrong and is a sign of the malfunctioning of the market economy. The “proletarianization” of large portions of the population (today’s “marginalization”) contributed to the rise of Communism and National Socialism. The social market economy was designed to prevent a repetition of similar developments.
- 9) The social market economy is open to the world; exports and imports increase both the welfare of the community and the efficiency of the national economy. However, cutthroat competition is not acceptable in foreign trade any more than it is among domestic companies.

- 10) European and global economic integration are welcome but there is a danger in excessive bureaucratization of international organizations. National policymakers need sufficient room for responsible policies that take into account the specific conditions they have to deal with. The importance of local conditions and of autonomy has to be recognized within a federalist framework.

One of the principal strengths of the “social market economy” is the linking of different levels of economic and social policy and the “macro” and the “micro” levels of the economy. For a didactic approach this is a handicap, as is the lack of the analytical tools developed in the form of the aggregates of the national accounts based on Keynesian theory.

2.3. Germany, Switzerland and the rest of Europe

The post-war Western economic models

The Western economic models developed since the 1940s were based on a combination of private initiative, free markets and competition, and of social concern and government responsibility for tasks that serve the common good. While the basic principles and values are common to all the variants of this model across time and space, there have been significant differences among the various national versions as well as the changing versions over time in the same country.

These differences have included the role and share of government in economic and social issues and responsibilities, the degree of openness and of government control of currency relations and the degree of centralization, and of the role of federalism at the national and international levels. While upholding competition and combatting monopolies have been a common principle across the Western Community, the effective implementation of this important objective has often lagged behind theory and official policy announcements.

Whereas Germany and Switzerland are the countries of origin of the social market economy, several other continental European countries have adopted various parts of this model. Also it should be pointed out that “the social market economy, when properly implemented, can and has to be adapted to crises and sudden changes in the domestic or external economic environment.”¹²

¹² See: European People’s Party (2009): *The Social Market Economy in a globalised World*, Congress Document adopted by the EPP Statutory Congress Bonn, 9–10 December 2009.

The second half of the 20th century was marked by the competition or even the “battle” of economic models and theories. While the social market economy was without doubt the most successful model, it has also known ups and downs over the years. The success and longevity of the model can be illustrated, however, by the fact that according to the Lisbon Treaty (the Constitution of the European Union) one of the fundamental objectives of the EU is the creation and development of a dynamic social market economy.

A rule-based system

The social market economy is usually known as a primarily rule-based system. Yet, in many respects it has proven to be more flexible and adaptable than some of the competing models. The principal areas where the lessons of the social market economy may prove to be particularly helpful are: (1) finding the balance in the division of tasks between private initiative and markets and government responsibilities; (2) finding the balance between competition and social justice and support; (3) dealing with monopolies and the abuse of economic power; (4) finding the balance between diversity and convergence; (5) stimulating sustained growth and social progress; (6) finding the balance between national models and rules, and European and global institutions and structures.

The adoption of detailed, binding international rules on economic and monetary policy was one of the innovations of the post-1945 international order. This trend, which started with the League of Nations, gained momentum with the planning for and the implementation of the so-called Bretton Woods institutions. Its scope and importance greatly increased with the Marshall Plan institutions (OEEC and EPU) and subsequently with the start and progress of European integration.

The emphasis on rules related to international economic relations – trade and currencies – was based on the collapse of international economic and monetary order in the 1930s and its disastrous economic and political consequences. Also, theories, concepts and policies related to international economics played a central role in designing the international economic and monetary organizations and their rules.

At the same time it was also evident that the state of the international economy was closely related to the conditions of the national economies, the national policies and the basic economic models adopted by the various countries. The fact that there is a close link between international economic and monetary policies and national economic “models” was an assumption shared by the architects of virtually all the major international economic organizations. By and large this assumption has been proven correct over many years of practice.

The objectives, scope and the rules and functioning of the international economic organizations have evolved over time partly because of changing conditions in the national and world economy, partly because of changing theories and policy objectives. In this process international economic and monetary organizations have tried time and again, with greater or lesser success, to influence and even bring about major changes in the “economic model” of their member countries.

Wilhelm Röpke and Ludwig Erhard

The global political and societal problems and goals of the desired new model were well defined by Wilhelm Röpke, one of the principal architects of the “social market economy”. Röpke’s approach was based on the analysis and rejection of the two principal opposing models that had been responsible for the prolonged crises of the preceding decades, “collectivism” and “cut-throat liberalism”.

Two important books by Röpke should be mentioned in this context, *The Social Crisis of Our Time* and *Civitas Humana*. A third one, *International Economic Disintegration*, dealt with the need to rebuild the bases of an integrated international economy. It should be pointed out that all three of these extremely important and influential works were completed and published before the end of the Second World War.

Ludwig Erhard, who was greatly concerned during the National Socialist regime about how German society and the economy could be rebuilt on a normal basis once Hitler lost the war (the raising of this question showed tremendous courage), read Röpke’s works, which left a profound impact on his own thinking. Röpke’s writings comforted him (as he told to me in a conversation in New York in 1968) in his own conviction that even during the darkest days one has to work for and believe in a better future. This was the source of Erhard’s belief in the essential role of human freedom (the freedom of the common man), human dignity and social safety and widely shared economic prosperity. This was also the fundamental sense of the term “social market economy” – as understood by Erhard and by the majority of Germans.¹³

¹³ The detailed two-volume study by Helge Peukerl (1991): *Das sozioökonomische Werk Wilhelm Röpke*, Peter Lang, is by all measures the most complete scholarly analysis of Röpke’s work. In his Introduction the author defines Röpke “als einen der bedeutenden deutschen Nationalökonomien und Vertreter des Neoliberalismus im 20. Jahrhundert...eine nichtkonformische, vulkanische Persönlichkeit, mit Zivilcourage, der humanistische Bildung, ein profundes Fachwissen und eine brillante Feder glücklich vereinen wusste.”

Differences from the other five economic models

On many important points the theory and the practice of the social market economy differ significantly from the other market systems mentioned earlier. The social market economy is also based on economic freedom, on private initiative and on markets and a well-functioning price system. Competition is recognized as an essential element also of this model. However, there are differences. Markets and competition are not attributed moral and ethical qualities that would make them the central values and organizing principles of a good and just society. Competition and markets are necessary mechanisms for optimum production of goods and services but they are not arbiters of who is a good citizen and who is not.

Markets have winners and losers, the winners are not necessarily ethically superior to the losers. The development of a multi-faceted system of social security was an essential aspect of the social market economy. This concept also recognized that markets and competition do not always function according to theory and that they may offer possibilities to distort and misuse them. It is the responsibility of the government (at various levels) to prevent and correct such “market failures”, either through legislation or other types of rules, or through assuming direct economic responsibilities. In the social area one may mention health, education, unemployment benefits, pensions and the protection of the environment as part of the scope of public sector action or surveillance.

Stable monetary conditions are an essential pre-condition for the model to work. Both inflation and deflation are sources of instability and of costly economic and social distortions. Fiscal discipline is important, excessive fiscal restrictions (austerity) are a threat to economic initiative and growth. The state – e.g. through central bank action – is also responsible for discouraging or preventing currency fluctuations and excessive financial speculation: the exact opposite of the “hedge fund” economies of the 21st century. Excessive concentration of economic power in a single or a few companies is a threat to the social market economy. International trade and payments liberalization are the external pendants of the domestic economic freedom. Regular consultations and negotiations between employers and union representatives help balance the interests of the companies and of their workers.

The introduction of so-called “*Mitbestimmung system*” allows the representatives of the employees to participate in overseeing corporate strategies. Finally, one of the most challenging tasks is the creation of the institutional framework that is required for the proper working of the system.

The contrasts between the social market economy and libertarianism

Prime Minister Antall had a favorable opinion of the political views and achievements of the British Prime Minister Margaret Thatcher and of the President of the United States Ronald Reagan. He was aware of their firm opposition to Communist ideology and against Soviet threats to the security of the free world. Antall also appreciated their skillful diplomacy with Michael Gorbachov and their historic contribution to the peaceful end of the Cold War and ultimately to the end of the Soviet empire and thus also to the possibility of regime change in Hungary and in the other Eastern European satellites.

Antall fully recognized the importance of the Euro-Atlantic concept and thought that one of the most important aspects of the end of the Cold War and of regime change was the possibility for Hungary and its neighbors to join the Euro-Atlantic Community. Prime Minister Antall, however, did not share the views of the English and American leaders on economic and social order and certainly did not believe that the economic model they were promoting was the right one for Hungary. Mrs. Thatcher's opposition to the idea of German reunification and to the progress of European integration was contrary to Antall's convictions and to his ideas about the road Hungary should follow. The "social market economy" that Antall believed was the social and economic model for Hungary is also a liberal economic system. It differs, however, greatly from both 19th century "*laissez faire – laissez aller*" liberalism and from the "libertarian neo-liberalism" that was promoted as part of the Thatcherite ideology and of the American Reaganomics. The various common features of these two trends born and developed in the late 1970s and early 1980s include a condescending attitude towards social safety and policies that aim at protecting the weak and the losers in market competition. They are both profoundly hostile to the rights of workers, in fact of all people living on a wage or salary who try to organize and defend their interest in orderly and organized negotiations with their employers. The followers of these two ideologies are endlessly proud that Mrs. Thatcher and President Reagan managed to destroy the power of trade unions in Britain and the United States – two economies where unions are by now barely a shadow of their former selves. Related features are the adulation of financial speculation and the belief that hedge funds and similar ventures should be recognized as the main instruments of real wealth creation today and in the future. For many of the advocates of this ideology, "shareholder interests" are the only legitimate criterion for success or failure even if these interests are economically or ethically not always legitimate. Total indifference to a frighteningly large and growing gap between the rich and the super-rich is one of the latest manifestation of these supremely egoistic ideologies.

2.4. Domestic and external constraints

Antall, Europe and the social market economy

The Antall government was committed to a liberal international economic policy and sought to accelerate Hungary's integration into the European and world economies through negotiating agreements on market openings for the period until the country could become a candidate and then a full member of the European Community. The Prime Minister followed closely the work of the country's Permanent Mission to the EC in Brussels. It was because of this clear guidance and consensus in the government that subsequently Hungary became the first Eastern European country to apply for membership in the EC/EU.

Antall had learned as a historian that without an effective social policy the market economy ("capitalism") would come under great political strains and might not have survived in the 20th century. He understood that the gradual introduction from the mid- and late-19th century onwards of policies in favor of the "working class" strengthened rather than weakened political and social acceptance of competition and the pressure of markets. Contrary to many people's beliefs, the quality of social services provided under the Communist system could not match those that were common in the Western market economies. The government would need to cut the widespread waste that prevailed also in this area under Communist rule and to make sure that the changes to be introduced would not deprive the population of resources and services on which they were truly dependent.

Tasks and challenges faced by the Antall government

The following list contains some of the other major economic policy issues and tasks that the government had to deal with during its four years. The topics in this list, which is far from complete, are discussed in somewhat greater detail in the other chapters of this book.

- 1) Market privatization, limiting "self-privatization" (see chapter seven).
- 2) External debt management and search for external financial support (see chapter five).
- 3) Reducing the obstacles to sustained growth (see chapters eight and ten).
- 4) Building the legislative and institutional framework of a modern social market economy (see chapters four and ten).

- 5) Bank reform, strategy of bank privatization, bank consolidation (chapters six and seven).
- 6) Limiting short-term speculative capital movements, encouraging long-term capital imports (chapter five and ten).
- 7) Business modernization (chapters four and eleven).
- 8) Last but not least the primary objective was to try to make up for the opportunities lost during the previous four decades.

2.5. A valid but forgotten objective

The validity of the basic concept of the social market economy

The validity of the basic concept of the social market economy is not limited to Europe and even less to the German speaking countries on the continent. The international recognition of the theory and practice of the social market economy compared with Keynesianism can be illustrated with a quote from the famous British economist and biographer of Keynes, Lord Skidelsky: “Those who value the market as an institution must be concerned to keep its support system in good repair. The state’s role is essentially threefold: (a) to create and maintain an appropriate legal framework for market exchange; (b) to limit and supplement the market where necessary; and (c) to ensure that the market is politically acceptable. A social market economy is, above all, one, which is embedded in social arrangements, regarded as ‘fair’...The German model had the great advantage of concentrating attention on the legal, social, and technical conditions required to make a market economy work well. Such clarity was never achieved in Britain, where old-fashioned capitalism, socialism, the Welfare State, and Keynesian macroeconomics were wrapped in an ill-assorted package labeled the ‘mixed economy’. The consensus which sustained this mixture proved to be highly vulnerable, because it concealed a basic ambivalence about the justification of markets, and indeed about the private enterprise system itself.”¹⁴

¹⁴ Skidelsky, Robert (1989): *The Social Market Economy*, Social Market Foundation Ltd., Paper no. 1, London, pp. 3 and 6; Péter Ákos Bod has also discussed the issue of relevance of the social market economy for the Easter European members of the EU at the 2009 Webster conference on the *Renewal of the Western Community*: „The moral concept of the Social Market Economy consists of three elemental principles: the *principle of individuality*, which aims to the liberal ideal of individual freedom; the *principle of solidarity*, which refers to the idea that any individual human being is embedded into a society of mutual dependencies; the *principle of subsidiarity*, which means an institutional rule to shape the relation between individuality and solidarity.” Bod, Péter Ákos (2009): “In Search of a Socio-Economic Model: Is Social Market Economy an Option Anew in Europe?” in

What were the results and consequences of the Antall Government's economic policy?

The more time passes, the more we see how Hungary and the world economy developed, the more surprising it is how much happened in Hungary between 1990 and 1993. I can attribute the results not only to government policy but primarily to the people of the country. The economic organizational change was accomplished in three years and was irreversible. Hungary transformed from a crumbling planned economy on the brink of collapse into a functioning, especially micro-economically integrated market economy. In 1993–94, the economy operated according to the rules of the market economy in Hungary at the level of families, individuals and companies.

There was no economic and financial collapse. There was no social crisis. The new legal and institutional system was the most complete among the former Communist countries. Long-term opportunities were favorable, but there were also dangers. Antall saw the dangers but he was convinced that the main poles could help overcome them, i.e. sustained growth and social concern.

There were, however, many inherited problems. Thus, for example the farming system was in total disarray; the fact that as late as 1985, some experts and officials were still drawing reform inspiration from the Yugoslav model; external and domestic disequilibria were self-re-enforcing processes. There were dissensions within the government on some policy issues, but Antall was skilful in managing them.

The often-vicious attacks in the press were a source of distraction and of discouragement for a large part of the population. The problem with this was that many in the party (*MDF – Hungarian Democratic Forum*) and many of the voters did not receive objective and sufficient information about the process of transformation in the country. Antall knew that for a market economy based on competition to be politically acceptable, there had to be social unity and a positive vision of the future.

What were the international conditions in Europe and in the world?

The principal advantage of the regime change was that the door was open for us to join the community of market economies. We could participate in the competition; we could integrate into the European or world economy. There was solidarity – but no direct aid. We could take our share of the benefits of globalisation. József Antall and

his team recognised not only the advantages this involved but also the risks libertarian excesses would create.

In my view the economic policy concept of the Antall Government was essentially correct – and successful.

The aim and hope of regime change can be summed up in one sentence: “back to Europe, back to the free world”. This hope was not born in 1989, not in the 1980s. Since 1945, the “year of the turnaround” in 1948, neither Soviet power nor Communist ideology had been able to suppress it, to eradicate it from the consciousness of the Hungarian people. The desire to “return to Europe” was not primarily the result of cold, deliberate material and economic calculation. It was the result of a thousand-year tradition of Hungarian desire for freedom and the determination to reject authoritarianism.

CHAPTER THREE

The European and Worldwide Models of Regime Change

This chapter starts with a series of reflections on the unprecedented contrasts between positive and negative political developments and between free and unfree societies witnessed in the 20th century. Without an appreciation of these contrasts it is impossible to understand the complexity of our time. A reminder of these contrasts used to be part of the introduction to most of the undergraduate and graduate courses of international relations that I taught at Webster University Geneva.

Political Order and the Paradox of the 20th Century

During no known and documented period in human history has there been a century characterized by such extremes of positive and negative developments as the 20th century.

On the negative side, the last 100 years witnessed: the spreading of aggressive nationalism; two world wars and innumerable other cross-border or “internal” wars; the rise of totalitarian regimes that were responsible for the persecution, the torture and the death of millions of their own citizens; the spreading of oppressive ideologies, of the “right” or of the “left”, which aimed to reshape individuals, entire nations or the whole of humanity according to a single rigid mold; the multiplication of corrupt and oppressive regimes of all stripes; the use of technology to increase the scale and effectiveness of human destruction; the justification of terrorism and of random killings in the name of nationalism, religion, class struggle, racial or ethnic difference or other similarly misused concepts and ideals.

On the positive side, the 20th century also produced achievements that were not only unprecedented, but also unimaginable, even as recently as the 19th century. These included: the spreading and consolidation of free, pluralistic and democratic societies; economic prosperity and social promotion on a scale that no “egalitarian” philosopher in the past could have hoped for; the respect of basic human rights including the right to be different; freedom of thought and expression, freedom of movement and freedom of religion, and freedom of economic, social, political and cultural initiative and expression; the reduction of discrimination of all kinds; protection and assistance of the weak and solidarity at the national and international levels; the development

and diffusion of technology to improve the material and spiritual quality of life; intensive international cooperation in all areas and economic and political integration respectful of the identity and the interests of small and large states alike; and last but not least, the realization of conditions of permanent peace in large areas of the world, including between nations that had been involved in the bloodiest wars in their history as recently as the middle of the 20th century.

The Lessons of the 20th Century. The various domestic political orders at the national level in the 20th century differed not only from political orders that had existed in the past, varied not only from one region or group of countries to another region or group of nations, but there were also widespread radical changes in political order within the same country or group of countries in relatively short time spans. What were the causes of these contrasting developments? Was it luck or misfortune, fate or accident, material conditions or the weight of history? While all these factors may have played a role, individually or in various combinations, at one time or another in some of the positive and negative trends listed above, by now there can be no doubt that the decisive factors of influence were the *differences in the nature and quality of domestic and international political order*. While various “objective” factors may have played a role in the “positive” or “negative” developments, what made the real difference were the “subjective” political ones: the differences in the quality of political order, in political leadership and ultimately in the *fundamental political organizing principles, i.e. in fundamental political values*. In fact, neither geopolitics, nor ethnicity, nor history, nor differences in religions or civilizations can fully account for the differences in the conditions and behavior of different states according to various positive or negative criteria listed above. Some of the major nations found themselves at various times during the 20th century in the positive or in the negative column; some of the truly democratic and prosperous nations of today had been dominated and driven at one time by some of the *most evil and destructive political value systems*.

3.1. Revolutions: a mixed record

Both as a historian and as a politician, Antall showed deep interest in and wide-ranging knowledge of the evolution of political regimes not only in Hungary but also across world history. Both in his speeches and in his private conversations he often quoted historical examples. His insights usually went well beyond the conventional wisdom not only of the general public but also of many professional historians and political analysts.

Whether the topic was Hungary or the broader international context, Antall never failed to remember and to remind people that the fundamental political issues of the last two centuries have been ***the contrast and conflicts between unfree and free regimes***. This marked the history of the 19th century, became particularly dramatic in the “interwar period” and has been also the case during the Cold War, and sadly enough is happening again during the post-Cold-War age. Today once again liberal democracy is under attack while the various types of authoritarian regimes (from dictatorships to totalitarian systems) seem to be on the rise and hope to consolidate their grip on numerous nations on four continents.

One of the most remarkable features of the end of the Cold War and of the collapse of the Communist system in Europe and of the Soviet Empire was that by and large this was not the result of war and revolutions.¹⁵ Attempts by the old cadres of the Soviet Party, Police and Army to reverse the situation and to restore the Soviet system by force also failed.¹⁶

*The complexity and the strengths and weaknesses
of the study of “comparative government”*

In order to understand the concept of regime change – in Hungary or in the world, in the distant or more recent past, or in the future – the first task is to find agreement on the most important features and the less important features and components of a political system. A simple change from one party to another in power as a result of regular elections in a stable democracy does not qualify as a regime change. A shift from a government in a one-party dictatorship to a freely and democratically elected government is an eminent expression of a (positive) regime change (as was the case in Hungary in the spring of 1990). Regime change can be assessed not only by composition and election or non-election of a “government in the narrow sense” but also by radical changes in other components and features of government in a broad sense, such as the judiciary system, the police and the military, etc. By definition there are positive as well as negative types of regime change.

The definition and the comparison of various political systems are traditional areas of historical writings and research and of political science. The analysis of the origins

¹⁵ Pricey-Jones, David (1995): *The War that Never Was – the Fall of the Soviet Empire 1985–1991*, Weidenfeld–Nicolson, London.

¹⁶ Some belated admirers of the Bolshevik regime and its use of force against the population, today blame Gorbachov for not being brutal enough to maintain Communist rule by violent means. See Zubok, Vladislav M. (2021): *Collapse – the Fall of the Soviet Union*, Yale University Press, New Haven

and the demise of political regimes is an especially relevant and popular field in the broader framework of “comparative politics”.¹⁷

In the Western world the definition and assessment of political regimes go back to the philosophers of classical antiquity, and in particular to Plato and Aristotle.¹⁸ There is also a wide range of writings by Greek and Roman as well as medieval authors that are part of the rich legacy of Western civilization. Parallel sources are the Old Testament and the work of the Church fathers. For many scholars Niccolo Machiavelli was the first “modern, realist” political philosopher.

The following are some of the key features that help define a political system or order and to differentiate it from other political regimes:¹⁹

Organizing principles: freedom or oppression; source of power; objectives; means used

Type of government: representative government; arbitrary government; rule of men or rule of laws

Sovereignty: sources; external and internal limits of sovereignty

Values (political philosophy): universal values; traditional values; new values; secular values; the role of religion

Legitimacy: objectives, interests – individual and common interests. Who decides about the hierarchy of interests?

Institutions: executive; legislative; judiciary (the respect of laws by citizens and by the government); administration; army, police; political parties

Laws: constitution; other laws and rules

Power: monopoly of the use of force

Other aspects: justice; stability; freedom; security; economy; social conditions; efficiency; external relations; test of time; test of crises

Selected specific factors

Who governs?

Democracy?

Freedom – human rights

¹⁷ Finer, S.E. (1970): *Comparative Government*, Albert Lane, London.

¹⁸ Aristotle (1995): *The Politics*, Translated by Ernest Barker, with an Introduction and Notes by R.F. Stalley, The World's Classics, Oxford University Press, Oxford.

¹⁹ See Hieronymi, Otto: *Introduction to Comparative Politics*, Unpublished Course Notes, International Relations Program, Webster University, Geneva.

Economy

Market?

Social dimension

Open economy?

International cooperation

Security

Peace and international law

Political values

Secular

Cultural, linguistic, religious, ethnic complexity

Centralization – federalism

Stability

Tradition – innovation

Geography

History

The creation and destruction of political systems

One of the undisputed features of political systems is that they are subject to change: the speed and direction tends to vary as do the nature of the process and principal factors of influence. The following two paragraphs give an (incomplete) list of the possible processes of regime change and of the role of various categories of people, organizations or other material or virtual factors.

How do “political systems” come about?

Evolution; revolutions – *coups d’état*; crises – “earthquakes”; reform – innovation; social contract; design – models; legislation, referendums; imported or “home-made”

Role of: theories – ideologies, political philosophy and political science; “popular will”; success – failure; trial and error; history – traditions; *Zeitgeist*; geography; international environment; wars; international communities; economic conditions; leaders; citizens – parties – communities; science; technology

Revolutions are among the most spectacular forms of regime change. They are also among the most controversial processes and far from being universally successful in bringing in a good or better regime than the one they destroyed.²⁰ The following

²⁰ “...a revolution is a sudden change in human affairs so traumatic that no one understood it, either at the time of its happening or thereafter.” Ellis, Joseph J. (2021): *The Cause – The American*

four examples can illustrate this point (directly or indirectly Antall also often referred to them):

The American Revolution

There is broad agreement (or at least there used to be before the Trump, respectively the “woke”, revolutions of today) that the American Revolution was the most successful revolution of modern times. The following are the main arguments supporting this conclusion: (1) the outcome of the revolution was a new constitutional federalist political system that is superior to all previous systems; (2) this system has proven to be both stable and flexible and has fully withstood the test of time and the test of spectacular growth during two and a half centuries; (3) the American system has been vastly influential and has been a positive influence on political order across the world; (4) the single most important original weakness was the failure to settle the problem of slavery – this issues could not be resolved even at the price of a murderous civil war that almost destroyed the American state and nation.²¹

The French Revolution

The French Revolution rightly deserves a mixed – positive and negative – judgement. On the positive side one can mention the principles of human rights, the weakening of political absolutism and out-of-date rules and institutions. Its positive impact on freedom and on the concept of the nation was partly reversed by the brutality of the *terreur* and the emergence of an absolute and imperialist empire that brought war and widespread suffering not only to the rest of Europe but also to the French nation. Even today most people in France remain blind to the crimes perpetuated by and in the name of the Revolution and by Napoléon. As for regime change, according to Tocqueville there was much more continuity in pre-revolutionary France (*Ancien régime*) and post-revolutionary France than was recognized or admitted at the time.²²

Revolution and Its Discontents, 1773–1783, Liveright Publishing, New York P. xii; See also: Wood, Gordon S. (2021): *Power and Liberty – Constitutionalism in the American Revolution*, Oxford University Press, Oxford.

²¹ “George Washington observed that any historian who managed to write an accurate history of the American War of Independence would be accused of writing fiction.” Ellis, Joseph J. (2021): *The Cause – The American Revolution and Its Discontents, 1773–1783*, Liveright Publishing, New York, p. xii.

²² Tocqueville, Alexis (1856): *L’Ancien Régime et la Révolution*, Paris.

Also, it had taken decades after the end of the Napoleonic era to turn the country into a modern parliamentary democracy.²³

The October Revolution in Russia

The Bolshevik revolution in Russia was a disastrous event in world history. In terms of “regime change” it was also highly deceptive and a source of much suffering not only in Russia but also in the rest of Europe and in the world at large. Three points are particularly relevant in the context of this section: (1) In the first place it squashed the hopes not only in the short term, but as it turned out for decades, for a “positive regime change”, by stopping and reversing the (slow and limited) movement of Russia towards the European model of a free society that could be observed previously. (2) The Bolshevik revolution created the first fully totalitarian regime in modern history and the Soviet rulers were directly or indirectly responsible for the imposition of this tyranny on millions of people also outside Russia. (3) While the regime created by the Communists contained many innovations (e.g. in the organization of the “one-party dictatorship”)²⁴ there was also a clear line of continuity from the centuries-old Russian political tradition of autocracy and oppression of the people. A quote from the path-breaking study of Orlando Figes on the Russian revolution can illustrate this point:

“(The Russian people) were not victims of the revolution but protagonists in its tragedy. This may be a tragic lesson to learn for the Russian people at the end of the twentieth century. Seventy years of Communist oppression might well be thought to have earned them the right to see themselves as victims. But Russia’s progress as a democratic nation depends to a large extent on how far the Russians are able to confront their own recent history; this might entail the recognition that however much they were oppressed by it, the Soviet system grew up in Russian soil. It was the weakness of Russia’s democratic culture that enabled the Bolshevik system to take root. That was the legacy of Russian history of centuries of serfdom and autocratic rule that had kept the people powerless and passive. ‘And the people remained silent’ was a Russian proverb – and it describes much of Russian history. To be sure it was

²³ “In her *On Revolution* Hannah Arendt has called attention to it all. The French Revolution is admired for attempting to implement its radical agenda all at once and failing. The American War of Independence is criticized for deferring its full promise and succeeding.” Ellis, Joseph J. (2021): *The Cause – The American Revolution and Its Discontents, 1773–1783*, Liveright Publishing, New York, Pp. xii–xiii; Wood, Gordon S. (2021): *Power and Liberty – Constitutionalism in the American Revolution*, Oxford University Press, Oxford.

²⁴ Applebaum, Anne (2017); *Famine Rouge: la Guerre de Staline en Ukraine*, Beernard Grasset, Paris.

a people's tragedy but it was a tragedy they helped to make. The Russian people were trapped by the tyranny of their own history."²⁵

The Communist Revolution in China

The Chinese revolutions were a long drawn out process and represented along with the Russian revolutions the transformation and destruction of political and societal systems and structures that claimed the largest number of victims among the revolutionaries' own fellow citizens. They were clear examples of 20th century democides. In view of the size and force of the People's Republic of China and its aggressive rhetoric and policies, the case of the Chinese Communist revolution is particularly relevant for the analysis in this section.

The Chinese example is discussed under four headings:²⁶

- 1) Destruction of the old order and the nature and objective of the revolution and regime change: The Communist revolution had several interdependent objectives among which the following were the most important: establishing a Communist regime; defeating their Nationalist adversaries; destroying the old imperial and traditional culture.
- 2) Totalitarian ideologies and totalitarian regime: The ideological foundations of the Communist revolution were a combination of Marxism, Stalinism and Maoism. The new regime was brutal with little concern for human costs.
- 3) Mao's successor tried to ease the weight of the political oppression and to adopt Western technologies and market reforms. Despite the success of Deng's approach and his moving closer to the Western economic model China remained a Communist dictatorship.
- 4) Under Xi Jinping China became both more aggressively nationalistic and ideologically more rigid as well as strategically more menacing and more anti-Western. Today it is a real threat for the security of the free world.

²⁵ Figes, Orlando (1996) *A People's Tragedy – The Russian Revolution, 1891–1923*, Pimlico, London. See also: Gessen, Masha (2017): *The Future is History, How Totalitarianism Reclaimed Russia*, Riverside Books, New York; McMeekin, Sean (2017): *The Russian Revolution – A New History*, Basic Books, New York; Dal Santo, Lucio (1993): *Il Liberalismo Russo*, Spirali Vel, Milano.

²⁶ Fairbank, John King (1991): *China, A New History*, Harvard University Press, Cambridge, Mass.; Vogel, Ezra F. (2011): *Deng Xiaoping – The Transformation of China*, Harvard University Press, Cambridge, Mass.

3.2. What happened after the First and the Second World Wars?

The legacy of both the First World War and the Second World War was marked by extensive and dramatic changes in domestic and international political orders. The political and societal aftermath of these two unprecedented military conflicts showed both certain similarities as well as some profound and lasting differences. The present section provides a few illustrations of the key issues and developments during the two periods considered and of their relevance for the regime change in Hungary.²⁷

*The 1918–1939 inter-war period: “la faillite de la paix”,
the “failure of the peace”²⁸*

The two decades between the end of World War One and the start of the Second World War were marked by some of the most turbulent developments in modern history, such as (1) the end of the Russian, German, Austro–Hungarian and Ottoman monarchies; (2) an ambitious but ultimately unjust peace settlement at Paris and the failure to live up to the Wilsonian promises “of making the world safe for democracy”; (3) the emergence of Russian, Italian and German totalitarian regimes²⁹ and the spreading of dictatorships throughout the world with democracy on the defensive; (4) the great depression and breakdown of the international economic and monetary order.³⁰ While the “failure of the peace” and of the League of Nations was the most important and visible development, two positive developments should be mentioned: (1) although neither collective security nor self-determination and respect for minorities were accomplished, the 1920s and 1930s witnessed the creation and growth of international cooperation through international organization³¹ and (2) there were important liberal counterforces at work that, while unable to prevent the outbreak of the war, ultimately made possible the defeat of the Axis powers.

²⁷ Ikenberry, G. John (2020): *A World Safe for Democracy, Liberal Internationalism and the Crises of Global Order*, Yale University Press, New Haven.

²⁸ Baumont, Maurice (1946): *La Faillite de la Paix, 1918–1939*, Presses Universitaires de France, Paris; Carter, Zachary D. (2020): *The Price of Peace – Money, Democracy, and the Life of John Maynard Keynes*, Random House, New York.

²⁹ Aron, Raymond (1965, 1990): *Democracy and Totalitarianism: A Theory of Political Systems*, Ann Arbor Paperbacks, Ann Arbor, Michigan, p. xvii.

³⁰ I.U.H.E.I. (1938) : *La Crise Mondiale : Collection d'études réunies à l'occasion du dixième anniversaire de l'Institut Universitaires de Hautes Etudes Internationales par ses professeurs*, Editions Polygraphiques S.A., Zurich.

³¹ Slobodian, Quinn (2018): *The Globalists, the End of Empire and the Birth of Neoliberalism*, Harvard University Press, Cambridge, Mass.

*The post-war period, the Cold War and the emergence of the Western Community*³²

In terms of political order during the decades that followed the end of the Second World War the world was essentially divided into three distinct systems³³: (1) the Community of Western democracies; (2) the Communist dictatorships; and (3) the countries of the “Third World”, some of which leaned towards the Western democratic model, while others adopted more authoritarian regimes. The post-war period also saw the explosive growth of the number and scope of international organizations even though the so-called United Nations order also failed to guarantee universal respect for democracy, human rights and peace. The three groups or sub-orders differed from each other not only in terms of their domestic political order (and the degree of liberal democracy) but also in terms of their external relations. In principle the end of the Cold War was meant to eliminate these differences and bring both domestic and international order close to the Western liberal democratic order.

3.3. Decolonization and the “planned economy”: betting on the wrong model

The Europeans did not invent colonialization. However, it was the European “maritime powers” that conquered the largest and most diverse parts of the world. There is a vast literature on European imperialism and colonial rule and on the factors that motivated the European countries to seek to expand their rule beyond the borders of their continent. Among the factors that allowed even relatively small European countries to defeat much larger populations than their own and to administer huge territories that were often several thousand kilometers away from Europe was technology (both maritime transport and military technology in particular), trading and administrative skills and organization, as well as demographic factors.³⁴ Many of the colonial conquests started out as private ventures (or rather adventures) that

³² Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

³³ Hieronymi, Otto (2007): “The Spirit of Geneva and Globalization” in Hieronymi, Otto and Intag, Kathleen (Editors): *The Spirit of Geneva in a Globalized World*, Refugee Survey Quarterly, Oxford University Press, Volume 26, Number 4, 2007, pp. 274–305.

³⁴ Finer, S.E. (1997): *The History of Government from the Earliest Times, Volume Three: Empires, Monarchies and the Modern State*, Oxford University Press, Oxford.

later were turned into sovereign properties. At various points in time the colonial conquests were declared by the Europeans to be “temporary” occupation in the very interest of the defeated nations – without specifying when and under what conditions the colonies would regain their freedom.

The earliest large scale movements of “decolonization” were the American war of independence in North America and the “Bolivarian revolution” in South America in the late 18th century, respectively in the early 19th century. Nevertheless, European colonial rule over large parts of the globe was to last almost another century and a half. In fact it was only after the Second World War that decolonization gained its full momentum.³⁵

The full story of colonialism and of decolonization is outside the scope of this volume. Only two aspects of this process are mentioned here as particularly relevant in the context of the discussion of regime change.

(1) ***Who was for independence?*** In virtually all colonial powers the questions of how much autonomy colonies ought to be granted and when and under what conditions colonies should become independent were subjects of intensive political debate. Usually liberal and left wing politicians favored a more rapid liberation, whereas conservative and right wing parties tended to be opposed to the independence of their colonies. The logical consequence of this was that the social and political elite in most colonies was leaning towards the left or was outright Communists and rejected the Western model of parliamentary democracy.

(2) ***How was independence achieved and what was the outcome?*** This is one of the factors that turned the process of decolonization into a much more conflictual and violent process than would have been necessary if there had been a convergence of views between the European and the local leaders both on the time-table of independence and the desirable political system after independence was achieved. In fact, in too many cases independence was preceded by brutal fighting not only between the local groups and the colonial power, but also between the “revolutionary” and the democratic elements in the local population. The economic, political and social models adopted corresponded too often to the Marxist–Leninist–Stalinist–Maoist model of the Soviet Union and Communist China, rather than the successful model of liberal democracy and the (social) market economy. Thus the population of many newly independent nations, who had been promised freedom, democracy, respect for human rights and economic prosperity once the colonial masters had departed, found

³⁵ See: Harlow, Vincent and Maiden, Frederick (1955): *British Colonial Developments 1774–1834, Selected Documents*, Oxford at the Clarendon Press, Oxford; Hancock, W.K. (1937): *Survey of British Commonwealth Affairs, Volume I: Problems of Nationality, 1918–1936*, Oxford University Press, London; Prévot, Abbé (1750): *Histoire générale des voyages*, 18 Volumes, Paris.

themselves in regimes that were economically inefficient and politically oppressive and corrupt. Countless “newly independent countries” became the ideological allies of the countries that practiced the worst kind of oppression and exploitation in the second half of the 20th century.

3.4. The international debt crisis: “marketization and structural change”

With the progress of decolonization, the so-called “development economics” became a veritable growth industry from the mid-twentieth century onward. The key issues raised by economists and other experts were: (1) how to stimulate economic growth in the “underdeveloped countries”; (2) what should be the division of tasks between governments and the private sector; (3) the role of economic planning, of private vs. public ownership; (4) protectionism and infant-industry policies versus trade liberalization; (5) the so-called theory of dependence; (6) the role of large government sponsored projects vs. encouraging small and medium-sized companies; (7) foreign capital borrowing; (8) planned closed economy or open private competition; and finally (9) should underdeveloped economies adopt the successful models of the Western market economies or follow the example of the collectivist and interventionist Communist planned economies of Russia and China.

Unfortunately, in the majority of underdeveloped countries the second option prevailed. Surprisingly international organizations like the IMF and the IBRD (World Bank) condoned or even encouraged these decisions. This prevented most developing countries from becoming competitive internationally and from providing opportunities for success to new generations of entrepreneurs. Since the financing of large government sponsored projects required massive borrowing abroad, many of the developing countries became heavily indebted by the end of the 1970s. When the “recycling of petrodollars” and the period of low and even negative real interest rates came to an end and a new stage of high interest rates started, major developing countries were driven into severe international financial crises. In order to save the balance sheets of the international banking system from the consequences of a default by the debtor countries, the Western governments and the Bretton Woods institutions (IBRD and IMF) put pressure on the debtors to adopt onerous and painful policies of “marketization and structural change” instead of the logical step of defaulting on their excessive debt burden. This second solution would have allowed them to avoid several years of no growth or even negative growth, with severe social problems, and would have created a sharing of the burden between borrowers and creditors. The idea that

interventionist, closed economies could be turned into dynamic competitive export-oriented market economies without severe social costs was an illusion propagated by the “international development bureaucracy”.³⁶

3.5. The collapse of the Communist system: the fallacy of the “shock therapy”

Professor Péter Bod is probably the person who has the broadest and deepest knowledge of the Hungarian regime change. During the Antall years he was one of the principal authors of the MDF (Hungarian Democratic Forum) election program and after the elections one of the main authors of the new government’s economic program. Bod became the Minister of Industry and Trade in the Antall Government. After the law on the Central Bank was passed he became President of the Hungarian National Bank. He resigned from this position when the Horn government came into power and moved to London to join the EBRD in London as a Director. Beside his unique experience as an active high-level decision maker during the crucial years of regime change in Hungary and in East-Central Europe, over the last three decades Professor Bod never ceased to continue to research and to write about the evolution of the Hungarian economy as well as about the success and failure of economic policies in Hungary, in the region, as well as in the world economy as a whole. Today, Professor Bod is recognized as one of the leading Hungarian economists of his generation.

In 1990s Professor Bod participated in a project that compared the history and the record of the economic policies of the three leading former Communist countries – Hungary, Poland and Czechoslovakia – at the time of the regime change. His detailed, overall analysis of the programs and results of the three countries still remains the single best comparative analysis of the economic regime change in the region.³⁷

³⁶ See: Bauer, P.T. and Yamey, B.S (1957): *The Economics of Underdeveloped Countries*, Cambridge University Press, Cambridge and Bauer, P.T. (1972) *Dissent on Development*. Harvard University Press. Cambridge, Mass. Peter Bauer (Lord Bauer) was one of the three British economics professors of Hungarian origin who became members of the British House of Lords, the Upper Chamber of the U.K. Parliament. The other two, Lord (Thomas) Balogh (Oxford) and Lord (Nicolas) Caldor (Cambridge) were at the opposite end of the political spectrum and of economic theory from P.T. Bauer, who was one of the few liberal market oriented specialists of economic development issues until the 1970s.

³⁷ Bod, Péter Ákos (1998): “*Hol tart ma a három ország, hol tart a rendszerváltozásuk?*” in Blejer, Mario I. and Coricelli, Fabrizio, Editors (1998): *Három ország, három történet, három szereplő. Rendszerváltozás Kelet-Közép-Európában, ahogy Leszek Balcerowicz, Bod Péter Ákos és Václav Klaus látta*. Széphalom Könyvműhely, Budapest, pp. 128–214.

One of the issues he discussed was the question of “shock therapy” to deal with the legacy of the collectivist economy.

*“Shock therapy” and international organizations vs. the policies
of the Antall government*

There was a close link between the crisis and ultimate collapse of the Communist system and its approach to international trade and payments. The collectivist economic system imposed and perpetuated under the Communist political system was essentially a more wasteful and less efficient model than a liberal market economy. This was true not only under the orthodox versions of the regime but also in the countries that experimented with reforms that aimed at narrowing the gap between the ideologically and bureaucratically controlled “socialist economy” and a true market economy. This was obviously also the case in Hungary, which was considered both in the “socialist camp” and in the “capitalist” West as a pioneer of economic reforms. In reality the Hungarian reform measures also had decisive limits and major shortcomings despite the apparent or real differences from the orthodox models that prevailed in the Soviet Union and in most of the other satellite countries.

Among the main driving forces of the remarkable growth of the world economy in the decades following the end of the Second World War were the gradual liberalization of international trade and payments, on the one hand, and the development and the diffusion of advanced technologies, on the other hand. These interconnected trends stimulated both competition and the rise of productivity and of living standards. Trade grew significantly faster than total output and foreign direct investment outpaced national spending. The post-war decades witnessed a remarkable degree of integration at the level of consumption and production among the market economies and the spreading of modern new production facilities. One of the most noteworthy aspects of this process was the emergence of a group of rapidly growing “underdeveloped countries” known in economic history as the “newly industrialized countries” (NICs) or *Schwellendländer* in German. Following the German and subsequently Japanese model of “export-led growth” was part of the recipes of success for most of them.³⁸

One of the most important expressions of the division between the Communist bloc and the Western world was the contrast in their international economic relations and performance. As noted above the Western economies participated in a process of liberalization and currency convertibility, whereas the “Eastern” economic relations

³⁸ This was certainly the case for the four “Asian Tigers” – South Korea, Hong Kong, Taiwan and Singapore.

were based on strict exchange control, planned exports and imports and a *de facto* barter regime. The Communist trading and payments systems were among the most closely controlled aspects of the “Socialist economic order” and one of the principal causes of its inefficiency and the constant waste and shortages of raw materials, as well as intermediate and final goods and services.

Although the relative weight of foreign trade in total output was also increasing in Communist economies, a large share of these exports and imports were “non-competitive” barter exchanges with other Communist countries or with “Third-World” economies. This was also the case for Hungary which in fact had achieved a very large trade/total output ratio and a relatively strong position in the Socialist (planned) specialization and division of markets.

The mixed trading system – “socialist” and “capitalist” sources and markets – and “dollar” and “rouble”, convertible vs. non-convertible currency payments and receipts provided confused signals to Hungarian enterprises and contributed to their weak and weakening international competitiveness.

The downward spiral that could be witnessed in the 1980s also in the Hungarian economy was the result of a cumulative process: the worsening external payments position made external financing more and more difficult and onerous, whereas the fiscal and monetary restrictions that became indispensable in order to escape a financial and currency collapse prevented the modernization of enterprises and of their product range which would have helped stabilize the country’s balance of payments.

What was the solution? As the likelihood of political regime change was increasing – due to direct and indirect signals from the Soviet leadership and from the “de-freezing” of East-West relations – the closing down of the trade and payments flows and the drastic re-introduction of central control of all economic and business decisions was not a realistic option. For Hungary at least, there were essentially two alternatives.

The *first one was the road followed by the Antall government*. Its main aspects can be summed up in the following points: (1) avoiding a total collapse of the Hungarian economy; (2) avoiding an external and domestic financial crisis; (3) a systematic approach to privatization; (4) creation of the institutional and policy framework required for a modern social market economy; (5) adopting the institutional and policy measures that would help eliminate the obstacles to sustained economic growth; (6) assuring political stability and the predictability and reliability of the government’s economic policies, which would help maintain domestic and international confidence and would encourage foreign and domestic investors and entrepreneurship in Hungary.

The other option was the so-called “shock therapy”. The term “shock therapy” originally referred to extreme or fundamentalist sudden introduction of a “market economy” through deregulation, liberalization, marketization and privatization to rapidly transform a state-controlled economy into a market economy. Key features include austerity through severe fiscal and monetary policies, floating exchange rates, radical anti-union policies. The basic assumption is that once the shock has destroyed the “sick, collectivist” elements in the economy, there would be spontaneous rapid flourishing of private enterprise to make up for the sharp drop in production and consumption (and living standards) brought about by the shock. In the case of Hungary the shock therapy would also have included a unilateral repudiation of at least part of Hungary’s external debt.³⁹

The Antall government distanced itself from the philosophy or ideology of shock therapy. The Prime Minister and his team considered shock therapy simplistic both in theory and practice. The deliberately anti-social orientation and rhetoric were contrary to the values and objectives of a liberal democracy. The Hungarian decision-makers rightly argued that in all the major areas of economic regime change Hungary was able to achieve better results than if it had followed the simple blue-print of the “Washington consensus” or of the “shock therapy” first invented in Chile in Pinochet’s dictatorship and later applied in other Latin American countries, in Poland and in the former Soviet Union.

In the process of “economic regime change”, whether it was in Latin American or other highly indebted countries, or in the former Communist countries, the international economic organizations were keen to assume a high-profile advisory role. The quality of their advice and of their overall performance remained by and large well below expectations. In the first place, they bought into the over-simplified versions of the “shock therapy” and of the “Washington consensus” virtually without reservations. Second, they systematically ignored the historical evidence that successful reconstruction and economic transformation required non-debt creating resource transfers from abroad. Third, they did not admit that they had access only to limited resources compared to the extent the urgency and complexity of the task; they accepted without reservation that their staff with limited direct experience should sit in judgment over national policy makers. It was rather frustrating to observe the limited knowledge of economic history and the considerable confusion between

³⁹ The principal promoter of the “shock therapy” in Poland, Russia and other Eastern European countries was the American economist, Jeffrey Sachs. Like many American academics Sachs could be quite arrogant when contradicted in open debate. He was quite resentful *vis-à-vis* Hungary and the Antall government for not having invited him as adviser to the government on its program of regime change.

balance-of-payments problems, economic regime change, economic reconstruction and economic development shown by officials of organizations like the IMF, the World Bank or the United Nations Economic Commission for Europe.⁴⁰

The case of the Russian Federation: a note on Boris Fyodorov

The dramatic collapse of the Russian economy in the 1990s and the ensuing poverty, corruption and misappropriation of the country's resources (*de facto* theft) by the so-called oligarchs was essentially the result of three major factors: (1) first and foremost the very nature of the Soviet economic system and the weight of accumulated waste and mismanagement; (2) second, the haphazard and incompetent approach to economic policy-making under both Gorbachov and Yeltsin, and in particular in introducing and then recalling various economic reform packages; (3) and third, the confusing and in many respects simplistic and contradictory nature of the reform plans. In other words there were problems not only with the implementation of the reform programs and with material obstacles and political and general human resistance to fundamental change, but also with some of the theoretical bases of the programs.

Gorbachov and Yeltsin were both honest and well intentioned when they said that they wanted a fundamental transformation of the Russian economic system. Of course, neither one of them was a "good" economist. Not because they were not "professional economists" but because they were raised and became successful party officials in the distorted ideology of Marxism–Leninism. Even when they wanted to reject the planned economy, they had great trouble understanding the opposite – i.e. the market economy – of what they wanted to reject and replace. If one compares the two initial pillars of Gorbachov's reforms – *Glasnost* and *Perestroyka* – the first one, an essentially political program, is clear and easy to understand. When it came to the second, i.e. *Perestroyka*, it was not only at the time difficult to make operational sense of it, even today almost 40 years later, it is difficult to understand the full objectives and the means to achieve them.

One of the best-known attempts to translate *Perestroyka* into an operational reform plan was the so-called "500 days plan" – a proposal to create a functioning market economy in Russia in 500 days. This plan was prepared by a group of Russian economists headed by *Academician Stanislav Shatalin*, an internationally known

⁴⁰ Hieronymi, Otto (1996): "The International Financial Institutions and the Challenge of Transition and Reconstruction in the Former Communist Countries of Central and Eastern Europe" in Szabó-Pelsöczy, Miklós, Editor (1996): *Fifty Years after Bretton-Woods – the New Challenge of East-West Partnership and Economic Progress*, Averbury Ashgate Publishing, Aldeshut.

expert in input–output modelling. The objectives in the “500 days plan” were more specific, and by and large they were the right ones. Nevertheless, there was a certain lack of cohesion about the general objectives and the final outcome and about the main problems that were likely to emerge in the course of implementation.⁴¹ At any rate, the plan was abandoned before it could have been put to the test. With my late friend, Emilio Fontela, who, among his many other qualities was also a world-class expert on input–output modelling, we invited Professor Shatalin to a closed-door presentation of the “500 days plan” to some of our colleagues at Battelle-Geneva. When we came away from the discussion Fontela and I had an uneasy feeling about the consistency, in terms of “applied economics”, of Shatalin’s presentation. While Gorbachov rejected it, later on Yeltsin revived it and tried to implement it. The outcome justified our original misgivings.

Another Russian high-level advisor and decision-maker I met was the late Boris Fyodorov. I first met Fyodorov when he was 28 years old at the first Szirák-Triffin Conference on International Monetary issues organized in the autumn of 1986 by the Hungarian-American economist, Miklós Szabó-Pelsőczy. Fyodorov gave the impression of someone who was very bright, and who was fascinated by “monetarism”. His interest and excitement about what had by then become the new fashion in economics and the dominant doctrine, especially in Britain and the United States and was at the basis of the “Washington consensus” mentioned above, were so intense that I asked him how much time he had spent studying at the University of Chicago, the center of Friedmanite monetarism and the home of numerous future winners of the Nobel Prize in Economics (or rather in monetarism and libertarianism). My question was a serious one thus I was stunned by his answer that since then I have not forgotten: “I have never been outside the borders of the Socialist camp.” I met Boris Fyodorov on a few more occasions and continued our discussions, when we had time, on international monetary issues. Both he and I cherished the memory of that first Szirák conference in the Hungarian countryside. The last time we met and talked very briefly, this time also about Hungary, was at the 2nd Biennial Meeting of the European Bank for Reconstruction and Development in Saint Petersburg in the spring of 1994. This was at the end of my advisory work in Hungary. It was also the first and only time that I was a (honorary) member of a Hungarian delegation at an international conference. I appreciated the gesture of my friends who invited me to

⁴¹ “Five Hundred Days Plan”, Stanislav Shatalin, *Man, Freedom, and the Market*. October 31, 1990, *Current Digest of the Soviet Press*, Vol. XLII, No. 35 (October 31, 1990); original source in Russian: *Izvestiia*, 4 September 1990.

join them at the EBRD conference. For them also this was the end of an important period in their lives.

From a distance, mainly through reading the international financial press, over the years I followed Fyodorov's impressive career until his untimely death in 2008 at the age of 50. No doubt he was one of the brightest young economists who were active in public life in Russia in the late 1980s and in the 1990s. Fyodorov came to play an important role in the economic regime change of the Russian Federation as an adviser of both Gorbachov and Yeltsin and of their teams, as Deputy Prime Minister, as Minister of Finance of the Russian Federation, as a high ranking official of the EBRD and of the World Bank, and ultimately as an investment banker. However, I was sad at the time and with hindsight I am even sadder today, that Boris Fyodorov with all his intelligence, with all the influence and all the power that he had at crucial moments, could not help to move the Russian economy towards a more balanced transformation. I believe that it is not an illusion that it could have happened. No miracle was necessary in order that an orderly market economy, with a decent ownership and social policy structure should emerge on the ruins of the Communist economic and political order. It would not have taken a miracle but it certainly required better judgment, more common sense and certainly a much better understanding of the real working of a free market economy and of the respective roles of the state and of the private sector in a modern democracy. We know that the costs of this failure are enormous for the Russian people, for Europe and ultimately for the peace of the world. In conclusion, there is no doubt that the approach chosen by József Antall was much better than the libertarian and monetarist shock therapy.

3.6. The failure of the “Arab Spring”: Was it the fault of “Liberal Democracy”?

The end of the Cold War and regime change

The Cold War represented essentially a conflict between two profoundly different political systems: one based on democracy, political freedom and the respect of human rights, and the other on a totalitarian ideology and an oppressive one-party State. The conflict ended with the victory of the liberal, democratic model. The road was open for peaceful “regime change” – for a change from dictatorship to democracy. In fact, numerous peoples took advantage of this opportunity on three continents and today the proportion of people living under free, democratic systems is much higher than was the case in the late 1980s or at any time in the last 100 years.

Yet, contrary to widespread hopes 30 years ago, the victory of democracy did not become universal, and the period since the end of the Cold War witnessed not only murderous “internal conflicts” in all parts of the world – conflicts that by definition reflected the absence and the rejection of democracy – but also the consolidation of existing authoritarian regimes and the emergence of new ones. While in many cases “regime change” towards democracy was successful, in too many other instances democracy became or remained a seemingly unattainable goal.

The contrast between democracy and political freedom, on the one hand, and authoritarian and oppressive regimes of various kinds, on the other hand, has profoundly marked the life of nations in peace and war during the last 100 years. Also, the future of humanity, the prospects for peace, for economic prosperity and social progress, depend to a large extent on the quality of the political regimes throughout the world and ultimately on the chances of success of democracy in small and large countries alike.

From the Arab Spring to the Arab Winter

According to the reports of *Freedom House* on freedom and repression in the world the Middle East is the part of the world where people are most likely to live under repressive, unfree political systems. The various authoritarian and quasi-totalitarian regimes that are spread over this large region use either religion or secular ideologies to justify the oppression of the population. Whatever the pretext the most common and most tragic feature is the brutal, bloodthirsty recourse to violence to gain and retain power. In the vast majority of countries, human rights is an empty slogan or an unknown concept. Many regimes punish severely any reference to human rights or political freedom and democracy. For decades, “regime change” in the Arab World and in fact in the entire Middle East has not meant a change from a bad unfree regime to a functioning, stable democracy, but from one dictator to another one, and/or from one type of oppressive regime to another one.

This does not mean that prior to the “Arab Spring” there were not brave and commendable attempts to establish democracy and political freedom in any of the countries of the region. Most of the time, however, these efforts failed or if they seemed to succeed were sooner or later reversed.

Thus, it was not surprising that people in the region as well as in the rest of the world rejoiced when a series of manifestations that began in Tunisia and then were quickly emulated in Egypt, Syria and other Arab countries, seemed to be successful in defeating and expelling dictators. The world watched the events of the Arab Spring unfold, “gripped by the narrative of a young generation peacefully rising up against

oppressive authoritarianism to secure a more democratic political system and a brighter economic future”.⁴²

The protest movements started in late 2010 in Tunisia and spread rapidly to other Arab countries. Beside Tunisia one should especially remember Egypt, Syria, Libya, Yemen, Saudi Arabia. Numerous factors led to the protests, including issues such as reform, human rights violations, political corruption, economic decline, unemployment, extreme poverty, and a number of demographic structural factors such as a large percentage of educated but dissatisfied youth within the entire population.

Following the self-immolation of Mohamed Bouazizi in Sidi Bouzid, a series of increasingly violent street demonstrations through December 2010 ultimately led to the ousting of long-time President Zine El Abidine Ben Ali on January 14, 2011. The demonstrations were preceded by high unemployment, food inflation, corruption, lack of freedom of speech and other forms of political freedom, and poor living conditions. The protests constituted the most dramatic wave of social and political unrest in Tunisia in three decades and resulted in scores of deaths and injuries, most of which were the result of action by police and security forces against demonstrators. Ben Ali fled into exile in Saudi Arabia, ending his 23 years in power.

In the aftermath of the Arab Spring in various countries, there was a wave of violence and instability commonly known as the Arab Winter or Islamist Winter. The Arab Winter was characterized by extensive civil wars, general regional instability, economic and demographic decline of the Arab League and overall religious wars between Sunni and Shia Muslims.

*Democracy and Regime Change – the 12th Annual Fall Conference
of Webster University Geneva – November 2011*

The quality of political systems and the respect for freedom and human rights are at the center of teaching in the International Relations Program of Webster Geneva. This was reflected also in the program of seminars and conferences that I initiated and organized as of 1995 when I joined the Faculty of Webster Geneva as the Head of the University's International Relations Program, on a broad range of political, economic, strategic and humanitarian issues of major current interest, and in particular of the annual humanitarian conference and the Annual Fall Conference of the International Relations Program.

The title of the the 12th annual Fall Conference of the International Relations Program of Webster University, Geneva, held on November 25, 2011, was *Democracy*

⁴² See: Wikipedia – “Arab Spring”.

and Regime Change: Success and Failure since the End of the Cold War. This was a little over one year after the start of the so-called “Arab Spring” and about six months after the beginning of the “Arab Winter”. The term “Arab Winter” is much less frequently used than “Arab Spring”, but it has lasted much longer than the short period of hope for freedom and democracy that marked for a few weeks or months most of the countries of the Arab world in early 2011.

The program of the November 2011 conference focused on the concepts and conclusions of both political theory and of distant or more recent history, which have shown that democracy is superior to tyranny and that people’s aspirations for political freedom and democracy are not limited by geography, tradition, race or religion. No part of humanity is predestined to live under oppression, nor can any political community enjoy the benefits of democracy without effort and commitment.

The 2010 “Fall Conference” dealt with *Values and Interests in International Relations in the 21st Century*. The topic of the 12th Annual Fall Conference of Webster University – *Democracy and Regime Change* – was chosen in the second half of 2010 in the afterglow of the celebrations of the 20th anniversary of the end of the Cold War. More than six months after the outbreak of the “Arab Spring”, and in the light of the difficulties encountered in this process of “regime change”, the subject of the conference on November 25, 2011 was more topical than ever.

The program of the 2011 conference included beside the “Arab Spring” a discussion of examples from the recent past of success stories and of failures in the process of democratic regime change, identifying common factors responsible for success or for failure, and reflections on the world-wide outlook for democracy and on how to deal with the threat of the consolidation and possibly even the spread of authoritarian regimes.

The following brief conclusions from the discussion at the 2011 Webster Conference and from the history of the subsequent decade and a half leading up to the current crisis brought about by Putin and his allies seem to be relevant in the context of the present section and chapter.

- 1) The **superiority of liberal democratic systems** over the various types of unfree regimes has to be repeated again and again. The idea that some people are not suited for democracy and/or that unfree regimes are valid alternatives for non-Western people are the most dangerous assertions by demagogues on the left or the right.
- 2) The **forces of political evil are powerful and establishing a stable democracy is a complex and demanding task**. The readiness of the enemies of freedom to murder and to destroy in order to maintain their power must never be underestimated.

- 3) True *collective security* – solidarity in defense against domestic and external enemies of freedom and democracy – *is difficult to implement*, but where it has been achieved it must be cherished.
- 4) The *quality of political institutions is the best guaranty against tyranny*. Careful institution building is an essential element of successful regime change. This is true both for domestic institutions and for the institutions of international order.
- 5) Thus, NATO and the European Union were and remain essential elements in the success of regime change after the Second World War and after the end of the Cold War.

CHAPTER FOUR

The 1990 Program of Hungarian National Renewal

A historical moment and a historical document

József Antall, the Designated Prime Minister, presented the detailed program of his government to the Hungarian Parliament on May 22, 1990. The presentation was followed by a debate with lively participation by opposition members of the House. The presentation of the program, the vote of confidence and the swearing in of the new Prime Minister and of the members of his government were truly historic moments. The text of the program was also a historical document. The use of the adjective “historical” is fully justified.

Politicians and political observers and commentators tend to overuse the term “historical”, often describing as such events or documents that are rapidly forgotten in a matter of days or weeks. Also, the late 1980s and early 1990s was a period rich in developments in Hungary and in the entire East-Central European region and could be viewed and remembered as “historical”. Still, the presentation of a government program by a freely elected Prime Minister in the Hungarian Parliament had a unique historical weight and importance.

4.1. A complex drafting process

The present chapter deals with a key moments in the change of regime in Hungary and one of the principal documents related to the transformation of Hungary from a one-party dictatorship to a modern democratic state. An important source in the history of Hungarian regime change is the five-volume verbatim documentation of the negotiations between the Opposition Round Table (*EKA*) and the ruling Communist Party (*MSZMP*) during 1989.

The several thousands of pages of this collection provide an insight into the complexity of the talks and into the reluctance of even the “reform-minded” among the Communist leaders to accept the idea that their party would lose its hold on power and that Hungary would cease to be a “socialist” state. The documents also show the many people involved at the various levels of the negotiations and on various issues, the differences of views and the search for consensus among the various opposition

groups. The day-by-day chronology of the negotiations also shows the intellectual and political inputs by some of the people who went on to assume important functions during the next phase, i.e. during the first free electoral campaign and after the vote of the people, and after the freely elected parliament and government were sworn in and started their historic mandate.

The record of the round-table negotiations also showed that there were differences on specific issues not only between the opposition side and the Communist side but also among the various groups on the opposition side, including the three groups that were going to form the first, three-party coalition government as of May 1990. As the record also shows, the Head of this new government, Prime Minister József Antall, was one of the most active members of the round table negotiations.

In some respects the round table talks are seen as a prelude to the actual regime change. Whatever the current views are on the importance of the decisions taken, one lesson stood out already at the time and has been confirmed by historical developments since then, during the four years of the Antall government and during the several mandates of the various parties that were in opposition during the Antall years. This lesson, clearly understood by Antall from the start, was that completing regime change was a difficult and demanding task. In order to make it successful and irreversible required dedication and a program that would show a thorough understanding of the deviousness of the preceding totalitarian system and the difficulties to be encountered in building a new modern democracy and market economy.

Rereading Antall's inaugural speech

On May 22, 1990, József Antall, as the designated Prime Minister, submitted to the Hungarian Parliament for approval the detailed program of his government.

Arguably in many respects this was the most important speech in modern Hungarian history. Both because of the occasion when it was delivered and because of its content the speech was unique. The historian, György Szabad, the Speaker of the Parliament and a close friend of Antall wrote a thoughtful article under the title "Re-reading the Speech", which commemorated both the text and Antall's delivery. Szabad's analysis incorporated his own personal memories of that day and his assessment of the lasting relevance of the key issues raised at a turning point in the life of the nation.

Antall's speech has entered Hungarian history under the title "The Program of Hungary's National Renewal" (in Hungarian *A nemzeti megújulás programja*). While the speech and the delivery were vintage Antall, tailored for the occasion, the text also incorporated inputs from earlier documents and suggestions from close associates of the head of the Hungarian Democratic Forum (MDF). The most important among

these documents was the electoral program of the MDF. Others to be mentioned are speeches delivered at the meeting of the MDF at the time of Antall's election as President of the Forum as well as during the parliamentary election campaign.

I happen to own a copy of a somewhat longer version than the actual speech delivered by Antall. This copy shows a number of passages crossed out and a few sentences added, partly handwritten, partly typed. These corrections do not represent modifications of substance. Their objective was to allow the text to flow more smoothly. The unabridged version also dated May 22, 1990, carried the longer title: "The Program of National Renewal: the Guiding Principles of the Government's Program" (*A nemzeti megújulás programja: a kormányprogram irányelvei*). At the end of this longer version is the following note:

"In the preparation of the Guiding Principles of the Program the following documents were used:

The electoral programs of the three parties in the government coalition:
Hungarian Democratic Forum
Independent Smallholders Party
Christian Democratic Party

Studies prepared by:
Battelle-Europe
The Bridge Group
The Blue Ribbon Commission."⁴³

Antall's speech served as the basis for the preparation during the summer of the detailed version of the government's program. This was completed and published in September 1990 under the title: "Program of Hungarian National Renewal: the first three years (1990-1992) of the Republic". (*A nemzeti megújulás programja: a köz-társaság első három éve*).

Overview of the guiding principles

I would like to highlight what I believe are some of the key aspects of the *Guiding Principles of the Government's Program*:

⁴³ *A program irányelveinek összeállításánál felhasználásra került a Magyar Demokrata Fórum, a Független Kisgazda-, Földmunkás és Polgári Párt, a Kereszténydemokrata Néppárt programja, valamint a Battelle-Europe, a Hid Csoport és a Kék Szalag Bizottság által készített tanulmányok.*

- 1) The *four basic principles of the government's program* were *freedom, the people's government, the fundamental transformation of the economic order and the choice of Europe*. Respecting these principles would allow the government to accomplish a long-hoped program for regime change.
- 2) The *historic importance* of the *free election of parliament and the new government*: a first in the modern history of the country.
- 3) The *two-fold interdependent aspects* of the unique challenge and opportunity: benefitting from the *end of the oppressive decades of the Communist regime* and the task of *constructing a new modern democracy*.
- 4) The challenge is to build a *new political regime for the future*. It is important to respect what was positive in the country's long history and tradition, without trying to recreate the past.
- 5) *Democracy means that power and sovereignty belong to the people*. The people exercise this power through elections and their elected representatives, and in some cases through direct decisions.
- 6) The *role of the human person, of individuals and of families* is emphasized throughout the guiding principles. Human-centered (*emberközpontú*) policies and society are the goal of the new government.
- 7) The *Constitution and the institutions* of the new free republic have to be revised and completed; this is one of the principal tasks of the new parliament and government. The *political opposition* also has to respect the fundamental rules of the Constitution.
- 8) *Freedom is an essential dimension of the new democracy*. The country has suffered enormously under the oppression of the Communist regime as well as under the Nazi occupation and *Nyilas* (Arrow Cross fascist) rule. One must never forget the horrors that occurred under those regimes.
- 9) Many people made a compromise with the *Kádár regime*. *Even if the regime "softened" at one point, it never became legitimate* and was never ready to give up its exclusive hold on the dictatorship and one-party rule.
- 10) From the start, through the end, Communism was a wasteful and inefficient economic and social system. One of the main objectives is *to build a Hungarian version of the social market economy*. The principal aspects are market economy, private initiative and social safety net.
- 11) Hungary has finally become a *sovereign, independent country* but it has also become a member of the *Western Community*. The first step towards becoming a full member of the European Community is joining the *Council of Europe*.

- 12) The **values** to be upheld include respect of human rights and the rights of minorities and the protection of the environment. Religious freedom is important, as is the separation of State and Church.
- 13) **Education** is the key to the future. Scientific, technical teaching and training, the learning of foreign languages are all part of a balanced high quality system of education from primary schools through to the university level.
- 14) The withdrawal from the Warsaw Pact is an essential condition of Hungary's independence. In fact, the **dissolution of the Warsaw Pact** is a condition of the security of the Region.
- 15) Hungarian foreign policy will aim at contributing to a free, peaceful and liberal international order. **Upholding the rights of Hungarian minorities** living in various countries is an important and legitimate objective and a condition of good relations with neighboring countries.
- 16) Finally, the Guiding Principles also contained a presentation of the **short-, medium- and long-term policy measures** that the government envisaged adopting in the framework of its program.

4.2. The central economic issue: growth or austerity?

The unabridged draft of the speech was 36 pages long. The detailed Program completed in September 1990 was 222 pages long and contained, beside three introductory sections, 14 chapters, numerous sub-chapters and sections and an Annex. It was estimated that two thirds of the volume dealt with economic and related issues.

Already in the Guiding Principles and in Antall's presentation in parliament, economic and social issues received considerable attention. As time went by, they gained further weight in the draft and the published text of the Program of Hungary's National Renewal.

The actual drafting and the completion of the Program were carried out in the office of the Prime Minister in the impressive Hungarian parliament building. The collection of information, the analysis and synthesis of the inputs required both organizational skills and balanced judgment.

After having been confirmed in the position of Personal Adviser of the Prime Minister and a member of the Office of the Prime Minister's Advisers, the Prime Minister asked me to participate in the preparation of the volume on the government's program. He asked me in particular to oversee the first part that dealt with the economic and social issues.

In this assignment I worked especially alongside György Matolcsy, Katalin Botos and Pál Tar, all three of whom I knew from earlier meetings or projects. This was the time that I first met Gyula Kodolányi and Tamás Szabó. I developed a close working relationship with both of them and they both remained life-long friends. We also became close friends with Péter Ákos Bod who has been by now for more than three decades my closest Hungarian friend in Budapest as well as in Geneva. I also had good contacts and frequent discussions with Ferenc Rabár who was the first Minister of Finance in the Antall Government, with Béla Kádár (no relationship with the former Communist ruler János Kádár) who was Minister of External Economic Relations and with his State Secretary János Martonyi.

The detailed *Program of Hungarian National Renewal* was adopted on September 18, 1990, by the Hungarian Parliament and became the basis of the Antall government's policies on a broad range of issues for the following years.

The diversity of the issues can be illustrated by the following examples:

- 1) The dual task of balance and growth: ***“The task consists of two parts: on the one hand, seeking internal and external equilibrium, on the other hand, creating the conditions for economic growth”***.⁴⁴
- 2) The ***crisis of the Hungarian economy*** as a result of the decades of the Communist economic system.
- 3) The government's objective to help transform the Hungarian economic system into a modern European ***social market economy***.
- 4) The government's method: adopting the ***necessary rules and creating or transforming the institutions*** required for the development and functioning of the market economy, but ***avoiding an interventionist approach*** and limiting the weight of the State.
- 5) ***Rejecting a so-called “shock therapy”***, but adopting ***radical measures where necessary***.
- 6) Taking into account the high economic and social burden that families and individuals had to bear as a result of the ***Communist legacy*** (including the ***heavy external debt burden***) and of the ***initial costs of the regime change***.
- 7) The importance of ***external economic relations*** and the full participation of Hungary in ***European and worldwide economic relations***.
- 8) The encouragement of ***private initiative***, the development of the ***private sector*** and a market-oriented ***privatization*** program.

⁴⁴ *Hungary's National Renewal Program: the first three years (1990–1992) of the Republic* p. 41.

- 9) Seeking an approach for *easing the external debt burden*, but firmly *rejecting a pseudo-solution* that would destroy for many years Hungary's international credit worthiness.
- 10) Finally, a *large number of sectorial policies and measures that would help complete regime change* across the Hungarian economy and society at large. These include (this random list is far from complete) the banking and financial sector, infrastructure, telecommunications, health, research, culture, the labor market, agriculture, environmental protection, energy, transportation, housing, social policy, forint (Ft – Hungarian currency) convertibility, price system, anti-inflationary policy, etc.

4.3. Mastering the bureaucracy: a classic challenge for all new governments

In all authoritarian regimes next to the organized bodies that can and do exercise control over the population through brutal force and terror, various categories and levels of bureaucracy enjoy considerably more power than officials do under democratic regimes.

In the Communist regimes there are essentially three broad categories of bureaucracies. Normally there is a hierarchical relationship among these three groups, which at times may be completed or superseded by personal exceptions or overlapping functions. These three categories are: (1) the functionaries of the ruling Communist Party; (2) the bureaucracy that runs the enterprises, from the smallest to the largest; and (3) the officials in the traditional “public sector”. Party membership is by definition obligatory in the first group, but often, depending on the importance of the position also in the running of companies (category 2) and in sectors providing public services, such as, health, education, various municipal services etc. (category 3).

As a result, business decisions are not made by private owners and their hired managers, but by employees of the state, as a rule under the guidance and supervision of party bureaucrats. It is symptomatic for the power of this anti-economic and anti-democratic tradition of the Communist system that Rezső Nyers, one of the leading “reform” leaders of the Hungarian Communist Party, was fighting tooth and nail at the round-table negotiations discussed earlier in this chapter that the Communist Party should be allowed to maintain its organization and network within companies and have a say in management decisions. In dictatorships it is common practice for Party officials to interfere in decisions by business managers and public service officials.

*What is the relevance of these reflections for the analyses
in the current chapter?*

First of all, Prime Minister Antall knew that in all countries – and not only in those that have gone through a profound political regime change – there is an initial learning period during which the established bureaucracy tends to “test” the quality of a new administration and the ability of the newly elected government to obtain the respect of the civil servants (“the experts”) and their cooperation to implement the views and directives of the (“inexperienced”) newcomers. The distrust and testing by functionaries of the Antall government’s program were bound to be magnified by the fact that the vast majority of the Kádár era civil servants retained their jobs. While they did not necessarily maintain a Communist or Marxist persuasion, they were often frustrated by not having more power. In fact, many of them would have preferred a more radical approach to regime change and felt that the Antall Government should have opted for a “radical shock therapy”.

I would like to illustrate this issue with one minor and two major examples. The first one was a paper prepared by the Ministry of Finance on housing policy. The central recommendation of the authors was that in the name of the market economy and the price system, all rent controls and housing subsidies to families should be eliminated by one stroke. The social and political consequences of such a measure would have been self-evident: disastrous. Our team passed the test: we discovered the bug and revised the recommendation. This was relatively easy as housing markets without any forms of control or social subsidies did not exist in the highly developed market economies either, in Switzerland, Germany, the United States, Britain or Japan, to mention only a few examples.

The second and the most important issue was the controversy, between, on the one hand, Ferenc Rabár and his team in the Ministry of Finance and, on the other hand, the Prime Minister, our team in the Office of the Prime Minister, and several Members of the government, about the key question of austerity against policies encouraging and supporting economic growth. To sum up the problem: Ferenc Rabár wanted to implement an economic policy, based on the “Washington consensus”, which was the exact opposite of the economic program of the Antall government. As it was clear from his letter of resignation, he was deeply offended that he was “hampered” in carrying out his intention to implement a policy that was based on propaganda of the principal opposition party, the Free Democrats Alliance (*SzabadDemokraták Szövetsége*). It was difficult to know whether Rabár was glad or sorry to have been dismissed from the government by the end of 1990.

The third issue I want to mention in this context was the appointment of Mihály Kupa as Minister of Finance to succeed Rabár. In the end this did not prove to have been a much happier choice than that of his predecessor. Kupa was an ambitious former official of the previous regime who was convinced that he would have been a better prime minister than József Antall. He also believed that he ought to be responsible for introducing new legislation and supervising agencies in numerous areas where he had no competence. Kupa's misplaced ambitions were boosted by the anti-Antall press, which spread the fallacious belief that Kupa was the only competent expert in the cabinet. It took, however, some time before Kupa was replaced by a new minister.

4.4. Issues of communication and of substance

The *Program of Hungarian National Renewal* was a detailed, carefully balanced document. It benefitted from both extensive political and expert inputs. It provided a clear analysis of the situation, of the country and of the policies to be adopted by the government to assure the success of the regime change, and was superior to what was available under the Kádár regime (including the much quoted *Change and Reform – Fordulat és Reform*).⁴⁵

The following are the titles of the Program's 14 chapters;

- I. Economic Goals: Principal Features of Hungary's Future Economy
- II. The Situation of the Hungarian Economy and the Starting Point of the Program
- III. The Three-year Program
- IV. The Tasks and Method of Economic Policy and the Government's Schedule
- V. The Environment
- VI. Education and Research
- VII. Public Welfare
- VIII. Cultural Policy
- IX. Religion
- X. Public Administration
- XI. National Security and Defence
- XII. Foreign Policy

⁴⁵ *Change and Reform* was a 1986 study prepared by economists of the Institute of Monetary Research at the request of the Hungarian Popular Front.

XIII. The State Ruled by Law

XIV. “The First 100 Days”

Addenda

Addenda 1 Major Planned

Addenda 2 The Main Problems

The key features of the program were:

- 1) A systematic analysis of the true nature of the Communist system and of the disastrous economic and social conditions that they created. The crisis that was ultimately recognized by the Party leadership was not the result of policy errors or outside circumstances, but of the very nature of the Communist system. It was not because the spirit of the 1960's reform measures had been abandoned; rather the problem was the inability to create the conditions of a modern market economy without eliminating the system as a whole.
- 2) Thus, the second feature and logical complement to the first one was the systematic discussion of what had to be done to deal with this legacy and what the government should do to create true democracy and a social market economy.
- 3) The text deals extensively with the question of how much people were affected by the changes due to the transformation of the political, economic and social system. There would be new opportunities but also more competition and inevitably growing differences in living standards.
- 4) A new relationship between people and the State would have to be created. The increasingly widespread habit of distrust and implicit hostility had to change.
- 5) People would need to become fully aware that Hungary was a member of a new Europe consisting of free and equal democracies, members of a community from which they were excluded not by the West, but by the Soviet and Hungarian rulers. Freedom meant opportunity and security, responsibility and accountability.
- 6) Finally, the program discussed the short- and medium-term policies and measures that the government would adopt in order to make regime change successful.

Surprisingly the average voters knew relatively little about these analyses and about the complexity of the regime change. It was probably normal that relatively few people actually read the more than 200 pages of the program. What was less “normal” was that the press and the “community of experts” failed to inform the citizenship properly and truthfully what the program was about. It was clear at the time and it is even clearer today that the majority of the intellectuals could not or did not want to

change their ingrained customs. Objectivity was not part of the rules favored by the Communist leadership and it was not part of the new rulebook of the journalists and “researchers” who should have made better use of the lifting of censorship and the newly won freedom of the press.

4.5. How was the program implemented?

During the first year of the Antall Administration the government’s economic policies focussed mainly on two key objectives:

- 1) The first one was *to avoid an economic and financial breakdown* and to assure the functioning of the national economy (*a magyar gazdaság működőképességének biztosítása*). The policies adopted to achieve this goal included a faithful servicing of the country’s external debt, restrictive fiscal and monetary policies, reducing subsidies, and accelerating the adoption of regulations designed to promote the development of the market economy. The raising of the price of gasoline was part of this approach. The overall goal was achieved: there was a significant improvement both in the budget balance and in the balance of payments, and the overall international confidence in the country’s economic policies could be shored up. The need for the restrictive policies was essentially part of the legacy of the long-term and short-term policies of the Communist regime that came to an end in the spring of 1990. The cost of the legacy⁴⁶ and of the policies that had to be adopted were reflected in the decline in GDP, of household income and consumption and of investments, as well as in the rise of prices.
- 2) The second main objective was to develop the ***Program of National Renewal*** discussed in this chapter. This program’s principal aim was to define the detailed framework for the creation of a social market economy and to make the passage from a socialist economy to a market economy irreversible.

During the elaboration of the Program of National Renewal Ferenc Rabár was Minister of Finance. The final, operational version, however, was completed in February 1991 when Mihály Kupa was already the new Minister. He chose to submit the three parts of this program to the Government’s meeting of March 7 1991 under the following title: “The Program of Transformation and Development of the Hungarian Economy: Stabilization and Convertibility”.

⁴⁶ On the legacy of the Communist system see chapter 11 in this book.

The above document presents information about the evolution of the Hungarian economy up to the end of 1990 as well as projections based on the expected implementation of the government's policy package. The actual evolution and the outcome of the policy measures were discussed in a report prepared by the Ministry of Finance in July 1992 and in the 1991 Country Study for Hungary published by the OECD Secretariat in Paris.⁴⁷

According to the report of the Ministry of Finance, the shrinking of the GDP in 1991 exceeded the original expectations. This trend continued in the first half of 1992: the overall economic situation was characterized by stagnation and no significant improvement was expected during the rest of the year. Industrial production declined by 15 to 20% and there were a further drop in investments as well as in household incomes and consumption. A major factor in the continued poor economic performance was the collapse of the trade with the former Eastern Bloc countries, especially with the former Soviet Union. Among the positive developments the report stresses the importance of the country's trade in convertible currencies.

According to OECD estimates the average annual *per capita* GDP in Hungary at the time of the regime change was \$2,750 compared with an average of \$17,387 for the 24 Member countries of the OECD. All the significant economic indicators – production, consumption and living standard – continued to decline as the newly elected government was grappling with systemic distortions and the haphazard policies left as a legacy by “the most reform-minded satellite of the USSR”. Moreover, as part of this legacy, Hungary's external convertible currency debt at the end of 1990 amounted to \$21 billion or about the equivalent of 65% of the country's GDP.

One of the major issues during the period of regime change following the collapse of the Communist economic system was the question: how reliable were the assessments and policy recommendations of the international economic organizations? The authors of the OECD report mentioned above argued that Hungary had gone the furthest toward a market economy among the members of the socialist bloc. They had to admit, however, that trying to approach it, the “Hungarian model” never turned into a real market economy as long as the Communists remained in power.

Thus it was rather awkward that once free elections brought the Communist political and economic system to its well-deserved end, the central thesis of the OECD experts was increasingly restrictive in macro-economic policies, while totally ignoring the logical and material possibility of providing financial aid to help reconstruct the Hungarian economy.

⁴⁷ Pénzügyminisztérium (1992 július): *Tájékoztató az 1992. évi gazdasági folyamatokról*, Budapest; OECD (1991): *Hongrie, Etudes Economiques de l'OCDE*, Paris.

In fact, the shortcomings of the interpretation of the situation, of the policy recommendations and of the actions by the major international economic and financial international organizations became rapidly evident. For them real solidarity with the new democracies was not called for; it would have been “too expensive”. This also explains the fact that in the report on Hungary the OECD Secretariat (and the Western member countries which had to approve the contents) very little have was said about how to create the conditions of economic growth and how foreign aid could have contributed to accelerate growth and the rise of living standards.

In conclusion of the present section and chapter, I would like to mention that the lack of trust in the theories and the work of the experts of the international economic organizations was one of the principal factors that led to the creation in December 1991 of the *Economic Policy Strategy Working Group* known as *GAM* by its Hungarian abbreviation. The objectives and the work of *GAM* are discussed in chapter seven of this book.

CHAPTER FIVE

External Debt, Resource Shortage and Crisis Management

5.1. Resource shortage: the central problem of regime change

Avoiding a debt crisis – seeking foreign aid

The main reason that József Antall invited me in January 1990 to join his team as his personal economic adviser, and why I was able to integrate rapidly the Office of the Prime Minister's Advisers after the elections, was a significant convergence in our general political philosophy and agreement on some major specific issues that were important for the political and economic regime change.

The list of these issues included: the model of the social market economy, the Euro-Atlantic orientation, bank reform, privatization, the need for sustained growth and the problem of the external debt burden. In addition there was the necessity to prevent a monetary and financial breakdown, the magnitude of the resource shortage, and the need, for material and psychological reasons, to seek international financial aid to facilitate the success of the regime change. As can be seen from the Table of Contents and from the chapter overviews in the Introduction, these were subjects I had the opportunity to work on during the 1990–1993 period.

The 1970s were marked by high inflation rates and low nominal and real interest rates across the world economy. Because of the recession and the worsening terms of trade for the oil-importing countries, there was also an impressive growth of international sovereign and private sector borrowing by developing and COMECON countries. The emergence and expansion of the new Euro-currency markets greatly stimulated international banking activity and the accumulation of international debt. All these developments were linked to the sharp decline of the exchange rate of the dollar, the currency in which the bulk of the newly created assets and liabilities were denominated. The high inflation in the United States and the loss of much of the external value of the world's leading reserve and trading currency shook the confidence of official and business circles in the stability and the future of the American economy.

The realization of the dangers inherent in inflation and the risk of a stock market collapse induced the US President Jimmy Carter to seek a solution through the Federal

Reserve. This solution was named after Paul Volcker whom the President nominated to the post of Chairman with a mandate to fight inflation. Volcker was confirmed as Chairman in August 1979 and under his leadership the Fed adopted a policy of extreme monetary tightness that brought the Fed funds rate and the prime rate to over 20%. The “Volcker shock” broke inflation and inflationary expectations. The price was a sharp recession with widespread unemployment and credit defaults and bankruptcies. The monetary rigor and the recession reversed the downward slide of the dollar. Soon, from an increasingly undervalued currency, the US dollar became progressively overvalued. This in turn depressed US exports and stimulated American imports, in particular from Japan and Germany.

The effect that was especially relevant for the theme of this chapter was the impact on the international banking situation. This impact was the “international debt crisis”. The sharp rise of the dollar and of interest rates enormously increased the burden of the debt accumulated so far, and made the incurring of new debts increasingly difficult and prohibitively expensive. The inevitable rolling over of interest payments and of the principals due led to a snowball effect that was dangerous for both the banks and for their debtors. The *debt crisis* threatened to become a major *international banking crisis*.

As usual, lenders and the creditors shared the responsibility for the excess borrowing and lending. Officials and experts in the major OECD countries and in the international financial institutions had encouraged the banking community to “recycle” the windfall profits of the OPEC countries to the developing countries and the COMECON region in order to avoid a financial contraction. “Selling loans” even to over-indebted sovereign and private borrowers became an accepted practice in the leading international banks.

Once the debt crisis started the main concern of the international community was “to save the banks” and to avoid a domino effect of bad debts on the balance sheets of the leading international banks. The correct solution from a banking and an ethical position would have been a sharing of the burden of dealing with the crisis between the banks and the debtors, between the taxpayers in the OECD countries and those in the developing nations. Yet, the solution advocated and largely implemented essentially shifted the weight of the correction on the excess borrowers and left the excess lenders largely off the hook.

The principal elements of the approach were the following: (1) strongly discouraging the borrowers from declaring their intention of non-payment; (2) rescheduling the debts with extensive roll-over provisions; (3) sharp monetary and fiscal tightening in the debtor countries; and (4) the adoption of radical “structural adjustment programs” that would turn the debtors into “dynamic exporter market economies” from “import-

dependent” state-controlled economies that had followed the long-term development models promoted by the World Bank and the IMF.

The results were a severe slowdown in growth or recessions and worsening social conditions, and growing anti-Western feelings in the countries that adopted the new policy packages advocated by the neo-orthodoxy of the “Washington consensus”.

As a heavily indebted country, Hungary did not escape a wide range of the problems connected with the heavy debt burden that it had accumulated in the 1970s and 1980s. In fact, the debt issue and the need to avoid a financial and monetary collapse were at the top of the new Antall government’s agenda. Thus, the management of the debt problem was one of the topics I discussed most frequently with the Prime Minister and on which I submitted analyses and suggestions to him. A closely related issue was the question of international financial aid needed to help the process of reconstruction. Our discussions and my memoranda usually treated these two convergent problems simultaneously.

Confidential topics and policy proposals.

During the Antall years there were recurring accusations in the ranks of the opposition and in the media that Antall neglected the debt issue and the possibility of foreign financial aid for Hungary. These misrepresentations, which continue to circulate even today, included the outright fabrication that the Antall government had been offered a significant debt reduction but out of pride refused the offer (!).

While for obvious reasons discussions about the debt issue and requests for aid were strictly confidential, the Prime Minister and the members of his team, including myself, never failed to raise the problem in discussions with foreign officials. I would like to mention here two examples to show how much the accusations of passivity were baseless.

In late October 1990, after the Taxi strike,⁴⁸ we submitted to Otto Schlecht, the German State Secretary for Economics, during his emergency visit to Hungary a

⁴⁸ “In the evening of October 23, 1990, Prime Minister József Antall entered a hospital, where he underwent surgery the following day. At the same time taxi drivers and truck drivers blocked the main transport routes in protest against the increase of gasoline prices, paralysing the whole country for several days. Some opposition groups attempted to take advantage of the crisis in order to topple the government. On the evening of October 28 the Council of Interest Groups representing workers, employers and the government agreed on a compromise solution terminating the nationwide protest. The Prime Minister, following several days of negotiations with members of his government and foreign government heads from his hospital bed, spoke to the nation in an interview transmitted in the evening of October 28 on Hungarian television.” Antall, József (2008): “The “pyjama interview on October 28, 1990” in *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, Edited by Géza Jeszenszky, József Antall Foundation, Budapest, p. 155.

request for a German direct aid of the order of \$3 billion. This was ignored by the Germans. Several years later Schlecht admitted that a favorable response by the Federal Republic would have been a politically intelligent and useful decision.

In May 1991, prior to the annual summit of the members of the G7, a letter of request, with an annex (in German, French and English) explaining the rationale for a direct aid to Hungary by the leading OECD countries, was signed by Prime Minister Antall and was delivered directly to the participating heads of government. No positive reaction this time either.

Capital shortage

It is generally recognized that the new market economies that emerged from the Soviet-type planned economies three decades ago, each of them individually and as a group, suffered during their regime change from a large-scale capital shortage. This capital shortage was the result of a continuation of the wasteful spending habits and of the wasteful management of new and existing capital, and of the inability to substitute voluntary savings for the forced savings obtained under the authoritarian or totalitarian political and economic systems in the past. However, in order to understand the difficulties of the transition process and the challenge of “international financial integration”, it is important to realize that new additional sources and new characteristics of the “capital shortage” appeared in these countries.

The following were some of the principal sources of the “new type” of resource shortage in the former socialist economies. The first major source had to do with the *financial inheritance* from the past. The weight of the foreign debt and of the debt service of several countries was most often mentioned under this heading. Hungary and Poland were the best-known examples, but Russia and other CIS countries also suffered from this problem. The “marketization” of inherited domestic obligations by the state, by companies and banks and by households also falls into this category. Also we must not forget the massive largely illegal capital exports from some of these countries, which belong to the murky political inheritance of the former socialist regimes. The so-called “Russian financial crisis” was the single most dramatic illustration of this phenomenon and a major factor in the failure of the Russian Federation to build a stable liberal market economy.

A second major source of the capital shortage had to do with the widespread depreciation (or even total loss of value) of tangible and intangible assets in the process of systemic change. The loss of external and of domestic markets and the sudden opening of borders to new, efficient competition were important, although not the only, factors responsible for this general phenomenon. The sharp drop in output and

the deep recession that followed the collapse of the socialist system in Central Europe and in the countries of the former Soviet Union had multiple causes. The systemic causes and frictional causes inherent in any radical change in economic systems and structures were amplified by restrictive fiscal and monetary policies aimed at achieving domestic and external macro-economic equilibrium. All these factors led to a general shrinking of private and public revenues of an order of magnitude that the Western economies had not known since the Great Depression. This pressure on the revenue side was responsible not only for the difficulties of controlling public budgets but also for the insufficient potential base for private savings.

An additional major source of capital shortage was the widespread and urgent need for reconstruction. Here we can leave aside the reconstruction problems of the countries and regions that were devastated by war, such as the members of former Yugoslavia. Even without war, the “transition economies” (including the leading new market economies that accomplished a peaceful transition to political democracy) suffered from major reconstruction problems as a result of the neglectful management of capital assets (including the environment) under the socialist system and the recent asset depreciation and destruction of productive and infrastructure assets.. Students of economic history know that after the Second World War the reconstruction needs of productive and infrastructure assets of some of the Western European countries were not as severe as those of the former socialist countries at the time of the regime change.

Finally, new private and public spending needs due to the transition process itself amplified the capital shortage. Five factors may be mentioned to illustrate this general problem: 1) the cost of unemployment and other transfers to avoid a marginalization of large segments of society; 2) the higher cost of “marketization” of social and other services; 3) the cost of modernization of productive resources (both machinery and human resources) to meet the increased competitive pressures of an open market economy; 4) the higher acquisition and replacement cost of admittedly higher quality durable assets; 5) the higher environmental protection costs.

Capital markets and the dimensions of the resource shortage in the transition economies

The collapse of the Communist system created in principle the political and economic conditions for the development of modern market economies. At the same time, the process of transformation was accompanied by a severe recession throughout the former COMECON countries. The deep recession increased the need for foreign capital. However, it also acted as a brake on capital imports. As was evident in the case

of China, there was a close connection between the rate of macro-economic growth and the growth of markets, and the attractiveness of a country for foreign capital. This was true for both direct investments and for medium- and long-term credits. One of the key manifestations of the resource shortage in the COMECON countries was the cumulative shrinkage of total output. The decline in output and income exacerbated the fiscal problems inherent in the transition from a socialist to a market economy, and increased the pressures in favor of restrictive macro-policies, thereby retarding the recovery.

In the Czech Republic, Hungary and Poland the decline in GDP between 1989 and 1994 averaged between 70% and almost 100% of one year's total output (depending also whether 1989 or 1994 is taken as a yardstick).⁴⁹ In the case of Bulgaria the loss of output and income during the five-year period was well above the equivalent of a year's GDP. For the four countries as a group, the decline in resources resulting from the shrinkage of the Gross Domestic Product was of the order of \$150 billion, or more than two and a half times the gross foreign capital inflow to the Eastern European countries as a group during the same period.

The decline in recorded production was even more dramatic in the Russian Federation and in the CIS countries as a group. For these countries the volume of 1994 GDP was estimated at little over 50% of the 1990 level. The estimated aggregate loss of output during the four-year period 1990-1994 ranged between 120% and 240% of one year's GDP, depending on whether it was compared to the 1990 or the 1994 level.

Transition and capital markets: less than satisfactory results

The transformation of the former centrally planned economies into dynamic modern market economies represented one of the largest political and economic challenges and opportunities of modern economic history. Thus, these countries should also have provided potentially great rewards for long-term foreign investments. The progress of integration into the international capital markets was closely connected with the development of a domestic capital market. The obstacles to foreign lending or investments were often the same as that which hampered domestic investments and lending. The role of foreign capital and foreign investors in the transformation of the former centrally planned economies is one of the issues that received the closest attention, both in the "new market economies" and in the OECD countries. There was

⁴⁹ See OECD Economic Surveys: *Hungary, 1991*. OECD Centre for Cooperation with the Economies, Paris, and OECD Economic Surveys: *Hungary, 1995*. OECD Centre for Cooperation with the Economies, Paris.

widespread debate about the role of foreign capital and about the conditions that were required to attract foreign capital.

From the start, the general principle followed by both Western governments and by the conventional wisdom of academics, newspaper commentators and other experts was that private capital markets have to be the principal source of foreign capital for the “new market economies”. At best, official organizations, national governments or international organizations were to provide loans, but no substantial grants or resource transfers.

Thus, with the major exception of the former East Germany, there was no significant official Western resource transfer to ease the burden of systemic transformation and of reconstruction in the former centrally planned economies. This was also true for handling the issue of the “external debts” inherited from the previous Communist regimes. No concerted initiative was undertaken to deal with the debt problem of countries like Poland and Hungary *ex ante*. The debt rescheduling in the case of Poland occurred on the initiative of the Polish government, with all the negative connotations attached to these negotiations. The lack of official grant-assistance diminished the efficiency of private capital as well.⁵⁰

On the whole, international financial integration played a positive role in the transformation of the former centrally planned economies into market economies. The results of this integration, however, were less satisfactory, both from a quantitative and a qualitative point of view, than had been expected at the beginning of the process of transformation. The reasons for this disappointing situation were to be sought in both the conditions in the new market economies and in the functioning of the international financial system.

5.2. The magnitude and nature of the Hungarian debt

The external debt of the socialist countries

During the 1970s and 1980s most of the socialist countries accumulated a considerable volume of foreign (“sovereign”) debt. The credits in the 1970s were incurred largely in connection with imports from the OECD countries, whose efforts in actively

⁵⁰ There was a difference in the pre-history of the debt issue of the People’s Republic of Hungary and the Polish People’s Republic. The latter declared default notifying the Club de Paris in 1981, starting a long series of restructuring negotiations; they also notified the London Club of creditors. Communist Hungary managed to join the International Monetary Fund and the World Bank in 1981, avoiding default and remained under the tutelage of the IMF throughout the years.

promoting Western exports towards socialist countries were stimulated by the recession in the world economy.

As discussed earlier in this chapter, the low and even negative real interest rates stimulated the willingness to borrow (as was also the case in many developing countries). The apparent creditworthiness of the socialist countries was bolstered in the eyes of the Western governments and bankers by the Soviet Union's impressive oil and gas exports and reserves, the relative price of which was expected to continue to rise. The fact that in most cases foreign borrowing did not contribute to a substantial improvement of the borrowing countries' economic efficiency went largely unnoticed by both borrowers and lenders. Foreign capital was used in the same wasteful manner as domestic savings.

The early 1980s brought a watershed in the external financial situation of the socialist countries. The sharp rise in nominal and real interest rates greatly increased the cost of servicing the outstanding debt and of new credits. In the 1980s the external debt of the socialist countries continued to show an impressive rise: however, the growth of external indebtedness of the socialist countries in the 1980s was to a large extent due to the capitalization of the interest charges on the outstanding debt, rather than to fresh trade credits. In fact, the socialist countries found it increasingly difficult to meet their debt service obligations. At the same time, as a result of the rapid structural and technological changes in the world economy, the competitive position of the socialist countries was rapidly deteriorating. The issue of external indebtedness, accumulated during the 1970s and 1980s, was an important issue at the time of the collapse of the Communist system. It remained a major source of concern after the regime change not only in Hungary but also in several other former socialist countries.

The case of Poland

Poland was among the countries that chose, or were forced, to declare a moratorium and to ask for a reduction of its outstanding debt. The large share of government credits in the country's external debt facilitated the negotiations with Poland. The country's reserve and balance-of-payments situation seemed to have forced the Polish government to ask for a moratorium on the debt service and a reduction in the outstanding debt. The hyper-inflation inherited from the last Communist-led government and the monetary stabilization which had to be adopted to deal with the macro-economic crisis left little other choice to the new Polish government.

The complex and prolonged negotiations led in fact to a medium-term reduction in Poland's debt service payments and to cancelling part of the principal. In addition to the short-term and long-term effective reduction of the debt burden, the Polish government

seemed to benefit from the political and psychological advantage of having obtained a major concession from its Western governmental and private creditors. At least initially, this raised the political acceptance of the so-called macro-economic shock therapy pursued by the Polish government.

Yet, despite the concessions, the external debt and the debt service obligations remained a major long-term constraint for the Polish economy. Also, the moratorium and the protracted debt negotiations had a negative impact, at least in the medium term, on the credit rating of Poland, as well as on the very limited direct investment inflow during the first four or five years following the establishment of the first democratic government.

There were essentially two reasons for this. The first one was the loss of confidence of potential investors. In fact, at the “micro-level” (i.e. the level of individual investors and at the enterprise level) the original assessment of the Polish process of transformation was much less favorable than the assessment of those heralding the virtues of macro-economic shock therapy in Poland. That the balance-of-payments constraint resulting from the debt service requirements appeared to be at least temporarily eased may have been at least partly responsible for the slower pace adopted in Poland at the level of micro-economic transformation and also for not having followed, at least at the start, a consequent market-oriented approach to privatization.

The case of Hungary

The new Hungarian government, elected in the spring of 1990, adopted a different policy on the country’s heavy external debt. It made a strong and explicit commitment to meticulously service and repay the large foreign debt accumulated during the preceding 20 years of the Communist regime.

At the time of the swearing in of the new government the country was facing a serious financial crisis: foreign exchange reserves fell to a very low point as a result of both a large current account deficit and because foreign creditors and investors feared that the Antall government was going to declare a moratorium and adopt severe exchange controls.

The government’s policy was motivated by the following considerations:

- 1) the determination to avoid a domestic and external financial crisis,
- 2) the belief that a debt crisis would severely, and for a long time to come, damage Hungary’s external creditworthiness and also keep out foreign direct investments,

- 3) that whatever could be obtained from a moratorium or a partial debt forgiveness would not solve the entire debt problem,
- 4) that the continued access to international financial markets would compensate for the continued heavy debt burden.

Table 5.1. Total (Gross) External Debt (Million US \$)

	1987	1989	1994
1.Bulgaria	7404	9414	9880
2.Czech Rep.	5504(1)	5968	9210
3.Hungary	19584	20390	28521
4.Poland	39249	41387	41507
5. Above 4	71741	92541	89118
6.China	35521	47004	100500

Source: JP Morgan, (1): 1988.

Table 5.2. Net External Debt 1990–1994 (end of period) (Million US\$)

	1990	1991	1994
1. Bulgaria	10400	11500	10000
2. Czech Republic	4000	7000	3100
3. Hungary	20200	18700	21800
4. Poland	44000	44800	35900
5. Above 4	78600	82000	70800
6. Eastern Europe	86300	82000	79400
7. Russian Federation	58200	66500	87000

Source: UN Economic Commission for Europe: *Economic Survey of Europe in 1994–95*.

At the same time, the government made a series of (largely unheeded) efforts to obtain at least a limited direct assistance from the OECD countries in the form of a non-debt creating official resource transfer.

Discussions with Prime Minister Antall and proposals for action

In 1990 and 1991 Prime Minister Antall and I had several discussions about the Hungarian debt problem. I also prepared various analyses and suggestions for his attention on this subject. Sometimes these discussions also included my colleagues, such as Pál Tar, Gyula Kodolányi and Péter Bod.

The following are excerpts from a memorandum I prepared for Prime Minister Antall in early 1991 under the title ***“The need for a concerted financial initiative in favor of the Hungarian economy”***.

“There are strong political, economic and financial arguments for a concerted medium-term financial aid by Western governments to increase the chances of success of the market economy in Hungary... Great efforts have been made and considerable results have been achieved in the last 12 months by the Hungarian economy. Hungary has made serious efforts to speed up development of the market economy and to achieve external and domestic financial equilibrium. Significant results have been achieved in a number of areas, such as privatization (proportionately, a larger number of companies have been privatized than in the former East Germany), the creation of new companies, the liberalization of markets, the elimination of subsidies and the reduction of the government’s deficit (the year 1990 closed with a small surplus), attracting foreign investments, completing the legal and institutional framework necessary for the market economy. One of the most remarkable results has been the surge in exports to OECD markets and the achievement, for the first time, of a balance-of-payments surplus even after full interest payments on Hungary’s foreign debt.

Yet, despite the remarkable results obtained so far, both political and social stability and the success of the market economy may be threatened by the continued considerable strain on resources. This shortage of resources is not the result of excess spending, but of the burden of the inheritance from the Communist system (such as the large external debt) and from the one-time costs of the change in economic systems.

The success of the transformation of the Hungarian economy remains of key importance for the economic and political stability of East-Central Europe. So far Hungary has gone the furthest in creating a functioning market economy in East-Central Europe. Also, through strict financial discipline, on the one hand, and through liberalization and privatization, on the other hand, during the last 12 months Hungary has managed not only to avoid a domestic and external financial crisis but also to attract foreign investors and to stimulate private initiative and the creation of new enterprises.

Foreign businessmen and other experts still attribute the highest chances of success to Hungary in the region for creating a dynamic market economy. Also, should the

Hungarian experience fail, as a result of the cumulated impact of the lack of resources and of new and inherited problems, this could have a strong destabilizing impact throughout the region and greatly increase opposition to the market economy.

The political, financial and economic burden of the external debt represents a major constraint for Hungarian economic policy. The annual interest payments represent more than 6% of GDP and the total annual debt service is in excess of 15% of GDP, a heavy burden especially at a time of shrinking production levels. Also, in order to maintain the confidence of the international financial community, the country has to pursue exceedingly restrictive fiscal and monetary policies, which lead to sharp cutbacks not only in consumption but also in the investments necessary to complete the country's economic transformation and to ensure future economic recovery and growth.

The debt is a politically sensitive issue. While experts rightly maintain that defaulting on the debt or on the interest payments would provoke a far-reaching crisis in Hungary's external economic relations, it is also argued that the debt represents a heavy burden inherited from the Communist economic system and that much of the debt itself is the result of the accumulated interest charges which had not been paid by the previous regime.

For economic as well as political reasons, Hungary cannot afford an open debt crisis. A unilateral Hungarian request or initiative for debt reduction or rescheduling would have a much more profound destabilizing effect than the recent debt reduction talks with Poland.

- a) Poland had stopped servicing its foreign debt still under the Communist government: Poland had gone *de facto* bankrupt under the Communist government. In the case of Hungary it would be the democratically elected government that would default. Also, a unilateral default on servicing the debt would be seen both at home and abroad as the failure of the market economy.
- b) The overwhelming portion of the Hungarian external debt is owed to commercial banks and a large number of foreign bond holders. Unlike in the case of Poland, the bulk of Hungarian external debt is held by a large number of commercial banks and other private investors. A unilateral action by Hungary would destroy the confidence of private financial markets in Hungary at the very time when this confidence is an indispensable factor for the development of private initiative and for the successful economic and financial integration of Hungary in the world economy.

Also, Hungary would be in no position to achieve a negotiated settlement on its own with its numerous private creditors. A unilateral Hungarian request for such

negotiations would be interpreted already as an intention not to honor the debt and would lead to an open financial crisis. Although Hungary is in a much better economic and financial condition than Poland, Hungary also needs external financial assistance to assure the success of the market economy.

It is obvious that domestic savings and foreign private capital alone cannot carry the full burden during the start-up phase of the market economy, and Hungary needs additional external financial resources. It is important, however, that this should not lead to a further increase in the country's debt burden. While the vigorous privatization program in progress is primarily aimed at attracting foreign capital, it would be poor economic policy to use the receipts from the sale of productive assets to pay interest on outstanding debt. Thus, there is a strong case for a medium-term program of direct financial aid to Hungary as a contribution to the one-time costs of the transformation of the Hungarian economy.

Such an aid, to be provided within the framework of a closely supervised program over a period of two to three years, would not increase the country's debt burden. It would be a powerful instrument to demonstrate the solidarity of the Western world with Hungary's pioneering efforts to create a market economy while avoiding a complete financial breakdown. If properly used it would help create the basis for sustained economic growth, which again would have an important domestic and external demonstration effect, while reducing the need for future economic assistance. Such a limited aid program would also show the Hungarian population that there is no political and financial penalty attached to the efforts of trying to avoid bankruptcy and financial chaos.

The bulk of this aid ought to come from the governments of Hungary's leading creditor countries, i.e. Germany and Japan. The United States, however, would also have to play an important political role, not only in accepting the rationale and necessity of such an approach, but also in convincing its partners of the need for such a program in the name of allied burden sharing.

As in the case of Poland where the governments took the initiative and have accepted a large financial burden, it would be also appropriate for the Western governments to provide direct financial aid (on an admittedly smaller scale) to help finance the costs of transition that cannot be carried by the private sector. It can be assumed that once such a direct aid program is set in place, it would be possible for Hungary to obtain, with the political backing of the Western governments, a similar easing of the debt burden from its private creditors without provoking a major financial crisis.

Better *ex ante* than *ex post*: providing the aid before the heavy burden imposed by the lack of growth, due to the strain on the country's financial resources, leads to an open political or financial crisis makes much better economic and political sense

than to wait for such a crisis. In the case of Poland the Western Governments did not have this option: the financial breakdown occurred before the end of the Communist political and economic system.

The direct aid, which would sufficiently ease the resource constraint in order to create the basis for sustained economic growth, can be estimated at around \$2 to \$3 billion spread over a period of two to three years. Close monitoring: the objective would be to use the resources for programs agreed in advance. These would have to combine the following characteristics: (a) neither private nor public resources would be available to finance them, and (b) they would ease the development and the political and social acceptance of the market economy, and would help create the basis for future economic growth.”

5.3. Antall's refusal to default on the external debt: a correct decision

The development of an alternative approach

There can be no doubt that Antall's decision to take determined measures to avoid default on Hungary's external debt was correct. Rejecting the default option did not mean, however, that the government remained passive with respect to this crucial problem. The alternative approach adopted by the Prime Minister was a major attempt to obtain direct financial aid from the G7 countries.

The following text is the *English translation from Hungarian of the Memorandum that I prepared for Prime Minister Antall at the end of May 1991* on the concept for an international aid program in favor of Hungary. The conclusion of this text contained the suggestion to directly deliver a letter and annex to the members of the Group of Seven (G7) prior to their annual summit meeting.

“STRICTLY CONFIDENTIAL

MAIN ELEMENTS OF A CONCEPT FOR AN INTERNATIONAL FINANCIAL SUPPORT PROGRAM IN FAVOR OF HUNGARY

(Second version)

Hieronymi Otto

May 27, 1991

Shortage of resources and need for international financial support

1. Hungary suffers from a serious lack of resources. This does not appear in the country's financial balance sheet, but in the area of spending necessary for the success of the regime change (especially in the investments required for the modernization of infrastructure and production equipment) and will be felt more and more in the coming years.

2. To create the conditions for sustained growth, the country needs relatively limited official financial support from the West.

3. It is not recommended to declare bankruptcy to private creditors, but to seek agreement on a relatively modest interstate aid package. The dimensions of the necessary support in question are much smaller in magnitude than, for example, debt relief of Poland.

Aid programs by the "24s" (OECD countries): global and individual (case-by-case) approach

4. The help by the "24" has two main characteristics:

- (a) the need for unique approach by each beneficiary (every country has a different situation and different opportunities),
- (b) in all countries the transformation has common or similar features and costs.

5. It is in the interest of both the Group of 24 and the countries of the region to maintain a balance between global and individual solutions and support.

Loans and direct support

6. One of the basic principles of the support concept of the "24" decided in the summer of 1989 was that the financial support should mainly take the form of loans.

7. This decision, which differed from the post-war reconstruction program, was motivated by the following reasons:

- (a) two years ago, the political transformation was not yet certain, neither in the case of Hungary nor Poland; there was no mention of Germany yet,
- (b) it seemed politically easier to accept the concept of loans.

The need for both loans and direct support

8. The current fundamental transformation (economic system change) must be compared to the reconstruction of a country and not to the problem of economic development.

9. It is not possible to finance all the costs of reconstruction and economic system change only with loans and private capital. This was proven after the First and Second World Wars.

10. Direct financial aid, if used well, leads to a relatively quick recovery.

De facto recognition of the need for direct aid

11. The German example and the Polish example show that the need for direct aid has gained recognition in terms of economic policy.

12. In the case of Poland this is *ex post*, in the case of Germany *ex ante*.

A lesson for Hungary

13. In the case of Hungary this practically means the following:

- (a) ***The lack of resources can endanger the success of the transformation in Hungary.*** The political and economic dangers arising from the lack of resources should not be underestimated in the case of Hungary either. This lack of resources cannot be compensated solely by foreign private capital, state loans and economic restrictions.
- (b) ***A comprehensive support concept tailored to Hungarian conditions is needed.*** Hungary also needs a comprehensive support package plan, which differs not only from the German program, but also from that of Poland in terms of its concept, size (smaller) and means (not primarily debt relief), also from the financial support provided.

Lack of resources and one-time costs of economic transformation

14. Hungary suffers from a serious lack of resources. If the current development continues, the Hungarian economy will suffer from a serious lack of resources in the next two to three years. This lack of funds will not appear primarily in the financial balance, but in the field of modernization and investments.

This lack of funds cannot be bridged by private capital or loans alone

15. ***The lack of funds is not the result of a wasteful economic policy by the current government.*** During the past year the fiscal and monetary policy of the Hungarian government was extremely strict. This policy will continue in the coming years. The population's savings rate and personal taxation are also high, and the lack of resources is by no means the result of excessive consumer consumption.

16. ***There are two reasons for the lack of resources.*** The lack of resources is closely related to the economic transition. There are two reasons for the current and expected lack of funds:

- (a) one part, the shrinking of the resources available to cover domestic needs;
- (b) another part, the urgent (one-time) surplus necessary for the success of the transformation.

17. *The magnitude of the transition costs and the lack of resources.* The attached table shows a summary and preliminary estimate of the order of magnitude of the lack of resources that the Hungarian economy has to reckon with in the period 1991-94 (provided the external conditions do not deteriorate further).

Lack of resources and the costs of economic transition: 1991–1994

A. Loss of resources:

- (a) decrease in domestic production: HUF 150 billion,
- (b) monetary and financial imbalance: HUF 120 billion.

Loss of internal resources: HUF 270 billion.

B. Increase in resource requirements:

- (c) infrastructure: HUF 120 billion,
- (d) industry and structural policy: HUF 100 billion,
- (e) international reserves: HUF 120 billion.

Additional resources required: HUF 340 billion.

C. total (A+B): HUF 610 billion.

(total approx. US\$ 8 billion)

(D. Reminder: withdrawal of funds by the foreign interest service: HUF 450 billion)

(interest service approx. US\$ 6 billion.)

(C+D: approx. 1060 billion HUF, approx. 14 billion US\$)

These figures do not take into account possible debt repayments or loan renewals, which are an additional US\$ 10 billion.

18. *What do these numbers mean?* As mentioned above, the lack of funds has two main components.

(a) **Resource loss.** Resource loss has two main aspects. One part is the decrease in domestic production, the other part is the transfer of resources through the financial balance (one part of this is a consequence of the deterioration of the exchange rates, the other part was a necessary correction of the external deficit). Some of the resource loss has already occurred (meaning a lower starting point), but even according to

optimistic estimates, it will continue. If a larger Soviet trade collapse would occur than is estimated in the government's program, the shrinking of funds (resources) could be much more severe.

(b) **Increased need for funds.** The increased need for funds refers to expenses related to the transition to a market economy, market change and the international liberalization of the economy and the gradual convertibility of the HUF. We are talking about funding needs that cannot be financed by private capital.

(c) **Infrastructure.** The government's policy aims at the maximum involvement of private capital also in the field of infrastructure (concessions). However, international experience (including the United States) shows that infrastructure cannot be financed exclusively by private risk capital. The above estimate is the non-private capital-financed part of infrastructure expenditures, which are absolutely necessary for economic growth and the international competitiveness of the Hungarian economy. They also include, for example, part of the costs arising from the necessary conversion of the energy system.

(d) **Industrial and structural policy.** Every modern economy needs an active industrial and structural policy. This can be found under different names even in the most liberal market economies. The purpose of these policies is not to replace the market, but to facilitate and enable its operation. During the period of reconstruction and economic system change these policies play a particularly important role. The most obvious example of this is Germany (not only now, but also during the 40 years before German reunification).

The above-mentioned amount would only enable the financing of an (in international comparisons very modest and at the same time extremely prudent) industrial and structural policy in Hungary. In the absence of resources of this magnitude the reduction in production and the loss of resources would be much larger than the above estimate.

(e) **Formation of international reserves.** Increasing foreign trade, liberalization and the gradual introduction of convertibility make it necessary to increase international reserves. This is not a direct expenditure, but it also means a withdrawal of resources.

19. The above are relatively optimistic estimates, the above numbers are global estimates that can (and should) be determined more precisely. Most objective experts would agree that these numbers are based on relatively optimistic assumptions.

If the absorptive capacity of the Soviet market decreases even more strongly than assumed and Hungarian goods and services encounter trade barriers on the Western markets (e.g. agricultural, metallurgical and textile products), then these figures should really be treated as too optimistic.

20. *Under what conditions can the resource problems be solved?* The main conditions for solving the source problem are as follows:

(a) *an ex ante financial support* for a part of the resource deficit in a form that does not increase the country's foreign debt;

(b) *avoiding a financial crisis* (bankruptcy), which would make the funding problem much more serious;

(c) *avoiding an increase in monetary and budget restrictions* (which does not exclude the deduction or reorganization of the budget amount);

(d) *consistent use of existing resources* (including foreign aid) *for the sake of modernization* and creating the conditions for growth.

21. *The magnitude of the necessary support.* The coverage of the loss of funds or the additional need for funds in the next three years (practically in 1992–1994) could be as follows:

(a) OECD countries direct support of US\$3 billion

(b) OECD financial safety net US\$1 billion (reserve)

A. OECD support (a+b) US\$4 billion

(c) privatization proceeds US\$2 billion

(d) internal restructuring of US\$2 billion

B. Hungarian property and source realignment US\$4 billion

A+B US\$8 billion

Debt policy and support concept

22. In the medium and long term, Hungary's solvency cannot be maintained without the success of the transformation towards a market economy, the modernization of the Hungarian economy and sustained economic growth. In the long term, without economic success and sustained growth, Hungary will not be able to, even at the cost of serious social sacrifices, fully fulfil its debt service. In a stagnant economy a financial crisis will sooner or later become inevitable. The burdens of the transformation and the provision of the foundations for growth cannot be covered only by loans or the import of private capital.

23. *Use of support.* The main purpose of the support is to stop shrinkage, boost growth and modernization. Main areas of use:

(a) production infrastructure;

(b) preventing the collapse of a part of Hungarian industry and promoting its competitiveness, combined with privatization.

24. For the success of the social market economy (and ultimately to ensure the internal stability of the country) a broad consensus is needed that the economic difficulties are not the consequences of Western democracy and that it is worth

working persistently for a credible debt policy. It is necessary for the public to know that the government will do everything to win maximum foreign support without sinking the country into a financial crisis, and at the same time to ensure that creditors know that they too have a direct interest in the recovery of the Hungarian economy.

26. It is in the common interest of Hungary and the creditors to jointly put the Hungarian debt policy on a more solid foundation. Despite the fact that Hungary is a good debtor and tries to meet its obligations, the country is also exposed to the natural mistrust of creditors and the fluctuations of the international financial situation. The positive side of this situation is that it forces the debtor country to exercise a certain “self-discipline”. However, practice shows that without guarantees and an equalization mechanism, the economic restrictions adopted in order to appease the creditors are much stricter than they should be and thus can lead to stagnation and ultimately insolvency. In other words, without a medium- and long-term debt management mechanism, there is a danger that debt and financial liquidity will remain the “sword of Damocles” of Hungarian economic policy, thereby making long-term growth impossible.

Favorable moment

27. Why the time is favorable? Both international developments and the situation of the Hungarian economy (problems and results) show that the current time is favorable for the development of a more active debt policy concept.

(a) International situation:

- the Polish debt reduction created a new precedent, which can and should be used now;
- the Gulf War is over, but the long-term costs of reconstruction are not yet felt in the financial markets;
- the high costs of the German economic transition are obvious and today no one believes that the transition to a market economy can be financed with private capital or loans alone, without external support;
- there is serious concern in leading Western circles about the deterioration of the political and economic situation in the entire Central and Eastern European region.

(b) Hungarian economic and political situation:

- the results of the balance of payments show that the Hungarian government takes economic discipline seriously;
- despite all reports to the contrary, experts are convinced that Hungary has reached the furthest point on the road to a market economy;

- at the same time, it is obvious that savings and foreign private capital cannot fully finance the costs of the transition and the success of the market economy in Hungary either;
- in addition, the necessary resources are an order of magnitude smaller not only than in Germany, but also, of course, in the Polish situation; as a result, a Hungarian economic and political crisis (internal crisis or external financial crisis), which would have serious negative consequences for the entire region, can be avoided at a relatively low cost.

Form and use of support

28. Form of support. The form of support must coordinate two aspects:

- (a) do not increase Hungary's foreign debt;
- (b) take into account the domestic policy requirements of the OECD countries (Germany, France, Japan).

29. Support could include, for example:

- (a) purchase of Soviet debt (\$1.5–2.0),
- (b) share packages or discounted (possibly interest-free) bonds in infrastructure investments,
- (c) interest payment insurance or “zero coupon bonds” paid by Western states,
- (d) conversion of loans stimulating private initiative or to share purchase or direct support package plans.

Hieronymi Otto

The following approach should be followed

1. A letter and memorandum from the Prime Minister to the seven heads of state and government during the weeks prior to the summit. At the summit it is also important to briefly discuss the situation of the countries in the region.

- Two years have passed since 1989, what are the results, what are the difficulties.
- It would be politically and economically wrong if the request of financial support for Hungary were seen as a closed chapter (i.e. it would not be discussed and approved at the summit). The situation of the Soviet Union and the countries of the region shows how important is the success of the Hungarian transformation.
- It is absolutely necessary to avoid a debt crisis.

2. Practical implementation:

- to send out information confidentially that a letter by the Prime Minister will be sent next week,
- preparation of a letter that will be signed by the Prime Minister, and a short appendix.
- Gyula Kodolányi (KGy), Otto Hieronymi (HO), György Osváth (OGy), Pál Tar (TP) will hand over the memorandum and explain the Prime Minister's position in the second half of June."

5.4. No easing of the debt burden: the political incompetence and indifference of the OECD countries

The debt problem was compounded by the virtually total absence of public non-debt-creating transfers (grants) from the OECD countries to assist the reconstruction process in the former Communist countries. Such grants were expected especially in the Central European countries that had played a significant role in the collapse of the Communist system. There had been repeated calls for such transfers also in the OECD countries. That the concept was not totally without realism (or economic merit) is demonstrated by the massive grants provided to East Germany, which during the 1990–1995 amounted to almost \$27,000 for each of the citizens of the former German Democratic Republic.

Thus, the volume of net capital inflows into the new market economies remained relatively modest both in the light of the total size of the international capital markets and the growth potential of these countries. For private lenders and investors this was because the *market risk turned out to be much higher* than had been initially assumed. The flow of official capital was slowed down by market risk, by the limited availability of financing and its high cost (approaching market rates).

The geographic pattern of both direct investments and of credit flows has shown very great differences among the individual countries. Both for private capital and for official credits the principal criteria have been the internal functioning and stability of the economy, the reliability of the political system and the respect of payments obligations. The deep recession in the former COMECON countries was also a major brake on direct investments and on credits.

Among the former COMECON countries Hungary benefitted from by far the largest volume of direct investments. This was due essentially to two key factors: a) the profound and systematic transformation of both economic structures and behaviour of the legal and institutional framework and b) the political commitment to liberal,

market-oriented policies, to social stability and to the respect of Hungary's external payment obligations. The non-discriminatory market-orientation of Hungary's privatization policy also played an important role in this respect.

The bulk of capital flows still took the form of private and official loans and the share of direct, long-term investments remained relatively low.

Integration into the international financial markets

One of the central issues in the process of transformation and reconstruction was "how to deal with the capital shortage" in the new market economies. However, in order to assure the success of this process, major policy changes were required both in the new market economies and in the Western market economies.

The international financial integration of the new market economies suffered both from macro-economic problems (inflation, sharp decline in production and income, etc.) and from the complexity of the task to create the necessary legal and institutional conditions. The integration, however, also suffered from the fluctuations in the international financial markets, and the general "short-termism" that characterized the global financial markets. The principal conclusion is that the successful integration of the former socialist countries into the international financial system was rightly seen as a key condition for their reconstruction and their long-term economic and social stability and development. The increased access to foreign capital and the gradual integration into the worldwide capital markets was one of the objectives in the process of transformation and liberalization of the former socialist economies. There was general agreement, both in the Central and Eastern European countries and in the OECD countries, at the time of the collapse of the Communist system about the desirability of this integration and about the potential contribution of foreign capital to the building of dynamic market economies.

On the whole, however, the difficulties of this process were largely underestimated not only in the transition economies, but also by Western experts, including market participants, commercial and investment bankers, brokers, and other financial intermediaries. In historical perspective, there is today a general consensus that the results of the integration into the international capital markets achieved by the former Communist countries during the early 1990s fell far short of expectations and of the potential contribution of international capital markets to the successful development of new market economies in Central and Eastern Europe. There can be no question that had there been a program of public grants (admittedly on a much more modest scale than in the case of Germany) to help deal with the financing of transition and

reconstruction in the former socialist countries, there would have been also a more rapid inflow of private capital.

5.5. Foreign direct investment in Hungary

During the five-year period (1990-1994) aggregate gross private capital flows towards the Eastern European countries as a whole and towards the Russian Federation amounted to less than \$90 billion, compared with \$550 billion of private capital flows towards the developing countries.

Capital markets and the dimensions of the resource shortage in the transition economies

The collapse of the Communist system created in principle the political and economic conditions for the development of modern market economies. At the same time, however, the process of transformation was accompanied by a severe recession throughout the former COMECON countries. The deep recession increased the need for foreign capital. However, it also acted as a brake on capital imports. As was evident in the case of China, there was a close connection between the rate of macro-economic growth and the growth of markets and the attractiveness of a country for foreign capital. This was true for both direct investments and for medium- and long-term credits.

One of the key manifestations of the resource shortage in the COMECON countries was the cumulative shrinkage of total output. The decline in output and income exacerbated the fiscal problems inherent in the transition from a socialist to a market economy, and increased the pressures in favor of restrictive macro-policies, thereby retarding the recovery.

In the Czech Republic, Hungary and Poland the decline in GDP between 1989 and 1994 averaged between 70 and almost 100% of one year's total output (depending also whether 1989 or 1994 is taken as a yardstick). In the case of Bulgaria the loss of output and income during the five-year period was well above the equivalent of a year's GDP. For the four countries as a group, the decline in resources resulting from the shrinkage of the gross domestic product (GDP) was of the order of \$150 billion, or more than two and a half times the gross foreign capital inflow to the Eastern European countries as a group during the same period.

The decline in recorded production was even more dramatic in the Russian Federation and in the CIS countries as a group. For these countries the volume of 1994

GDP was estimated at little over 50% of the 1990 level. The estimated aggregate loss of output during the four-year period 1990-1994 ranged between 120% and 240% of one year's GDP, depending on whether it was compared to the 1990 or the 1994 level.

Transition and capital markets: less than satisfactory results

The transformation of the former centrally planned economies into dynamic modern market economies represented one of the largest political and economic challenges and opportunities of modern economic history. Thus, these countries should also have provided potentially great rewards for long-term foreign investments. The progress of integration into the international capital markets was closely connected with the development of a domestic capital market. The obstacles to foreign lending or investments were often the same that hampered domestic investments and lending.

The role of foreign capital and foreign investors in the transformation of the former centrally planned economies is one of the issues that received the closest attention both in the "new market economies" and in the OECD countries. There was widespread debate about the role of foreign capital and about the conditions required to attract foreign capital.

From the start, the general principle followed by both Western governments and by the conventional wisdom of professors, newspaper commentators and other experts was that private capital markets have to be the principal source of foreign capital for the "new market economies". At best official organizations, national governments or international organizations were to provide loans, but no substantial grants or resource transfers.

Thus, with the major exception of the former East Germany, there was no significant official Western resource transfer to ease the burden of systemic transformation and of reconstruction in the former centrally planned economies. This was also true for handling the issue of the "external debts" inherited from the previous communist regimes. No concerted initiative was undertaken to deal with the debt problem of countries like Poland and Hungary "ex ante". The debt rescheduling in the case of Poland occurred on the initiative of the Polish government with all the negative connotations attached to these negotiations. The lack of official grant-assistance diminished the efficiency of private capital as well.⁵¹

⁵¹ The Community aid program for the countries of Central and Eastern Europe (PHARE) was started in 1989 for the benefit of Poland and Hungary. Subsequently it became the main financial instrument of the pre-accession strategy for the countries of Central and Eastern Europe (CEEC) applying for membership in the European Union. Since 1994, PHARE's missions were adapted to the priorities and needs of each CEEC. The renovated PHARE program had a budget of more than 10 billion euros

On the whole, international financial integration played a positive role in the transformation of the former centrally planned economies into market economies. The results of this integration, however, were less satisfactory both from a quantitative and a qualitative point of view, than had been expected at the beginning of the process of transformation. The reasons for this disappointing situation were to be sought in both the conditions in the new market economies and in the functioning of the international financial system.

Table 5. 3. Foreign Direct Investments 1990–1993 (Million US\$)

	Total 90–93	% of total	\$per cap.(1)	% of GNP(2)
Albania	39	0%	13	0.49%
Bulgaria	164	1%	19	0.49%
Croatia	46	0%	10	0.25%
Former CFSR	2600	21%	167	1.7%
Estonia	180	1%	113	7.05%
Hungary	5441	44%	528	6.03%
Kazakhstan	400	3%	24	1.4%
Latvia	103	0%	38	n.a.
Lithuania	45	0%	12	n.a.
Poland	839	7%	22	0.41%
Rumania	140	1%	6	0.19%
Russia	2000	16%	13	0.63%
Slovenia	275	2%	138	1.03%
Uzbekistan	145	1%	7	0.18%
TOTAL/AVE.	12417	100%	41	1.17%

Source: European Bank for Reconstruction and Development: *Transition Report*. October 1994.

(1): 1990–1993; (2) 1993 FDI divided by 1993 GNP.

for the period 2000–2006 (around 1.5 billion euros per year). One of the main initial objectives of PHARE was to help the administrations of candidate countries to acquire the necessary capacities to implement the Community *acquis*. PHARE also helped national and regional administrations and regulatory and supervisory bodies in candidate countries to familiarize themselves with Community objectives and procedures.

The total volume of gross financial flows remained below expectations.

Official capital flows amounted to less than \$55 billion, compared with \$271 billion for the developing countries. The theoretical gross flow includes the “interest and principal coming due but not paid” by Russia and some of the Eastern European countries. This amounted – under the euphemistic misnomer of “special finance” – to almost \$90 billion during this period.

Debt-creating inflows continued to predominate

Debt-creating financial flows continue to predominate in the international financial relation of the Central and Eastern European countries and the CIS countries. During 1990–1993 direct investments were less than \$13 billion and grants amounted to a paltry \$16.5 billion for the Eastern European countries and Russia as a whole, compared with over \$500 billion net transfer payments to the former East Germany.

Limited or virtually no net resource transfer

In fact, there was no or only limited net resource transfer from the international capital markets towards the European transition economies. The net interest payments on their foreign debt and the need to increase their international reserves (this increase represented about \$32 billion for the CIS and the Eastern European countries) reached or outweighed the net capital inflows. The paradox of this situation (which resembles that of the developing countries during the debt crisis of the 1980s) was often pointed out at the time. The Geneva-based *UN Economic Commission for Europe* in its annual surveys drew attention to this anomaly in private and public financial flows.

Hungary and China

Despite their considerable political and economic differences, the two transition countries for which international financial integration appeared to be the furthest advanced were Hungary and China. Beside the size of China and the potential of the Chinese economy, two major factors played a decisive role in this development: a) the impressive growth record of China and the consistent growth orientation of Chinese economic policy since the 1980s, and b) the ability and the willingness of the large overseas Chinese community to invest and develop new businesses in China.

Limited direct investment flows

Direct investments were probably the economically most advantageous form of capital imports for the former centrally-planned economies: (a) they tended to be long-term as a rule, and were influenced by interest-rate developments or other short-term macro-economic and financial indicators; (b) they were the best way to import Western know-how and technology, and (c) they created new jobs or helped maintain jobs.

Statistics from different sources on foreign direct investments had different breakdowns and there were also some differences in definitions and coverage. Yet, on the whole a consistent picture emerged from the various sources.

- 1) As noted above, Hungary and China attracted the largest volume of foreign direct investments. Depending on the definitions, during the first half of the 1990s Hungary accounted for about 50% of the direct foreign investment inflows into the former CMEA countries. As for China, the estimated net direct investment inflow during the 1990-1994 period was about five times larger than the total for all the other transition economies combined (including the share of Hungary).
- 2) The countries that were the most conspicuously under-represented in the rankings of direct investment inflows were the CIS countries. Macro-economic instability, political uncertainty, declining output and uncertain property rights and institutional guarantees all tended to discourage or keep out foreign investors.
- 3) At the same time, even so-called advanced reform countries like Poland or the Czech Republic attracted a relatively low volume of direct investments, especially during the early years of the transition towards a market economy. Differences in the degree of the institutional framework of the market economy, in privatization policies and human resources accounted as much for the differences with Hungary, as differences in macro-economic policies or environment.

As had been the case with foreign direct investments since the 1950s throughout the world (both in Europe, North America and Japan, and in the developing countries) foreign direct investments have been a source of both mutual advantage and of tensions and mutual misunderstandings. During most of this period the bulk of the successful foreign direct investments in the OECD countries and in the developing countries was in the form of the newly created companies, rather than the takeover of existing operations.

Privatization and foreign capital

During the years of regime change some of the most important obstacles to direct investments were the uncertainties concerning the nature of privatization and the protection of private property. Yet, privatization of existing companies was one of the most efficient ways of attracting foreign direct investments. This was recognized in some, but not all new market economies. Hungary was a leader in this respect. Its good performance in attracting foreign direct investments as of 1990 was closely linked to its “market-oriented” privatization strategy. There was no discrimination against foreign investors in the privatization process in Hungary. In fact, in the privatization of many Hungarian enterprises there was a *de facto* bias in favor of foreign investors because of the type of investors defined in the tender documents.

The non-discriminatory approach in the privatization process also tended to reassure foreign investors planning joint ventures or fully owned green field investments. The market orientation of privatization was considered to be a guaranty for the protection of the rights of foreign investors.

Whatever the moral and political justifications of the free re-distribution of the nationalized companies or of “re-privatization”, the “non-market approaches to privatization” were problematic from the point of view of economic efficiency:

- 1) they did not result directly in more efficient ownership-control (the new “owners” through the coupon privatization programs did not become “efficient owners” overnight),
- 2) at least temporarily they created confused ownership conditions,
- 3) they confused, rather than clarified, the issue of the „market price” of the privatized assets,
- 4) they discouraged or made more difficult the participation of foreign investors in the privatization process by creating two sets of prices (i.e. domestic and foreign investors),
- 5) they contributed to nationalist opposition to foreign investors.

The rights of foreign owners were not clearly defined; coupon privatization did not establish clearly the rights of owners as managers, etc. The rights of managers to sell their companies also created an atmosphere of uncertainty and even corruption.

Direct investments by small and medium-sized companies were relatively slow in forthcoming: for these companies, which could produce both for the domestic market and exports, the legal uncertainty as well as the cultural differences proved to be a source of excessive risks. Despite the lip service being paid to the importance

of these investments, Western governments and organizations did not undertake systematic efforts to help create new export capacity towards Western markets. Large multinational companies have been more rapid in seizing opportunities and in establishing key positions in the former centrally planned economies.

Competition and over-supply of assets to be privatized

The period of the privatization of potentially the entire productive assets of the former Communist countries coincided with the peak of the worldwide trend in privatization and with a generally strong demand for capital on international markets. Thus, there was an oversupply of assets within each former Communist country and in the region as a whole. This added further to the downward pressure on asset prices in these countries, including Hungary, and allowed a policy of “cherry-picking” among foreign investors (including foreign official institutions participating in privatization projects).

The downward pressure on asset prices was not only due to the oversupply; it also resulted from the recession, the general disorganization accompanying the systemic change and the uncertainty surrounding the change of ownership.

Limited and unequal access to medium- and long-term financing

Another area where progress was slow was the access to medium- and long-term financing on the international capital markets (bonds and banks). For the Eastern European countries as a whole during 1990–1994 capital market financing accounted, with \$14.5 billion, for one third of gross private capital flows to Eastern European countries as a whole. The proportion with Russia included falls to about 20%. After 1990, the Soviet Union and subsequently Russia virtually disappeared from the market.

However, according to the estimates of the Economic Commission for Europe, since 1991 Hungary alone accounted for over 75% of the funds raised in the international capital markets. At the end of 1994, Hungary accounted for 78% of the international bonds outstanding of the transition countries (not including China). Whereas Hungary pursued a consistent policy of seeking to develop and to maintain access to, and gained the confidence of, international capital markets in order to lengthen the maturity and to diversify the composition of its foreign liabilities, this source of finance became or remained inaccessible for the majority of the transition economies.

Limited or no portfolio investments

In the early years after the collapse of the Communist system portfolio investments were a relatively unimportant source of foreign capital for the former centrally planned economies. One of the main areas where the illusions about the nature of the transformation process were the most widespread was in the field of portfolio investments. At the start of the transformation process, there were widespread illusions both about the speed with which domestic stock exchanges and bond markets could develop and about the possibilities of substantial capital inflows in the form of portfolio investments towards the former centrally planned economies. These illusions contributed to the misconceptions about the role of foreign capital, to the fallacy about the lack of need for official resource transfers. The Budapest Stock Exchange, founded in 1864, was re-instated in June 1990. It took longer for others in the region to create or recreate bourses.

These illusions were based on the following factors.

- 1) They ignored the long time it had taken in Western Europe to develop a “stock-exchange culture”. Even today, in most European countries, including Germany, the shareholder culture is much less developed than in the United States.
- 2) Even in Western Europe most companies (even the successful ones) would not pass the test of being „portfolio-grade” for foreign investors.
- 3) Even for „large companies” the potential market capitalization is relatively small. The information requirements alone would have been excessive.
- 4) The attempts at portfolio investments took the form of special funds that usually had similar characteristics to „venture-capital funds”: relatively small volumes and seeking a high rate of return.

Project finance

For many years, international financing of major industrial and infrastructure projects (from official or private or from mixed private/official sources) has played an important role in the long-term capital movements towards the developing countries. Most of traditional “project finance” take the form of debt instruments (credits or bonds) rather than equity financing. Yet, both the international financial institutions and the private banks tend to believe that “project finance” provides greater safety to creditors than so-called sovereign lending not linked to specific projects. There is no doubt that project finance makes it possible to calculate the micro-economic potential of major

investments. Nevertheless, over-borrowing (beyond the potential of a country) was still possible under project finance.

Because of the deep recession in Central and Eastern Europe and in the former Soviet Union, there was relatively limited scope for project finance in this region for major productive or infrastructure projects. In China, however, project finance continued to play a major role along with other forms of capital imports.

Investments in real estate

The various forms of real estate (housing, commercial real estate, agricultural land) were an important source of potential capital inflows. At the start, however, most former centrally planned economies maintained restrictions on the purchase of at least some categories of real estate by foreigners.

The impact of globalization

Globalization has been one of the outstanding developments of international capital markets since the 1980s. The liberalization of remaining exchange controls on capital movements, the deregulation of financial markets and of the banking sector, the introduction of new financial instruments as well as developments in information technologies, all contributed to the emergence of an increasingly homogeneous world-wide market for savings and financial assets.

The characteristics of the markets underwent profound changes since the 1970s. There was a dramatic shortening of the time horizon of international capital movements. Real interest rates were fluctuating greatly. Despite the advances in technology and despite the increased competition, the overall cost of international financial intermediation increased rather than decreased during the 1980s and 1990s. These costs include the risk premiums of increased uncertainty and instability and the costs of faulty investment decisions (boom and bust cycles). The former socialist economies had to compete for funds in this global market, with advantages and disadvantages being attached to being part of the process.

The growth of private finance

Marketization and a growing share of private capital in international financial movements was another important development affecting the former socialist countries. A brief overview confirmed the increased and important role of private capital compared with official financing. During the 1990–1995 period the former

accounted for about two thirds of gross new financial flows towards Russia and the Eastern European countries. The share of private capital was almost as high as for the group of “emerging markets” as a whole.

Financial integration and capital flight and the culture of the “oligarchs”

In some countries financial integration was also accompanied by substantial reverse flows, or by capital flight. In some cases this represented the export of the proceeds from capital imports, although there were no examples for the large-scale foreign borrowing in order to re-export the funds, as had been the case in Argentina.

Capital flight was especially large from Russia. Because of the confused ownership conditions, the illegal capital exports were not only contravening exchange control regulations, but also represented to a large extent illegally obtained funds. The welcome extended to these funds in the leading Western financial centers was one of the most disastrous decisions by the alleged advocates of free markets in the West. The safe havens offered to these funds and their owners laid the foundations of the Russian and worldwide culture of the so-called *oligarchs*.

CHAPTER SIX

Bank Reform and Monetary Policy

6.1. From Communist “banks” towards a “real” banking system

The domestic and international background of the banking reform

The reform of the banking system, the modernization and strengthening of the banks and the entire financial system was a fundamental condition for the transformation towards a market economy and the international economic and financial integration of Hungary. The unanimous opinion of domestic and foreign experts was that there was a close connection between the success of the banking reform and the recovery of the economy.

This mutual relationship is true not only for former socialist countries in the process of transformation. In every modern economy the position of the banking system, and its safe and at the same time dynamic operation, is closely related to the balance and development possibilities of the overall economy.

During the 1970s and 1980s the banking and financial sector had gone through a real metamorphosis, primarily in the developed OECD countries, but also to some extent in the developing countries. Only a few of the various aspects and driving forces of this complex process need to be briefly mentioned here:

- a) the technological revolution (in telecommunications and IT in general);
- b) the explosive growth of international capital mobility;
- c) integration of international capital and currency markets;
- d) liberalization of banking and financial activities in general („deregulation”);
- e) intensifying competition between banks and between banks and other financial institutions on national and international markets;
- f) the spread of new „financial instruments” in the passive and active business sector;
- g) the growth of clients’ needs for all types of banking transactions;
- h) due to the strong international demand for capital and the competition between securities and traditional banking businesses the transformation of the loan

business into a securities business, the increase in real interest rates and the decrease in the profit rate of the traditional banking business;

- i) continuous revision of the responsibility of central banks, state banking and financial supervisory authorities.

Both in theory and *praxis*, money, banks and finance in general differed profoundly from the concepts that had similar names in a market economy. The transformation of the banks and of the entire banking system was a central issue of regime change, not only because of these fundamental differences, but also because of the penetration of money and banking into all aspects of the economy – and in fact of the entire structure of society. This is, and was, true both in market economies and in planned economies, and in all versions of authoritarian systems. Moreover, the pace of change in the so-called “real economy” and in the financial and monetary system is not identical. If one looks back over the history of the last 500 years, from the discovery of America to the beginning of the 21st century, one becomes aware of the frequent variations in the respective importance of the changes in two principal dimensions of all economies: at times the changes in the “real economy” provided the main pulling forces; at other times, it was the monetary and financial aspect that was the source of major changes for better or worse in individual countries or on entire continents, or what we call today the world economy as a whole. One may also add here that money and finance were as often the sources of crises, of wars, and “economic disintegration”, as they were the opposite, i.e. factors of peace and economic and political integration.

The banking and monetary crises of the first half of the 20th century left a deep mark on national and global political conditions across the globe. The main objective of the creation of the “Bretton Woods system” was to avoid a repetition of the monetary crises and banking breakdowns of the interwar period that had contributed so much to the emergence of totalitarian regimes, to the Great Depression and ultimately to the Second World War. One of the significant features of the Bretton Woods system was the prudence in liberalizing short-term international financial flows and thus international banking activity. As is well remembered, the beginning of the explosive growth of international money markets and international banking coincided with the breakdown of the Bretton Woods order. Without going into too much historical detail it should be remembered that the turbulent 1970s and 1980s were followed by major efforts to reform both the European and international banking and monetary systems.

This is highly relevant from the point of view of the present chapter, and in fact of the entire book. The task of transforming the monetary and banking systems of Hungary and of the other former Communist countries into structures and systems required by a market economy (including the privatization of banks and the establishment of

the supervisory framework) coincided in time with the Maastricht Treaty and the setting up of the European Monetary Institute (headed by Alexander Lámfalussy), the predecessor of the European Central Bank, the revision of bank regulation (Basel rules), including capital requirements and portfolio evaluations, as well as a thorough revision of the banking rules in the United States, rules that had been in force since the days of the New Deal in the 1930s.

All this means that, to a significant extent, the Western models in the banking and financial fields to be followed by the new market economies in Eastern and Central Europe and in Russia and the other former Soviet Republics were “a work in progress”. The shortcomings and the high degree of instability and insecurity of the new monetary and banking order built on short-term speculation came to a boiling point in 2007 and 2008 and 2009 when the so-called “sub-prime crisis” almost led to the collapse of the entire international banking and monetary system.

The Hungarian post-war hyperinflation: plundering the middle class and prelude to full nationalization of the Hungarian economy

The exclusive right to issue money, or legal tender, is a privilege and responsibility of governments since the 19th century. Assuring the stability of the value of the national currency, i.e. avoiding inflation and deflation, is part of this monopoly of power. Run-away inflation (or hyper-inflation) can be the result of inefficient or deliberate policies or both. This was the case in Hungary after the Second World War.

Between the end of 1945 and July 1946, Hungary went through the highest inflation ever. The national currency (*pengő*) lost value dramatically and hyperinflation was so out of control that at one stage it took about 15 hours for prices to double and about four days for the *pengő* to lose 90% of its original value. The hyperinflation that swept through Hungary served the political purposes of the Communist minority in the coalition government and of their Soviet masters because it prepared the ground for turning the country into a state-controlled economy.

The new national currency (*forint*) was introduced on August 1, 1946, after the *pengő* was rendered worthless. This was brought about by a mixture of the high demand for reparations from the USSR, Soviet plundering of Hungarian industries and the holding of Hungary's gold reserves in the United States. The different parties in the government had different plans to solve this problem. To the Independent Smallholders' Party – which had won a large majority in the 1945 Hungarian parliamentary election – as well as the Social Democrats, outside support was essential. However, the Soviet Union and its local supporters in the Hungarian Communist Party were opposed to raising loans in the West, and thus the Communist Party masterminded the procedure

using exclusively domestic resources. The Communist plan called for tight limits on personal spending, as well as the concentration of existing stocks in state hands.

The inefficiency of Communist banks

The nationalization of banks was an essential feature of turning Hungary (and the economies of the other satellite countries) into a state-owned planned economy. The price system as a regulator of supply and demand was abolished and production, consumption, investments and trade were planned and carried out in quantitative terms. Bureaucrats allocated money to politically controlled managers and to workers most of whom were employed by the state. Banks were simply carrying transfers of money without being responsible for who should get how much and whether the “credits” would be repaid in the future. Banks pretended they were banks in what was an economic system based on barter and hoarding. In fact socialist banks were among the principal agencies responsible for the prevailing waste and misallocation of scarce material and human resources. This meant that without a fundamental transformation of the banking system economic regime change was unimaginable, and without regime change and the development of a market economy the modernization of the banking system would have been equally impossible.

In a 2005 article Steven Fries wrote:⁵² “In the post-communist transition, East European banking systems have undergone fundamental transformations. Like most industrial enterprises at the start of transition, socialist banks were in need of deep restructuring. Under communism and the command economy, the state directed credit allocation with scant regard for repayment capacity, using state banks to channel funds to state (or socially) owned enterprises for inputs and investments authorised under planning. To allocate resources in this way, banks specialised by economic sectors, rather than diversified across them. State savings banks specialised in collecting deposits from households, although most savings was forced and done by the state. The payment system consisted of a cash circuit for households and commercial transfers among enterprises handled by the central bank. At the same time, inputs used by state banks were not necessarily of the scale and mix that minimised costs, because there was no incentive for profit maximisation. Because of the structure of socialist banking systems, they had to restructure fundamentally both their outputs and use of inputs with the onset of transition.

⁵² Fries, Steven M., “*Financial and Enterprise Restructuring in Emerging Market Economies*”, International Monetary Fund, Washington, D.C.

Governments and central banks adopted several policies to promote the transformation of socialist banking systems into market-oriented ones. Banking systems were liberalised by freeing interest rates and decentralised by transferring commercial banking activities from the central bank to state banks, restructuring and privatising state banks and allowing entry of new private banks, both domestic and foreign. Moreover, to enable arms-length lending relationships between banks and their borrowers and to foster confidence of depositors in banks, the legal framework, including commercial codes and laws on secured transactions and bankruptcy, were overhauled or introduced and the system of prudential regulation and supervision was initiated. The timing and sequence of these reforms, however, differed significantly across countries, as did the initial conditions at the start of the transition in the banking systems and overall economies.

We find that banking systems in which foreign-owned banks have a larger share of total assets have lower costs and that the association between a country's progress in banking reform and cost efficiency is non-linear. Early stages of reform are associated with cost reductions, while costs tend to rise at more advanced stages. Private banks are more efficient than state-owned banks, but there are differences among private banks. Privatized banks with majority foreign ownership are the most efficient and those with domestic ownership are the least."

6.2. The structure of the Hungarian "two-tiered" banking system

The separation of the two main banking functions was carried out in Hungary in January 1987 still under the Communist regime. Thus, Hungary preceded the other Communist countries in trying to create a banking system that would resemble that of a market economy.

The principal feature of this process was the separation of (1) the central banking function and (2) the "commercial" banking activity. This involved carving out from the books of the Hungarian National Bank the assets and liabilities related to the financial activities and position of what passed for "corporations" in the state-owned and controlled economy, and the creation with the help of these "portfolios" and of the respective administrative staff of first two, and subsequently a third (Budapest Bank), large commercial banks. At the same time, as the files and staff from the Hungarian National Bank (MNB) were being transferred to the new entities, the right of the central bank to carry out commercial activities was abolished.

The distribution of the credit portfolios followed no banking logic but the administrative structure of the state-owned planned economy. Thus there was no

intent or possibility to distribute the portfolios of the new institutions in such a way that they would have an equal or similar competitive starting position. This point became important during the debate on the loan-consolidation issue and in the process of bank privatization.⁵³

At first, the newly created large commercial banks could conduct business only with enterprises and not with households. This restriction was lifted subsequently and the scope of their activity also came to include households. The National Savings Bank (*Országos Takarékpénztár – OTP*) was the principal banking partner of households. OTP provided housing credits to families and was also the principal collector of savings deposits. The Foreign Trade Bank (*Külkereskedelmi Bank*) provided foreign trade finance.

The development and functioning of the banking sector was hampered by various factors on both the borrowing and lending sides. One of the major problems was that the potential corporate borrowers had no clear and relevant “credit history”, nor business plans for establishing reliable repayment schedules. The issue of privatization added an important factor of unpredictability to past and future credit relationships. At the same time the resources of the banks (reserves, own capital and deposits) were insufficient for a dynamic lending policy and for financing corporate investments at a level that could stimulate economic growth.

The absence of a capital market and of a money market made it difficult for banks to raise funds from third parties. One of the consequences of this situation was the proliferation of inter-company lending. In practical terms these inter-company credits were “forced credits”, as companies had growing difficulties in paying their suppliers’ bills on time. This had a domino effect since relatively healthy companies had liquidity problems and difficulties to meet their own payment schedules.

⁵³ Lajos Bokros, Head of the Budapest Bank, was one of the most adamant opponents of the suggestion that the government should assume the cost of the loan consolidation program. He argued that this program would be to the benefit of banks that were not sufficiently prudent in their policies and disadvantage banks that were more careful such as Budapest Bank. In fact, Budapest Bank was also burdened by bad debt assets. A privatization deal had to be stopped when the problems in Budapest Bank’s loan portfolio became known.

6.3. The Bank Reform Commission

The work of the Bank Reform Commission

The Bank Reform Commission operated as an independent expert group. Its members worked in a personal capacity at the request of the Prime Minister. The Chairman of the Bank Reform Commission was Lajos Komár; its members were Ádám Batthyány, Gyula Czirják, Sándor Czirják, Miklós Pulai, István Szalkai, Sándor Takácsy, Pál Tar (as of September 1991 István Lakits). I was the rapporteur and secretary of the Commission and the principal author of its Report to the Government.

The objective of the Commission was to promote the development and effective reform of the Hungarian financial and banking system, and primarily dealt with its long-term (strategic) development. The Commission's task was to address issues related to the banking and financial system in a broad sense, including the capital markets, savings banks, the central bank and banking supervision. The task included the study of the current situation, the consideration and application of foreign experiences, and the elaboration of the main features of the desired long-term structure of the Hungarian financial and banking system, the conditions for the transition from the current situation to the long-term structure, and the general rules for the effective operation of the system.

The Commission determined its rules of procedure, conducted meetings, and organized its working methods and the pace of its work within its own powers. The founding meeting of the Commission was held on February 26, 1991. During the following year, the Commission held ten meetings and its members held numerous discussions with Hungarian and foreign experts and members of the Economic Cabinet. In its research and deliberations the Bank Reform Commission primarily dealt with the most important and urgent issues of banking reform: the draft of the Central Bank Act and Bank Act and the problem of the so-called "inherited bad loans" in the portfolios of the major banks, and within the framework of a subcommittee with IT issues affecting bank operations. The Commission's resolutions and proposals were continuously brought to the attention of the government through the Economic Cabinet.

Implementing and completing the new legislation concerning the banking and financial sector

With the adoption of the texts concerning the Central Bank, the banks and the investment funds, the bulk of the legislative framework (together with the new

accounting law) necessary for the financial sector were put in place. Additional legislative measures dealt with the revision of the law on securities and the stock exchange, with mortgage finance and foreign exchange regulations. The effective implementation of the new legislation was a major task requiring considerable adaptation by the banks, the Central Bank and Agency of Bank Supervision and not the least by the companies that had to revise their accounting and reporting system.

Improving the quality of banking services

There was an urgent need to speed up (e.g. transfer of funds among clients, etc.) and to improve the quality of banking services for both businesses and households. An additional effort had to be made to provide services for small, new enterprises.

Improving the banks' manpower and technical resources

At the time extensive efforts were made to ease the shortage of experienced manpower in the banks and in the financial sector in general, and to upgrade their technical resources. In order to assure safe and efficient banking services the banks had to make significant investments in training and information technologies and intensify their cooperation with foreign banks.

Developing the domestic capital market

Privatization was to provide a unique opportunity for the development of the domestic capital market in Hungary. The so-called "compensation certificates" could become one of the instruments. It was also important that there should be more systematic efforts in the future to sell shares in new and existing companies in Hungary and to develop a market for them on the Hungarian stock exchange.

Furthering the international integration of the financial and banking sector

International banking and financial integration had a domestic and an international objective: (a) raising the quality of financial and banking services and of the availability of capital on the domestic market, and (b) providing the financial and banking services required by the growing international integration of the Hungarian economy. Two priorities had to be emphasized: (a) the implementation of effective internal information and control mechanisms in the banks and of adequate supervisory instruments and techniques concerning international transactions in order to prevent

both major errors and fraud, and (b) the development of strategic alliances between Hungarian commercial banks and major international banks.

Bank privatization

The eventual privatization of the banks (stipulated in the new banking legislation) was to be part of a strategy to strengthen the individual banks concerned and the banking system as a whole.

The strategy of bank privatization

From early 1992 to the end of 1993 bank privatization was one of the issues on which I spent the most time in my capacity of the Prime Minister's Adviser and as Advisor of Minister Tamás Szabó whose portfolio also included bank privatization. The principal aspects of my work in this context included major inputs in the following tasks and activities: (1) the organization of the development of the strategy of bank privatization; (2) drafting of the guiding principles of bank privatization; (3) preparing the strategy and schedule of bank privatization; (4) selection of the bank privatization advisers; (5) the launching of the bank privatization strategy.

My work included (1) frequent meetings and discussions with the heads and senior staff of the major Hungarian banks, of the Hungarian National Bank, of the Ministry of Finance, of the Bank Supervision and other financial agencies; (2) organizing and participating in meetings between Minister Szabó and the heads of the major banks, and between Minister Szabó and visiting international officials and bankers and other banking experts; (3) organizing the meetings of Prime Minister Antall and bank leaders and foreign officials (e.g. Alexander Lámfalussy, the Head of the Bank for International Settlements); (4) contacts with major international investment banks; (5) extensive international interview program (USA, France, Germany, Great Britain, Italy, Switzerland, Poland, Czechoslovakia, Japan); (6) evaluation of the documentation submitted by the candidates (major international investment banks) for the position of privatization advisor.

In order to illustrate the approach developed in the course of our work, in the rest of this sub-section I reproduce a few excerpts from a note I prepared in February 1992 for Tamás Szabó and from a note I prepared in August 1992 for the Minister and for the Members of the Bank Privatization Committee.

“STRICTLY CONFIDENTIAL

NOTE for Minister Dr. Tamás Szabó

The main objectives of bank privatization

By Otto Hieronymi

February 5, 1992

1. Political objectives

Hungary has a good chance to play the role of a regional international banking center in the region. Important economic and political advantages for the country could result from such a possible development. Banks everywhere have an important symbolic and real political importance. Banks are not really popular anywhere: so it would not be right to pursue an excessively “pro-bank” policy, to the detriment of the real economy. Nevertheless, the appearance of an “anti-bank” policy must be avoided: trust and lack of trust in banks is closely related to domestic and foreign trust and lack of trust in the economy.

The strategy of bank privatization is also fundamentally a question of trust.

(a) A well-thought-out bank privatization strategy is an additional, fundamental part (and proof) of the “irreversible” economic transformation and the strengthening of the market economy, competition and international integration.

(b) The fact that the Hungarian government decided in favor of a well-thought-out, not hasty bank privatization strategy can be further proof of the advantages of the “Hungarian model” from the point of view of both the domestic economy and foreign partners.

The role of banks is a politically sensitive issue everywhere. The banking system generally retains its national characteristics to a large extent everywhere. It is therefore difficult to imagine that the leading banks of a country would come under *de facto* foreign control. This would not be economically acceptable either. Politically, it could be particularly disadvantageous, given the general “unpopularity” of the banks.

(c) The geographically balanced selection of foreign partners is a politically important issue, but its importance should not be exaggerated.

2. Portfolio clean up and bank privatization

There is a close connection between portfolio clean up and bank privatization. One of the important objectives of privatization is raising capital. However, it would not

be an optimal solution if the new capital obtained through bank privatization was primarily used to resolve the existing portfolio. The portfolio arrangements must therefore precede the privatization itself. One of the prerequisites for successful bank privatization is that the banks' loan portfolio does not contain a large proportion of doubtful loan claims. However, it also facilitates portfolio planning if it is developed and implemented as a preparation for the privatization strategy.

(For further details see Section 6.5. in this chapter.)

3. Ownership structure

One of the basic tasks of privatization is the formation of more economically efficient ownership structures. Currently, the state does not really act as an owner, and the banks are not always happy about this either (they feel that the state's role is rather that of a tax collector).

It is not only necessary for the bank privatization strategy that the state's "bank owner action" becomes more effective within the framework of the new structures. In view of the spring public meetings, this is a particularly urgent task.

In relation to the ownership structure, two fundamental objectives, already mentioned above, play a decisive role:

- a) economic efficiency in terms of banks and the economy as a whole; and
- b) what is desirable and acceptable from a political (non-party) point of view.

Both aspects are closely related when determining the ownership share of the state and foreign banks.

Neither the Hungarian banking system nor the final ownership structure of Hungarian banks can be determined in advance with complete accuracy. It is possible (but not absolutely necessary) that the privatization strategy would include the merger of existing banks and the sale of certain bank divisions. In any case, the bank privatization strategy will significantly influence the long-term ownership structure.

In a simplified form, in the case of large banks, the following ownership combinations can be imagined:

- the state remains as a major shareholder;
- a large number of domestic shareholders (companies, institutional investors, individual investors);

- a relatively large number of foreign shareholders, but a relatively small total ownership share;
- foreign banks also participate only as portfolio investors.”

The Guiding Principles of Bank Privatization

On March 6, 1992 I submitted a 30-page document on the *Strategy of Bank Privatization: General Guiding Principles (First Version)*. The following was the Table of Contents of this paper:

“Objectives

General guiding principles – individual implementation

Timing

Orders of magnitude

Ownership structure

International opening

The strategy of foreign banks and their likely role in the Hungarian banking system

The improvement of efficiency and furthering of competitive capacity and raising the quality of banking services

The current situation of the Hungarian banks and their likely future development

The issue of the cleaning up of the bank portfolios

Efficient ownership policy of the Hungarian State

Information tasks and the detailed assessment of the banks’ condition

The range of potentially interested partners and investors

Selection of bank privatization advisor(s) – major international investment bank

International experience with bank privatization

Urgent tasks

Discussion of guiding principles

Organization and responsibilities

Schedule of implementation”

Progress of the implementation of the Bank Privatization Strategy

On August 17, 1992 I submitted a detailed report on the progress of the bank privatization to Minister Tamás Szabó and to the members of the Bank Privatization Committee. The following pages are taken from this text.

(Excerpts translated from Hungarian)

“THE CURRENT STATE OF THE BANK PRIVATIZATION STRATEGY

By Otto Hieronymi

To Minister Tamás Szabó and the Members of the Bank Privatization Committee

August 17, 1992

Main points:

1. Selection of the bank privatization consultant
2. Cleaning bank portfolios
 - The loan consolidation system
3. The situation of the banks
4. Possible bank privatization strategies
5. Which bank to start with
6. Bank privatization objectives
7. The international situation
 - (a) timing;
 - (b) financial objectives and ideas (portfolio planning, capital raising, share price idea, etc.);
 - (c) the role of foreign banks and other foreign investors and the desired long-term ownership structure;
 - (d) the role of domestic investors;
 - (e) efficient management of state property;
 - (f) possible restructuring or consolidation, which may affect both small and large banks.

1. Selection of the bank privatization consultant

In agreement with the bank privatization committee, international investment banks with extensive experience were invited to act as consultants. These banks showed great interest.

The main aspects of the selection:

- international experiences
- the realization of the Hungarian government's bank privatization objectives
- the quality of the team
- avoiding conflicts of interest
- price, etc.
- geographical aspects

Two-step selection:

- first step: "short-list" (based on written material and possible competitive negotiations)
- second step: selection of general and individual consultants based on the short-list

Points selection system.

6. Bank privatization objectives

6.1. General objectives

(based on the adopted guidelines of Hungarian bank privatization)

6.2. Detailed objectives

- (a) competitiveness: increasing competitiveness both on the Hungarian market and internationally;
- (b) merger or split: it is impossible to know at this stage;
- (c) the purpose of the capital increase:
 - promote safe operation, taking into account the capital adequacy indicators.

The Bank Privatization Strategy – current state

1. In the framework of the development and implementation of the Government's bank privatization strategy, the following steps have been taken so far:

- (a) a brief overall analysis of the banks' general situation;
- (b) development of the objectives and guidelines of the bank privatization strategy and their adoption by the government;
- (c) establishment of the Bank Privatization Committee;
- (d) initiation of the two-step process of selecting the bank privatization consulting firm;
- (e) extensive information process and discussions with banks, interested official organizations, investment banks, international financial organizations and domestic and foreign experts;

- (f) organization of expert groups and projects, partly with foreign support, for decision-making and background work;
 - (g) developing guidelines for bank portfolio arrangement and discussing the proposal related to the credit consolidation system in the Economic Cabinet;
 - (h) initiation of expert work aimed at implementing the credit consolidation system.
2. In the period starting now, the following short-term tasks should be highlighted:
- (a) organization of expert work, initiation of the USAID project (selection);
 - (b) evaluation of applications received for the role of bank privatization consultant(s);
 - (c) discussions with selected (short-list) investment banks;
 - (d) selection of the first consultant(s) in two steps;
 - (e) defining the role of general and specific advisers;
 - (f) determining the sequence of banks to be privatized;
 - (e) implementation of the credit consolidation system.
3. Main strategic objectives
- (a) The most important goal is to modernize and strengthen the Hungarian banking system and Hungarian banks, and increase their competitiveness. The planning and implementation of bank privatization must primarily serve this purpose.
 - (b) The dual task of the investment bank (privatization consultant): strengthening and preparing the given bank for privatization and conducting the privatization.
4. The main features of the Hungarian bank privatization strategy
- (a) It is not about the privatization of the entire banking system, but the privatization of individual banks must fit into the overall strategy.
 - (b) For some years now, bank privatization, like privatization in general, has been an internationally widespread phenomenon. The privatization wave of the past years affects a wide variety of industrial and service sectors, both in the OECD region and in developing countries. Privatization of banks and public utilities (electricity, gas, waterworks) plays a prominent role in this field.

In the case of bank privatization three broad general categories can be distinguished:

- (a) the privatization of banks that were nationalized relatively recently. This is reprivatization in the basic sense of the word. Typical examples of this type of privatization are the privatization of French banks and Portuguese banks.
- (b) privatization of directly or indirectly state-owned (including municipal) banks in countries where the majority of banks are not state-owned;

- (c) the sale of shares in state securities in banks in which there is significant or majority private ownership.

The ownership structure of banks, the nationalization and privatization of banks received different evaluations during the past 40 years in different market economies. National differences were basically at least as important as the party's political orientation. In some countries the social democratic parties spearheaded the nationalization of banks, but there was a chance for radical socialist parties, whose program did not include the nationalization of banks. Although civil governments in many countries did not privatize state-owned banks for many years.

So far, there are few examples of successful bank privatization in the former CIS countries (as in all other areas, the former East Germany cannot be taken into account here either).

It is no coincidence that in the case of the former Czechoslovakia the most successful bank privatization took place in the case of the foreign trade bank. In Poland, the privatization of the foreign trade bank has not been successful so far.

5. The importance of international experiences from a Hungarian point of view
 - (a) International experience naturally plays an important role, but local conditions are at least as important both from the point of view of the bank to be privatized and the domestic and foreign investors.
 - (b) Neither bank privatization carried out in traditional market economies, nor bank privatization attempted or carried out in other CGST (Central Goods and Service Tax) countries, can serve as an absolute model for Hungarian bank privatization.
6. Timing
 - (a) In the first phase of bank privatization, attention should be focused on four banks: *Budapest Bank*, *Magyar Hitelbank – MHB*, *Magyar Külkereskedelmi Bank – MKB*, *Országos Kereskedelmi és Hitelbank – OKHB*. The privatization of these four banks must be started in short intervals. The start-up does not take place at the same time, but it is not necessary to wait for the completion of the privatization of the first bank before the others begin.
 - (b) The partial privatization of the National Savings Bank (*Országos Takarékpénztár – OTP*) could be discussed in the second phase.
 - (c) However, the privatization of small and medium-sized banks cannot be postponed too much. The development of the strategy for these banks should be started shortly after the launch of the action mentioned under point (a).

- (d) The privatization of a given bank may take six to twelve months, including the preparation of the bank for privatization. From the point of view of neither the bank nor the investors, it would not be correct to drag out the privatization of individual banks too much.

7. Which bank to start with?

Several criteria can be identified for selecting the first bank:

- how prepared is the bank for privatization,
- how transparent is the bank's situation (quality of loan and investment portfolio, quality of top and middle management, internal structure and control, capital adequacy, etc.),
- the profitability of the bank,
- what level of interest is expressed on the part of potential investors,
- ideas of bank management.

10. Selection of the bank privatization consultant

The following general criteria will play a particular role in the assessment:

- (a) bank privatization and bank merger and sale experiences (what method, what result, etc.);
- (b) the quality of international (and especially European) bank relationships and experience, consulting and other services offered to other banks;
- (c) the quality of the bank strategy team, project manager and direct colleagues;
- (d) cooperation within and outside other companies (lawyers, auditors, etc.);
- (e) the own bank's strategic results;
- (f) knowledge of the Hungarian economy, the banking system and Hungarian banks;
- (g) the quality of the privatization idea:
 - how can they best represent the Hungarian bank and banks,
 - how can they realize the privatization objectives of the Hungarian Government (e.g. strengthening banks, including raising the quality of banking services, strengthening the banks' international relations system, etc.) with particular regard to ensuring the success of the Hungarian economic transformation,
 - what type of strategic partner can they find and what conditions can they represent,
 - what kind of steps are recommended to strengthen Hungarian banks and prepare them for privatization,

- to what extent can they participate in the strengthening of the Hungarian bank and its preparation for privatization.
- (h) cost, price;
- (i) the form and quality of cooperation with the government and the given bank.

The price of bank shares will be affected by:

- (a) the situation of each bank (doubtful debts, reserves, capital adequacy, etc.) and its development possibilities and profit prospects,
- (b) the schedule of the privatization process (oversupply of Hungarian bank shares must be avoided),
- (c) the interest of customer categories (strategic or portfolio investors),
- (d) evaluation of the Hungarian economy and economic policy, as well as,
- (e) the situation in the international banking market.

In order to realistically estimate the final magnitudes, it is necessary, on the one hand, to review the banks, and, on the other hand, a series of strategic decisions. After all, the actual magnitude of bank privatization will have to be approached from the following aspects, among others:

- (a) the current value of the banks based on the annual results and the decisions of the spring public meetings, the value of the state share, and the rate of reduction of the state share;
- (b) the magnitude of doubtful accounts, the method of portfolio arrangement;
- (c) the banks' capital requirement and the extent of any capital increase;
- (d) the market situation and the interest of investors (domestic and international), both for the privatization of individual banks, clear qualitative and quantitative information is needed.

Without claiming to be exhaustive, the following major categories should be mentioned here:

- (a) the development of the main balance sheet items;
- (b) the size and development of doubtful accounts;
- (c) subscribed and paid-in equity and capital adequacy ratios, general and special provisions, gross profit, profitability, profit proportional to capital, liquidity ratio, etc.

7. Ownership structure

One of the fundamental tasks of privatization is the formation of more economically efficient ownership structures.

In relation to the ownership structure, two fundamental objectives, already mentioned above, play a decisive role:

- (a) economic and business efficiency for banks, and
- (b) national economic efficiency and a desirable or acceptable ownership structure from a political and social point of view.

From both points of view, it is necessary to gradually reduce the state's share (for example, this is prescribed by the Banking Act). It is equally important to reduce the weight of debtors/companies among shareholders.

Currently, there are no data on the ownership structure of the banks at the end of 1991. According to data from the National Bank of Hungary (*Magyar Nemzeti Bank – MNB*) at the end of 1990 the share of the state (excluding OMFB and budget institutions) was 42% of the registered share capital of the major banks, 100% for the OTP, while this ratio reached only 9% for the large banks.

Based on these calculations, according to the MNB, at the end of 1990, narrowly understood state assets reached 33% of the registered share capital. The foreign shareholding reached 11% of the total registered share capital, while the proportion of foreign shareholding in the large banks reached 31%.

Neither the Hungarian banking system nor the final ownership structure of Hungarian banks can be determined in advance with complete accuracy.

In any case, the bank privatization strategy will significantly influence the long-term ownership structure.

In a simplified form, at least until the second half of the 1990s, the following structure appears to be the most favorable, at least in the case of large banks:

- (a) the state will remain as a major shareholder (its share will gradually decrease to 25%);
- (b) one or two foreign strategic bank shareholders (without full control);
- (c) domestic and foreign institutional portfolio investors (including international financial organizations), not all with full voting rights;
- (d) domestic small shareholders (individuals, companies).

From an economic political and social point of view, the two most important long-term groups of domestic investors are (a) institutional investors and (b) personal "small" investors (a certain percentage of bank shares could be reserved for the redemption of compensation tickets.). These have not yet been sufficiently developed, neither from the point of view of resources nor from the point of view of institutions.

To deal with this problem, a two-pronged solution must be developed:

- (a) maintenance of temporary state property;
- (b) rules on how, for example, social insurance as a potential institutional investor should manage its assets, including bank shares.

When developing a detailed strategy and carrying out bank privatization, paragraph 19 (3) of the Banking Act may need to be re-examined from the point of view of the proper representation of ownership interests.

8. Foreign opening

One of the main economic policy goals of strategic privatization should be the involvement of foreign capital and foreign banks. However, this cannot mean that the Hungarian banking system will come under foreign control. This would not be in the interest of the Hungarian economy (the banking system generally retained its national characteristics everywhere), just as such a role and responsibility would not be in the interest of foreign banks either.

The following foreign partners and investors can be counted:

- (a) strategic partners: large international banks;
- (b) portfolio investors: banks, investment funds and institutional investors, international institutions (EBRD, IFC, etc.), national official or partially official institutions.

In the medium term, the presence of various investor groups would contribute to the diversification and strengthening of the Hungarian banking system.

9. Foreign banks as strategic partners

Under the right conditions, the involvement of international banks as “strategic partners” in the Hungarian big banks can speed up the modernization of the Hungarian banking system and strengthen its domestic and international competitiveness.

From the point of view of foreign banks, a strategic investment can be considered as stake that allows the partner bank to effectively influence the bank’s business policy. This should not mean absolute control, but it may give a certain right of veto in certain decisions. More than one strategic partner can be imagined if these banks already work closely together, or if they are allies. If 10–15% of the shares of a large

bank are already owned by one or two foreign banks, it is difficult to imagine that another foreign bank would enter the given bank as a strategic partner.

The geographically balanced selection of foreign partners is a politically important issue, but its significance should not be exaggerated. It is more important that the profile of the partner banks meet the needs of the Hungarian economy and banking system, that they show a long-term interest in the development of the Hungarian economy, and that they commit the necessary financial and human resources. It is also important that the partner bank provide the Hungarian bank with an appropriate system of relationships and that the Hungarian bank, through the foreign partner, have preferential access to up-to-date banking technology that improves competitiveness. A basic condition is mutual trust and synergy between partner banks. Such a strategy makes it necessary, from the point of view of both Hungarian interests and foreign banks, to have an active Hungarian major shareholder opposite the major foreign shareholder. Currently, only the state can fulfil this role.

The point of view of international banks

Foreign banks may be interested in a strategic investment in a major Hungarian bank for the following reasons:

- (a) a safe starting point in a dynamically developing market in the long term;
- (b) ensured positional advantage over their international competitors;
- (c) greater business opportunities than through the establishment of a new and relatively smaller bank;
- (d) wider business opportunities through strategic partners.

The Hungarian strategy of large, international banks is influenced, among other things, by the following aspects:

- (a) The aspect of minimum risk: One of the most important determinants of the investment strategy of foreign banks in Hungary is the goal of minimizing risk. Different aspects of risk analysis and risk minimization should be highlighted:
 - The most important risk in the eyes of international banks is the so called „country risk”. The essence of this is how the banks judge Hungary’s economic and political future.
 - Possible low capital contribution.
 - Sharing the risk with other foreign investors (either banks or non-banks, such as insurance companies or other portfolio investors).
 - Sharing the risk with domestic investors (from this point of view, the ownership role of the state receives a positive evaluation).

- Right of veto is decisive, especially in matters concerning the bank's profitability and safe operation.
- Preference for investing in smaller, specialized banks, as opposed to participating in "big banks."
- (b) Rate of transformation
 - The development of the market economy in Hungary and the relatively advantageous situation of the country.
 - Hungary as a regional financial center.
- (c) Growth of the economy and the banking system
 - The main investment aspect is participation in a truly growing economy.
 - The economy itself will also grow: within this, the banking system must grow at least as fast as the economy.
- (d) International competition
 - Other banks should not be put in a more advantageous position.
- (e) Profitability
 - In the short term, the expected profit is not the most important criterion for international investors: in the long term, however, it is a decisive factor.
- (f) Building business relationships
 - One of the most important reasons for foreign investments is the establishment of business relations.

In addition to strategic partners and Hungarian arguments against

From the Hungarian point of view, among others, the following arguments speak in favor of strategic involvement:

- (a) it facilitates capital raising and fund transfer;
- (b) it can speed up the modernization of banks and the improvement of the quality of banking services;
- (c) solves the problem of integration into an international banking network and promotes preparations for European banking integration;
- (d) can significantly improve the quality of bank management and bank control;
- (e) may facilitate or enable subsequent capital increases;
- (f) can ensure that Hungarian banks can keep up with the development of banking technology and international standards;
- (g) may improve the acceptance and distribution of bank shares on the stock exchange;

- (h) strengthens the banks' competitiveness on the domestic market and prevents them from being at a serious competitive disadvantage against new Hungarian or mixed banks.

Among other things, the following arguments should be considered against the involvement of foreign strategic partners:

- (a) as a strategic partner, the foreign bank often wants full control;
- (b) politically, the impression may arise that foreign interests dominate the Hungarian banking system;
- (c) in the case of current business policy or certain strategic decisions, the international strategy and interests of the foreign bank, and not the domestic aspects, will be decisive;
- (d) it can have a demoralizing effect on Hungarian bank managers and can make dynamic development difficult if the construction is not sufficiently thought out;
- (e) a strategic relationship with one or two international banks makes it difficult to build a partner relationship with other banks (especially raising capital);
- (f) the foreign partner bank, if it is not familiar with Hungarian conditions, may force the Hungarian bank to make wrong decisions in personal and business matters;
- (g) the foreign bank may demand an excessively high dividend policy, instead of reinvesting the profit.

10. Private portfolio investors and international financial organizations, and national institutions.

Bank privatization also has an important task of attracting domestic and foreign portfolio investors. However, a primarily market portfolio privatization would not solve the banks' strategic problems. There would also be a danger of forcing an overly dividend-oriented policy.

Various international financial organizations (EBRD, EC) and state institutions show great interest in the Hungarian banking reform and bank privatization.

Solutions must be developed that would enable their participation in (a) portfolio management and (b) capital raising of banks (possibly also through non-voting shares). The possible participation of international organizations must be treated as part of the overall strategy, and the negotiations must be prepared in this sense.

11. Domestic small shareholders and institutional investors

Preparing future domestic institutional investors (social insurance, etc.) for a prudent ownership policy will be an important task during the implementation of the bank privatization strategy.

From the point of view of domestic and foreign investors and the national economy, it is important that bank shares prove to be a good investment.

The role of domestic small shareholders in the target ownership structure should not be neglected either. This applies to existing and new shareholders.

Reserving a certain part of the bank shares for the redemption of carpet tickets is one of the necessary steps.

12. Current and expected situation of banks

When analyzing the situation of banks, three basic general aspects closely related to the possibilities and strategy of bank privatization must be taken into account:

- (a) the burdens accumulated from the banks' previous activities, and at least partly due to the previous economic and regulatory environment,
- (b) the task of mid- and long-term modernization of banks,
- (c) the current national economic situation and its expected development.

Banks must play a central role in providing credit and capital to the economy and companies (existing and new).

In the short term, the national economic situation, the recession, the uncertain legal, financial and market situation of debtors have a negative impact on the situation of banks and the perception of their situation.

This is manifested in the relatively narrow demand for loans with acceptable risk, in high real interest rates, in the increase in doubtful debts and in the high demand for reserve formation. As a result, banks are currently unable to fulfil their role to the extent necessary.

Privatization should help banks to operate more efficiently. The improvement of real economic conditions is important for the efficient operation of banks. Just as a positive assessment of the expected development of the Hungarian economy can be considered one of the most important conditions for successful bank privatization."

6.4. Tensions between the Ministry of Finance and the Central Bank

Mihály Kupa vs. the rest of the Cabinet

There was a rivalry between the National Bank of Hungary and the Ministry of Finance during the 1980s. Tensions also arose during the Antall years when Ferenc Rabár and later Mihály Kupa headed the Ministry of Finance.

Well until his retirement in the late 1980s János Fekete, Vice-Chairman of the MNB (Hungarian National Bank) was the most influential Hungarian Communist leader not only in international but also in domestic financial matters. While towards the international financial community Fekete liked to appear as a “market-oriented” official and monetary expert, when it came to introducing domestic liberalization measures he tended to adopt a much more orthodox position faithful to Moscow’s “party line”. The officials of the Ministry of Finance who sought to reform measures that would make the monetary policy and the banking system more flexible resented this. This was in particular the case with those who were part of or close to the Institute of Monetary Research (*Pénzügykutató Intézet*).

One of the paradoxes of Hungarian history is that during the years of regime change many of the members of the *Pénzügykutató* adopted a pronounced anti-Antall rhetoric. During Mihály Kupa’s tenure in office there were various controversies between the Minister of Finance and other government departments. Beside the Working Group of Economic Policy Strategy (GAM), a topic discussed in chapter eight, I can mention four issues that illustrate these tensions.

The first one was the interpretation of the mandate and the work of the Bank Reform Commission set up by Prime Minister Antall. The members included bankers, officials of the MNB (Hungarian National Bank) and other experts in monetary and banking questions. I was the secretary and rapporteur of the group. When the Commission started its work, Mr. Kupa informed me that he assumed (wrongly) that our main task would be to discover what illegal activities were going on at the Hungarian National Bank. We were to report our findings directly to him. When he finally understood that our mandate was not a spying mission of this kind, he lost interest in the Commission and its work.

The second issue was the conviction and insistence by Mr. Kupa and by his senior officials that the principal objective of privatization was to increase fiscal revenue and the other criteria defined in the government’s program were irrelevant. The blatant and recurring criticism of the privatization program from inside the government showed a lack of team spirit and delighted the press and the members of the opposition.

The third problem worth mentioning was the claim by the Minister of Finance that bank privatization was his *quasi*-full responsibility. In fact the responsibility for the development and implementation of the strategy of bank privatization was attributed to the Minister without Portfolio in Charge of Privatization. The Minister of Finance, like other members of the Administration, was involved in this process but he was not in charge.

Finally the last issue to be recalled here was the controversy about the loan consolidation program. The need for adopting a loan consolidation program in order to absorb the large volume of bad debts that tended to paralyze the proper functioning of the banking system was admitted by virtually all foreign and Hungarian experts – outside the Ministry of Finance. Finally common sense prevailed and the Ministry of Finance also had to recognize that trying to finance the costs of loan consolidation from the “banks’ profits” (i.e. interest payments by current and future clients) was a non-starter and the government approved and carried out a loan consolidation program. However, the delays and misunderstandings around this key subjects interfered seriously with the implementation of the bank privatization strategy.

Factors affecting the banking system

Until the 1960s the banking sector was basically a branch of business aimed at domestic markets (“domestic business”). As a result of the differences in national traditions, economic structure, legal system (or even basic economic philosophy), the national specificity of the banking and financial systems prevailed. Thus for example, there used to be fundamental differences between (a) the American, (b) Japanese and (c) European systems. Furthermore significant differences could be observed between individual European countries.

However, from the early 1970s onwards international influences (“internationalization”) began to play a decisive role in the development of the banking and financial system. This process got a further momentum in the 1990s. The Communist countries participated only to a very limited extent in this trend. Although Hungary was somewhat more advanced than the rest of the region, until the early 1980s the Hungarian banking and financial system was largely cut off from international developments.

There is no doubt that there were significant results in the transformation and modernization of the Hungarian banking and financial system in the years of the regime change. Extensive and comprehensive efforts had been made to strengthen and modernize both individual institutions and the entire system. Hungary had a good chance to become one of the international banking and financial centers of the region.

At the same time, Hungarian and foreign experts agreed that there was still much to be done to meet fully the domestic and international requirements of modern business.

In time, the reform of the Hungarian banking system coincided with a number of relatively unexpected or newly emerging processes taking place in the world economy, which influenced the requirements for the reform and modernization of the Hungarian banking system.

The collapse of the “socialist” economic system

The collapse of the socialist economic system in the entire former COMECON system, on the one hand, confirmed the goals and pioneering role of Hungary and the Hungarian banking reform and increased the expected competition within the region and the expectations towards Hungarian banks and the financial system. On the other hand, by increasing uncertainty and tensions on the international money and capital markets, it complicated the situation of the Hungarian economy and Hungarian banks.

Recognizing the excesses of deregulation

In terms of the nature of the Hungarian banking reform, one of the most important phenomena, besides the advantages of banking deregulation (more competition and efficiency), was the increasingly general recognition of some harmful and dangerous outgrowths of this process. Contrary to the widespread perception a few years prior to the regime change, it was once again generally recognized that banking was fundamentally different from all other business sectors on a macroeconomic level, just as on the level of individual banks. The resurgence of this somewhat traditional approach in a decisive, formative period of the new Hungarian banking system may have contributed to the fact that Hungary had avoided the forms of banking and financial deregulation and innovations whose excessive or even dangerous nature had already been proven elsewhere. Here it is also worth mentioning the need for close cooperation between central banks and national banking supervisors in order to ensure the stability and safe operation of international and national banking systems.

Bank crises in the OECD countries

One could observe the deterioration of the situation of many banks in OECD countries in the early 1990s. This process reached such proportions that in some countries the banking system (or significant parts of it) were threatened by a crisis. In many cases, the problems could be attributed to careless, or at least “not careful enough”, bank

business management. However, the dimensions and general nature of the difficulties were the joint consequence of cyclical and structural distortions in the real economy and the shortcomings of the banking system.

Contrary to the situation observed in the first half of the 1980s, when primarily the international debt crisis and the management of foreign exchange positions put many (especially American) banks in a dangerous situation, the main source of the difficulties was to be found in the domestic economic and financial structures. Of course, as a result of the never-before-seen integration of the financial markets of the OECD countries, the domestic and international influences and consequences affecting the banks and the entire banking system cannot be completely separated. In the early 1990s the Hungarian economy was not yet in a position to take over the rules and obligations of the European Community regarding the banking and financial system without any transitional period. However, since the general political and economic aspiration of Hungary was rapprochement and integration with the European Community, it was important that the reform of the banking and financial system take into account common market standards and objectives.

Adoption of the Central Bank Act and the Banking Act

Drafting or revising a banking law or central bank law is everywhere a complicated and often lengthy political, economic and legislative task. This is illustrated, among other things, by the example of the United States from the recent past: the revision of the banking law adopted not long ago contained much smaller far-reaching reforms than the banks or the economy had originally hoped for.

For the Hungarian economy, the adoption of the Central Bank Act and the Banking Act represented a milestone in the banking reform process. Without these laws, the further development and modernization of the Hungarian banking system in a market economy based on decentralized decisions and private initiative would have been unthinkable.

Taken as a whole, both laws meet modern European requirements, even if at some point – especially as a result of gradual integration with the European Community – changes were necessary later (this applied, for example, to the full development of the universal bank type). However, these mostly foreseeable changes would not significantly change the basic orientation of the legal texts adopted at the time.

6.5. The controversy about cleaning up the banks' balance sheets: who shall pay the bill?

Strengthening the banks' balance sheets

As in some of the OECD countries, the quality of the commercial banks' portfolio was a source of potential problems also in Hungary: partly because of the bad loans inherited at the time of the creation of the two-tier banking system, and partly because of the financial and market difficulties of current borrowers. The first issue was handled through a government guarantee, the second could not be handled exclusively either through the banks' own resources or through a "market solution" alone.

Portfolio clean up and bank privatization

There is a close connection between portfolio clean up and bank privatization. One of the important objectives of privatization is raising capital. However, it would not be an optimal solution if the new capital obtained through bank privatization was used primarily to resolve the existing portfolio problems.

The portfolio arrangements, therefore, had to precede the privatization itself. One of the prerequisites for successful bank privatization is that the banks' loan portfolio not contain a large proportion of doubtful loan claims. However, it also facilitates portfolio planning if it is developed and implemented as a preparation for the privatization strategy.

The issue of portfolio clean up went beyond the issue of the so-called "inherited" doubtful loans. As a consequence of the recession in 1991, the proportion of "non-inherited" doubtful loans in the banks' loan portfolios probably increased significantly. Some of the doubtful claims consist of unpaid interest and penalty interest. The banks' loan portfolio included (a) *de facto* definitively uncollectible and (b) doubtful claims, some of which might still have been recoverable. How much of this latter category can be recovered depends partly on the management of banks and companies and partly on the development of the economic situation.

The following main objectives had to be kept in mind when organizing the portfolio:

- a) From the point of view of the economy and the banks, it would be incorrect to take the approach that the costs of portfolio management (reserve formation) should be covered primarily from the profits of the banks or from the revenues of bank privatization.
- b) It is not possible to avoid a significant burden on the state in the costs of portfolio management. However, if possible, an off-budget solution should be sought. It

was also necessary to take sectoral aspects into account (e.g. agricultural debts and loans).

- c) On an official international level, interest in participating in the strengthening of the bank's structure appears to be unchanged. In my opinion the focus should be on portfolio management, perhaps combined with temporary or redeemable share packages. It should also be possible to exploit the means of attracting foreign official or semi-official capital through national or international organizations. A separate guarantee fund or a holding solution could facilitate this.
- d) The problem should not be minimized or exaggerated. There is therefore an urgent need for a new reflection of the banks and a realistic assessment of the magnitude of the portfolio problem. There is absolutely a need for a fairly comprehensive solution that enables banks, and thus companies, to get rid of the burden of bad credit and debt and thereby become competitive. At the same time, however, it must be avoided that either banks or debtor companies get rid of bad loans and debts "too easily" or "too cheaply". It is also necessary to avoid that the other bank shareholders benefit "for free" from the state burden.
- e) The portfolio arrangement must have two main aspects: (a) the description of debts that cannot be collected definitively and (b) a partial guarantee system for doubtful but possibly still recoverable debts.
- f) The management and review of guarantees can be entrusted to an existing or a new organization. The handling of unwritten but doubtful claims can be entrusted to the banks or can be taken out of the banks' portfolio and entrusted to the guarantee fund.
- g) It would be useful in portfolio planning to combine a market and a state approach. Part of the solution can be the founding by the banks of a specialized subsidiary for this purpose.

CHAPTER SEVEN

Privatization and the Strategy of Bank Privatization

7.1. From nationalization to privatization: a global trend

The forms and conditions of land ownership and of other “means of production” have varied across the world and throughout history. These conditions have also shaped the economic efficiency and the degree of freedom or oppression prevailing in a given society.

The end of feudalism – and the severe restrictions on land ownership and of the system of serfs – coincides with the beginning of the modern economy and with the industrial and agricultural revolutions. Liberal thinkers like John Locke have affirmed the importance of the respect of private property as an indispensable condition of a free and just political order.

The most systematic and virulent attacks against private property from the mid-nineteenth century onwards came from Marxist–Leninist ideology. For the Communists private property was the source of all evil in society. The single most important task first under Socialism and then under Communism was the abolition of all private property and the “exploitation of the masses” that it makes inevitable. Nationalization was an essential component of the tools used by the regime to deprive people of their freedom and to prevent any temptation at opposition.

State ownership and even state monopolies were not limited to the Communist system. They were maintained or introduced in some sectors out of respect for certain traditions or for real or alleged “national security” reasons. Right-wing authoritarian and totalitarian regimes also tended to impose strict controls on the “nation’s wealth” and expropriate the “treasures amassed by our enemies” (e.g. the properties of Jews).

The period following the Second World War saw essentially three models of ownership: (1) the Communist model, which implied a complete nationalization (expropriation) of all private property and an attempt to plan and control all production, consumption, investment and trade by the Communist Party and the government (also dominated by the Party); (2) a market economy with a relatively large share of companies in industry, services and trade owned and controlled by government

(mixed economy); (3) a more complete market model, where public ownership and control was a relatively small share of the economy.

In Western democracies one of the principal issues of political debate was how much of the economy should be owned and controlled by the government, and what should be the extent of economic freedom and private property. However, even the Social Democratic Parties rejected total control of the economy on the Communist model; neither did the Centrist or Liberal-Conservative Parties want to eliminate all public ownership or influence in the economy.

In this context there were no two Western democracies where the ownership structure would have been identical during the entire post-war period or would not have fluctuated between the two poles of more or less public sector ownership or control. What made the fundamental difference between the Western “mixed economies”, on the one hand, and the left-wing totalitarian (Communist) countries, on the other hand, was not only the percentage difference in private respectively public ownership, but the degree of economic and political freedom. The Western democracies were free and the large and small Communist countries were not.

The freedom and efficiency of the Western economies were re-enforced not only by the competition favored through private ownership and initiative, but also by the systematic liberalization of international trade and payments (and integration) across the world of the market economies. At the same time, Soviet dominated COMECON, a trading system based essentially on barter rather than real price and currency relations, remained an obstacle to prosperity until the very end of the Communist empire.

A note on the legacy of corporatism

Before turning to the global wave of privatizations of the 1980s and 1990s, one should mention the legacy of pre-1945 corporatism and its impact on the share of public ownership in many countries not only in Europe but also in Latin America.

In absolute terms Italy was the most important example (see IRI, Istituto per la Ricostruzione Industriale, 1933–2002). From the point of view of Hungary, the example of its neighbor Austria was probably even more relevant. In fact, Austria had gone through major successive waves of nationalizations since the years before the First World War until the period after the Second World War. Thus, for decades thereafter, a very large percentage of the Austrian heavy industry and the banking sector was owned and controlled by the state. Two contrasting periods: the oil and currency crises of the 1970s and the post-1980 globalization.

The 1970s witnessed the worst economic and currency crises in the OECD countries and in the world economy as a whole since the late 1940s. The combined

causes were the oil-price crisis and the collapse of the Bretton-Woods international monetary order. The combination of high inflation with rising unemployment was a new experience that created social tensions and also led to renewed government interventions, including nationalizations in order to save jobs and companies threatened by bankruptcy.

The political and the economic policy backlash against what was seen as a socialist threat to the market economy and to the liberal international economic order was especially strong in Britain and the United States, but subsequently also spread to the rest of the OECD area as well as to the developing countries. Many of these suffered from the “debt-crisis” and the risk of international financial collapse. The combined answer to the multiple crises of the 1970s was “monetarism” and vigorous emphasis on private initiative and markets, and cutbacks of public ownership and of trade-union power.

The ideology of “Thatcherism” and “Reaganomics” and their excesses remain subjects of debate to the present day. On the whole, however, the world economy witnessed from the early 1980s onward a strong turn to the markets and diminished direct government economic interventions. A wave of privatization, both in the developed and in the developing countries, was a major feature of this development.

The principal exception to this trend was in the Communist countries. The final crisis of the economic model, based on the absolute economic power of the party and the government and the prohibition of private ownership, began at the start of the 1980s, a crisis that led to the collapse of the model by the end of the decade. It was also around this time that the term “globalization” gained widespread use to describe the Western liberal economic and social model.

Main aspects of globalization

The term “globalization” has a triple, interdependent meaning: it is an objective, a process and the state of the world economy.

The following are some of the key aspects of globalization.

- 1) “Deregulation” was the principal and most widely discussed “new” feature of the Western liberal economic order. Its main objective was to eliminate legal obstacles to competition and the entry of new firms in sectors where the government had previously imposed obstacles to entry and *de facto* or *de jure* protected private or state monopolies. The first and most important sector where this was carried out was telecommunications. It was rather paradoxical that the United States, the world’s largest market economy had the most restrictive telecommunications sector and the most systematic protection of the monopoly position of its single telecommunications company. There were few if any other countries where the three major segments of the

telecommunications market – (1) telecommunications services and networks, (2) telecommunications equipment and (3) telecommunications research and development – were as firmly in the hands of a single giant company. Once the monopoly was broken up (the famous decision of Judge Green), the standard argument that telecommunications was a “natural monopoly” lost most of its followers. Among the numerous sectors where deregulation was subsequently carried out, public transport, airlines, electricity, water and the health sector should be mentioned.

- 2) “Privatization” was an almost direct corollary of deregulation. This was the case not only where the government was the monopolist owner prior to deregulation, but also often when the deregulation was combined with a “breaking up” of a company into smaller components to achieve “market efficiency”.
- 3) “Marketization” has been one of the most ideologically laden and controversial issues in the new neo-liberal or libertarian doctrine. Its aim has been to turn public services or products, which had been available free of charge or at prices below their true costs, into “market products sold at competitive prices”. In fact, “marketization” of public services turned into one of the most questionable features of the “globalized economy” and in many cases it is rightly seen as an unjustified attack against a well-established social order.
- 4) “Liberalization” of international trade and payments and non-discrimination between national and foreign buyers, sellers and investors.
- 5) Elimination and prohibition of direct or indirect subsidies.
- 6) The pendant of “privatization” has been the reduction or elimination of government supplied public services.
- 7) The general reduction of the right or freedom of government agencies to make “economic decisions” has been one of the consequences of globalization. The belief that the “private sector knows best” and that “government bureaucrats are always incompetent” has turned out to be a dangerous over-simplification. Thus, the unquestioned reliance on the “self-regulation” of the banks (and their highly over-paid speculators) was one of the key causes of the near-collapse of the entire international banking sector in 2008–2009.
- 8) The last point to be mentioned here is one of the most widely felt and criticized features of globalization; this is the deregulation of the banking and financial sectors and the prioritization of financial tools and transactions over the “real economy”.

Positive and negative aspects of globalization

For many years a recurring question has been raised by economists, politicians and the general public: Is globalization good or bad?

The answer to this seemingly oversimplified but in fact very complex and important question is not a “yes” or a “no”. Without “globalization” the world economy – rich and poor countries alike – would be much worse off than it is with an open, global, liberal international economic order. At the same time, some of the major faults of globalization also have important (negative) consequences for prosperity and social progress, and, in case nothing is done to correct them, the world economy might face an even more severe crisis than the one 15 years ago.

Without going into an extensive discussion of the multiple aspects of globalization only a few of the positive and negative aspects of globalization will be mentioned in the rest of this section, those aspects that are particularly relevant from the point of view of privatization, ownership and control as well as from the perspective of Hungarian regime change.

Strengths or positive aspects

The principal positive aspect of globalization is that it includes, beyond the general benefits of trade and payments liberalization, as described in the standard texts on international economics, further features, which help reduce differences between national and foreign actors. It aims to create a maximum degree of resemblance between legal and institutional conditions within national borders and beyond state borders. The main rule is that government agents must not interfere with the proper working of markets either through subsidies or legislative or executive measures; nor should they discriminate in favor of national actors.

Weaknesses or negative aspects

The worse aspects of globalization can be summed up under the closely interdependent issues of “short-termism”, the domination of finance over the real economy and of speculation, and of the “hedge-fund mentality” over the growth of the real economy. Globalization has been accompanied by growing inequality between and within nations, by widespread destruction of jobs and production facilities (de-industrialization and out-sourcing) and by fragility of markets and supplies (“supply-chain” problems) across the world. Lack of respect of common rules and standards by non-free, non-market economies is a frequent threat to the liberal international economic order.

7.2. A broad range of approaches: from the German *Treuhand* to “coupon privatization” and to “market privatization”

The initial wave of privatization of the 1980s was driven by three major interdependent developments: (1) the new emphasis on markets and on private initiatives in the OECD countries, (2) the international debt crisis and the pressure on the debtor countries (primarily in the developing world) to reduce the economic role of governments and to bring about “structural adjustment” (more competition and private initiative, fewer subsidies, and the tightening of fiscal and monetary policies) and (3) the enormous wealth and income transfer to the oil-producing countries as a result of the shift in terms of trade brought about by the increase in oil prices. (4) A fourth major factor that gained momentum towards the end of the decade and subsequently in the 1990s was the crisis and ultimate collapse of the Communist economic system in East-Central Europe and in the Soviet Union.

The basic “textbook definition” of privatization is quite simple: the transfer (as much as possible through a commercial sale) of a government-owned and controlled company or real estate to private owners. In theory this is the exact opposite of an earlier transaction, i.e. the nationalization (through expropriation or against payments to the owners) of factories, banks, stores (including the corner tobacco shops) without the prior consent of the legitimate owners.

Most of the nationalizations carried out in the past were for ideological reasons, but at times also for more legitimate economic reasons, i.e. in order to save companies from impending collapse. Most of the “ideological nationalizations” were carried out by authoritarian or totalitarian governments. A famous exception was when under President François Mitterand during the early 1980s the French government carried out a massive program of nationalizations in order to comply with the *Programme Commun*, the electoral programme between Mitterand’s Socialist and Georges Marchais’s Communist party. Once the Socialist Party lost its parliamentary majority (and the Communists had left the coalition), the nationalization program was duly reversed and Mitterand and his Conservative Prime Minister presided over a large-scale privatization program.

In practice, privatization has proven to be a much more complex exercise than the textbooks suggest, or as was the case in France under Edouard Balladure’s premiership. Thus, privatization during the last three decades has been more of a trial and error process than a smooth transition from “irresponsible state owners” to “responsible private owners”. The complexity and diversity of the numerous approaches adopted in Eastern Europe and elsewhere have been due to varying objectives and political, economic and social conditions in the countries concerned.

This diversity can be illustrated by the three approaches mentioned in the title of this section: the German *Treuhand*, the Czech coupon privatization and the so-called market privatization, which was supposed to be the main Hungarian approach.⁵⁴

The German Treuhand experience

East Germany had one of the most orthodox Communist regimes in Europe. By the standards of the Eastern bloc East German industry was relatively efficient, but in comparison with the advanced market economies, and in particular compared with the industry and the economy of the Federal Republic of Germany, East Germany suffered from all the shortcomings of the Communist economic and social model.

German reunification was carried out through the dissolution of the East German State. The East German provinces joined the Federal Republic and adopted its free political, economic and social system. This has provided great benefits for the population of the former German Democratic Republic (GDR). There were, however, also major “transition” costs as well as psychological tensions among the *Osties*.

The large competitive shock registered by the East German economy can be explained by the overnight lifting of all borders and administrative controls and restrictions on the movement of goods, people, services and capital between one of Europe’s and the world’s most competitive export-driven economies (Federal Republic of Germany – FRG) and one of the most conservative planned economies in the world (GDR). There were no sectors of the East German economy that were fully competitive with their Western equivalents. The decision to carry out reunification with an exchange rate of one to one made the East German economy even less competitive.

The Federal Republic and its citizens and the West German firms and other institutions willingly assumed the financial and other material costs of reunification. One of the major tools in this reunification and transformation process was the *Treuhand*.

“The *Treuhandanstalt* („Trust agency“), colloquially referred to as *Treuhand*, was an agency established by the government of the German Democratic Republic to reprivatise/privatise East German enterprises, Volkseigene Betriebe (VEBs), prior to German reunification. Created by the Volkskammer on June 17, 1990, it oversaw the

⁵⁴ For a country comparison see: Blejer, Mario I. and Coricelli, Fabrizio, Editors (1998): *Három ország, három történet, három szereplő: rendszerváltozás Kelet-Közép-Európában, ahogy Leszek Balcerowicz, Bod Péter Ákos és Václav Klaus látta*. Széphalom Könyvműhely, Budapest.

restructuring and sale of about 8,500 state-owned companies with over four million employees. At that time, it was the world's largest industrial enterprise, controlling everything from steel works to the Babelsberg Studios. The *Treuhand* was responsible for more than just the 8,500 state-owned enterprises. It also took over around 2.4 million hectares of agricultural land and forests, the property of the former Stasi (secret police), large parts of the property of the former National People's Army, large-scale public housing property, and the property of the state pharmacy network. On the day of reunification, October 3, 1990, it took over the property of the political parties and the mass organisations of the German Democratic Republic. Its operations drew criticism for unnecessarily closing allegedly profitable businesses, misuse and waste of funds and layoffs that were claimed to be unnecessary. It also drew substantial protest from the workforces affected, as 2.5 million employees in state-owned enterprises (out of 4 million in total) were laid off in the early 1990s. Supporters argued that not placing the former state-owned enterprises into private hands would have caused the loss of many more jobs and slowed economic recovery. When its operations ended in 1994, it had amassed 260 to 270 billion DM in debt.”⁵⁵

A 1993 publication of the International Monetary Fund described the options considered in privatizing the East German economy and the differences between possibilities open to *Treuhand* and those that the other former Soviet satellites had.⁵⁶

“The transition of the industrial sector from planning to market orientation is a central problem facing East Germany after German unification. The industrial sector has to be completely rebuilt, and the privatization of viable firms is as important a step in this process as the liquidation of nonviable firms. While these problems have been intensively discussed in all former communist states, it is important to keep in mind the particularities of the German situation. These features explain why policies adequate for, say, the former Czechoslovakia, might not be recommendable for East Germany. Being part of the united Germany, the new states and East Berlin now enjoy:

- the West German system of laws and regulations for government and business, which has been well developed over many years of application,
- instant currency convertibility and, by using a currency with a longstanding reputation for stability, guaranteed absence of hyperinflation as a consequence of price liberalization,

⁵⁵ Cf. Wikipedia: *Truehandanstalt*. Emphasis added

⁵⁶ Tanzi, Vito, Editor (June 1993): “CHAPTER 11: Privatization in East Germany”, in *Transition to Market, Studies in Fiscal Reform* International Monetary Fund, Washington, D.C.

- the benefits of special recovery programs set up and financed from the West for infrastructure, restructuring of old firms, establishment of new firms, and stimulation of investments,
- access to West German human resources and expertise; West German investors, banks, and insurance companies are available for starting and redeveloping businesses,
- the mature (West) German social security system,
- direct access to European Community markets (and to EC regional and development aid).

The policy of the Treuhandanstalt consisted of privatization by low-price sales or giveaways of industrial firms to those investors who presented the best investment pledges and job guarantees.

East Germany is in a privileged position. Using a “parental guidance” model helps explain the transition from a planned to a market economy better than the “help yourself” model, applicable to the former Czechoslovakia, Hungary, Poland and other countries. The Treuhandanstalt, founded by the Government of the GDR in December 1989 and restructured in June 1990, owns most industrial enterprises in East Germany. The privatization or restructuring of East German firms started with this government agency in charge of transforming the East German economy from central planning to “market socialism”; unlike Hungary, there was in East Germany no movement toward “spontaneous privatization.” The application of people’s shares or vouchers has been advocated by many advisors to former communist countries. The German Federal Government never intended to implement a scheme of general vouchers or shares.

Most former communist countries lack the purchasing power to allow rapid privatization. ...In Poland ... savers could ... purchase approximately 1 per cent of the capital stock... Czechs could currently purchase 10 per cent of the state assets ... and at the current rate of saving would take a further 150 years to purchase the entire capital stock... Giving away the firms solves the problem of the lack of purchasing power and also allows comparatively rapid privatization. In Germany there is more purchasing power than in the former Czechoslovakia or in Poland. Moreover, it may more easily attract foreign capital. However, even in Germany it is uncertain whether all viable East German industrial firms can be sold at prices equal to their estimated value.

As in the other former Communist countries, there were great difficulties in evaluating the firms to be sold. The Treuhandanstalt dealt with these problems in the following way. The agency shared with the investor, or even fully assumed, the

environmental and ownership risks. It also may have entered into some agreement about the servicing of former company debts. The agency sold firms at a low price, sometimes at even DM 1, but coupled with investment pledges and job guarantees (with penalties to be paid by those who did not abide by their commitments). This illustrates that the Treuhandanstalt was giving the firms to entrepreneurs and not to citizens or employees and managers – the other possible recipients.

Restructuring – preparing an industrial firm for privatization – included the following activities:

- The breakup of large conglomerates, the so-called Kombinate; the Treuhandanstalt has been active in this,
- The dismissal of former managers who are politically incriminated or lacking in managerial skills. By the end of June 1991, the Treuhandanstalt had replaced over half of its force of enterprise managers; approximately 20 percent of the new managers came from West Germany.
- The reduction in the labour force; here the Treuhandanstalt has acted cautiously.
- The development of new investments to render the firms more attractive to private purchasers; here the Treuhandanstalt has not accomplished much...

If restructuring and privatization proved impossible, the Treuhandanstalt had to take over and liquidate the firm. By 1993 Treuhandanstalt owned only firms that private investors were unwilling to take over. Shipyards and steel, coal, and chemical industries constituted the core of the doomed remnants of the former GDR economy... (As noted above) at that end, the Treuhandanstalt became not a source of income from privatizations but a financial liability with a huge net indebtedness.”

The 1993 IMF study pointed out that “much remained to be done by the federal and state governments to provide opportunities for the private establishment of new firms, for instance:

- improving the infrastructure;
- improving the public administration;
- more rapid processing of property right claims;
- increasing bank flexibility for granting loans to potential new entrepreneurs;
- training East German managers to promote the entrepreneurial spirit;
- retraining East German employees to stimulate occupational changes;
- relaxing minimum wage provisions; and
- diluting labour market rigidities.

7.3. Hungarian privatization policies and institutions (ÁVÜ, the Office of the Minister of Privatization)

The general approach to the renewal of the Hungarian economy proposed by József Antall and his government is discussed in various other chapters of this book. Also discussed is their assessment of the accumulated economic and social costs of the more than four decades of Communism in Hungary as well as the crisis and impending break-down of the Hungarian economy at the time of the free elections and the change of government.

The focus in this chapter is on the issues of property rights and the imperative to rebuild an economic order where private property and private initiative would prevail over government ownership.

Antall explained on numerous occasions that the goal of his government was the creation of a modern social market economy based on private ownership and initiative. He was fully aware of not only the moral and legal harm done by the nationalizations and expropriations of private enterprises, but also of the negative long-term economic consequences of these measures. It was also clear to him that despite the much-heralded “reforms” the fundamental features of the economic regime were never really questioned or reversed.

Antall knew that market economy and private ownership and initiative in the Western democracies at the end of the 20th century did not mean that the state did not have important responsibilities in the economic area. These responsibilities included public ownership of enterprises in selected sectors. In the case of Hungary it also meant a careful management of the state-owned assets – both the part that was meant to be privatized and the part that was to be retained temporarily or in the long run in government ownership.

Antall was a careful observer of the strategies and tactics of the ruling Communist party. Never a follower or a member of the Party, he was a convinced and unshaken opponent of the totalitarian system, a life-long adherent of liberal, democratic values and ideas. Antall understood well how the system worked. This was also the case in the 1980s, a period of complex and contradictory parallel developments that by the end of the decade made the Hungarian economy even more fragile and crisis-prone than it had been 10 years earlier.

The following are relevant:

- 1) During the 1980s the Kádár regime remained as secretive as before. The most important decisions concerning the rules of economic plans and the distribution of resources were never made public.
- 2) There were prohibitions and taboos that could not be violated, as, for example, the return to a privately owned enterprise structure.
- 3) Many of the small steps of liberalization and “enterprise reforms” were designed to strengthen the position of the Communist managers and to allow them to suck out the substance of the enterprises and to make themselves *de facto* owners and beneficiaries.
- 4) While there was a significant number of administrative and legislative measures that dealt with features of a market economy, they did not amount to a full set of market reforms.
- 5) An important commitment by Antall and his team was to treat State property with respect and not give it away freely. In contrast, for example, to the Czech approach of *de facto* giving away public property without being paid for it (see “coupon privatization”), the Antall government aimed to set a realistic market value and conduct a market transaction within the framework of privatization.

The state of the Hungarian economy at the time of regime change and the beginning of systematic privatization is discussed in earlier chapters. However, two issues have to be mentioned here in addition to the five points mentioned in the preceding paragraph. The first one is (6) the creation of ÁVÜ (*Állami Vagyongynökség* – the National Property Agency) by the Németh government before the elections and before the actual transfer of power to the new freely elected government actually began, and (7) the adoption among the rules of ÁVÜ and of privatization in general of specific regulations that would facilitate or tolerate spontaneous privatization, an approach everyone knew that Antall and his team were opposed to.

*Prime Minister Antall's presentation of his government's program in
Parliament: “On the Road to National Renewal”, May 22, 1990*

The issue of recreating a market economy based on private property and private initiative was a key theme of Prime Minister Antall's presentation of his government's program to the Hungarian Parliament on May 22, 1990:

“It is our objective to establish a social market economy, or, in other words, an economy where the open market is coupled with social, and let me hasten to add, environmental considerations of a caring and forward-looking society. Although

some facets of the market economy have appeared recently, it must be understood that 43 years of the so-called planned socialist economy cannot be done away within the space of a few weeks.”⁵⁷

And further on:

“The state confiscations of enterprises carried out in the late 1940s were politically motivated, socially unjust and economically inefficient. These confiscations, however, cannot be compensated with a single action. Property reform and privatisation must be based on property relationships, as they existed in the previous system. With the exception of productive agricultural land, the confiscated properties cannot be restored fully to their previous owners. The management of state enterprises by enterprise councils will be terminated. We will initiate employee stock ownership. The government will prepare a comprehensive privatization programme. This programme will be socially accountable and just, but will be based exclusively on the principle of efficiency. We shall initiate some evaluations of some business units structured from some existing state enterprises and if necessary require the restoration of the original status. Those private establishments and state enterprises that operate productively and pay dividends will play an important role in the future. The effective operation of these enterprises is a basic condition for a growing economy.”⁵⁸

These objectives were developed in greater detail in the summer and autumn of 1990 in the government’s Program of National Renewal.

Enterprise Development and Privatization

“The government endeavours to create a social market economy where private property, personal freedom, competition are fundamental values. This social system can only be based on an economy integrated into the global economy and on the overwhelming majority of private property.

The principal goal of the government is to privatise state property, which has swollen to giant size – the ‘de-nationalization’ of public property – by entrusting it to suitable (i.e. anti-bureaucratic) property management agents, and to increase the forms and proportions of enterprises and organisations that have evolved in the developed market economies. Privatization means turning property into private ownership.

⁵⁷ Antall, József (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, Edited by Géza Jeszenszky, József Antall Foundation, Budapest, p.113.

⁵⁸ Antall, József (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, Edited by Géza Jeszenszky, József Antall Foundation, Budapest, p. 124.

Without private ownership neither a free society nor a genuine market economy can be imagined. The introduction of the concept of genuine private ownership, after a period of more than 40 years, and the solution of privatization in a way both efficient and socially equitable constitutes one of the key issues of the government's program.

Private ownership brings about a spirit of enterprise, the efficient, economically justifiable utilization of savings, strengthening at the same time the freedom and autonomy of savers. In developed market economies private property for the broad strata of the population – beside income deriving from work – is the foundation of financial security and at the same time a determinant condition of the country's international integration.

The nationalization cases of the forties and fifties were not only unjust but they also destroyed the national economy. The liquidation of private property, the expropriation of citizens' savings, production facilities and business funds by the state have resulted in Hungary being diverted from the universal processes of social and economic development in Europe. In Hungary private initiative and thereby the basic conditions of responsible management and work style were made impossible at the very time when in Western Europe the process of re-development and integration was started, a process based on private property and initiative and leading to the welfare of broad strata of the population.”⁵⁹

The 1980s – a period of failed attempts

As in most other countries, in Hungary also, privatization policies had many ups and downs. Although the official Marxist–Leninist ideology was not abandoned by the Hungarian Communist regime, various attempts at privatization were undertaken already during the 1980s. Some of these had to do with the particular economic problems caused by the growing crisis in the Hungarian economy, which was felt from the beginning of the decade. The external debt, the size of which had been considered a state secret, represented not only financial and material burdens. It was also the reason why Hungary was allowed to join the Bretton Woods institutions in order to facilitate the managing of its large and growing indebtedness.

While the Hungarian governments promised the international organizations that they would return to earlier reforms and would introduce more “market” features, these half-way measures could not satisfy the criteria and the strict check-lists of the experts from Washington, D.C. The fact that as late as the second half of the 1980s

⁵⁹ Hungarian Government (1990): *Hungary's National Renewal Program, The First Three Years (1990–1992) of the Republic*, Budapest.

Hungary was experimenting with the “Yugoslav model” (Workers’ Councils) shows how far the country was from a proper market economy.

Three approaches to privatization, or allowing private initiative, which could be observed in this last period of the regime, can be mentioned.

- 1) The first one was the creation of small-scale production or service enterprises (“work communities”) that in the absence of access to capital used the equipment of the state-owned companies. These much larger entities were thus drained of substance, without being truly privatized.
- 2) The second approach, much propagated in the waning days of the regime, was “spontaneous or self-privatization”. Under this “model” the managers and the rest of the staff took over the enterprise and declared themselves legitimate owners. It was a convenient way for the members or the children of the *nomenklatura* to secure a position and an often significant amount of wealth and starting capital in the new market economy.
- 3) The third approach was an attempt by the Communist government to sell to foreign banks and investors some of the principal Hungarian enterprises in return for a reduction of Hungary’s large external debt. This “package deal” did not work in the case of Hungary, and it did not work in virtually any of the other countries where it was proposed and attempted.

The 1980s witnessed in Hungary an expansion of the so-called “second” or “parallel” economy. People still had to have an “official job” but more and more had to accept a second or third job in order to make ends meet. These jobs also helped deal to some extent with the shortage of goods and services caused by the inefficiency of the state-owned enterprises. The income from the second jobs provided certain autonomy for the people. At the same time the already low productivity of state-owned entities continued to decline quite dramatically.⁶⁰

The initial role and structure of ÁVÜ

In August 1990 the new government adopted the proposal “Property and Privatization”, which defined the directions of property reform, business revitalization and privatization.

The objective was to speed up privatization along the following lines:

- 1) State-initiated (so-called active) privatization. The ÁVÜ offers a group of state-owned companies for sale on the stock exchange, after liquidation, after

⁶⁰ Kopátsy, Sándor (1989): *Levél a magyar reformerekhez*, Budapest.

- organizational deconcentration, reorganization, or it can transfer them to a business (asset management).
- 2) Privatization initiated by public companies and cooperatives. The companies develop their privatization program themselves, which the *ÁVÜ* can overrule or modify (the implementation of the program is either entrusted to the company or an external organization – a consultant – is entrusted with this).
 - 3) Externally initiated privatization. A domestic or foreign private entrepreneur, group of entrepreneurs, investor or group of investors announce their claim to the state company or a given unit, and then the process starts according to the method regulated by law. In addition to asset management, the privatization techniques included open and private (invited) bidding, capital increase privatization and public sale of shares.

The Németh government designed *ÁVÜ* as the principal tool to manage Hungarian government-owned property and to privatize whatever could be sold.⁶¹ After the free elections *ÁVÜ* functioned under the supervision of a Minister without Portfolio and a Board of Directors. The first Minister and Head of the Board of Directors was Ferenc Mádl, a highly respected international lawyer. Mádl had extensive experience with the laws of European integration and with European business law. The Deputy Director of *ÁVÜ*'s Board was János Martonyi who had been the Privatization Commissioner of the Németh government and subsequently the Deputy Director of the Board of *ÁVÜ*. He held the same position for two years in the Antall government, besides being Secretary of State first in the Ministry of External Economic Relations and then in the Ministry of Foreign Affairs. Martonyi was one of the most successful and respected politicians of the post-1990 decades. In addition to his role in the launching of *ÁVÜ* and his position as State Secretary in the Antall and Boross governments, he was Foreign Minister in the first and second Orbán governments. The Director of *ÁVÜ* was Lajos Csepi who later assumed the same position at the *ÁV Rt*.

Hungarian privatization got off to a slow start, which led to criticism both from the opposition and from within the parties of the government coalition. The slow initial progress was due to multiple factors. A first set of factors had to do with the novelty of the exercise, with the legitimate concern “to do things right” and to respect administrative and legislative rules, and not least to make sure that state property was sold at the right price. The fact that the government was committed not to “give away” state property made the assessment of the value of the companies to be sold a more important task than, for example, in countries where “coupon privatization”

⁶¹ *Magyarország a XX. században* (1996–2000), Babits Kiadó, Szekszárd.

was the rule. It may be mentioned here that throughout the years of privatization by the Antall government there was contradictory or contrasting criticism of *ÁVÜ* and the Minister in charge: privatization is too slow or privatization is too fast, we have not privatized enough, we have privatized too much.

Ferenc Mádl resigned from his position at *ÁVÜ* for differences in opinions concerning land ownership. He stayed, however in the Antall government. Subsequently he became a highly respected President of the Republic.

Tamás Szabó and the Csuhaj Report

After Mádl, Tamás Szabó, also a close associate of Prime Minister Antall, became the new dynamic Minister without Portfolio in charge of privatization. Tamás Szabó (who at the time was State Secretary in the Ministry of Finance), together with State Secretary Kodolányi and me in the Prime Minister's Office and Pál Tar proposed the creation of the Working Group on Economic Policy (*Gazdaságstratégiai Munkacsoport – GAM*) in December 1991. Szabó became the Head of the Working Group and I became the rapporteur. One of the recommendations of *GAM* was to review and accelerate the process of privatization.

Tamás Szabó decided early on to create a Working Group charged with the preparation of a detailed set of recommendations in the area of privatization. Imre Csuhaj, the Chief of Szabó's Cabinet, who had also been a member of *GAM*, headed the Group.

There is no need or room to discuss here in detail all the conclusions and recommendations of the "Csuhaj Report". The following few points will be sufficient to indicate its importance for the orientation of the privatization strategy of the second half of the Antall years.

The data provided in the report confirmed the slow start of privatization in the first year of the Antall Government, but also showed a significant acceleration in the following year. The report emphasized the political, social and economic importance of creating a middle class ("*polgárság*", "*Bürgertum*") in Hungary. An essential characteristic of this new middle class had to be its access to ownership in the Hungarian economy.

It was necessary to distinguish between the general objectives of privatization and the actual techniques, procedures and decisions in specific cases.

The 1990s were characterized not only in East-Central Europe but virtually throughout the world by an oversupply of enterprises seeking to be privatized with the help of international investors who had at their disposal not only capital but also state-of-the-art technologies. There was also a difference between a "demand-driven" and "supply-driven" privatization strategy.

The government's objectives included:

- 1) a privatization that would help improve the economic performance of the government-owned enterprises;
- 2) a mix of Hungarian and foreign owners;
- 3) foreign investors who would bring both capital and technology to help make the privatized enterprises more competitive;
- 4) foreign investors who would not only seek new markets in Hungary for their own products and squeeze out Hungarian products.
- 5) There was a need to find a balance between those who wanted to maximize the revenue from privatization in order to ease the pressure on the government's budget and those who wanted a sale to the most efficient buyer rather than to the highest bidders.
- 6) A complex issue was how to select the enterprises to be privatized to domestic or foreign investors, and how to select those in which the government wanted to keep minority or a controlling interest.
- 7) There were also properties reserved for municipalities and public bodies (e.g. hospitals, etc.).
- 8) One of the significant problems encountered in the privatization process was the lack of sufficient capital for Hungarian investors – either in the form of their own savings or as credit from banks.
- 9) While the government was strongly opposed to free distribution of property or the return of factories to previous owners, the system of “compensation” (*kárpotlás*) allowed people whose property had been confiscated by the Communist regime to receive entitlements, which could be used as capital in the process of privatization.
- 10) The creation of the *ÁPV Rt. (Állami Privatizációs és Vagyonkezelő Rt.)* should also be mentioned here. The objective of this new agency was the longer-term or even permanent management of the state properties that were not destined to be privatized in the short term. While this was a constructive initiative, the implementation ran into difficulties because of the poor communication skills of the designated head of the new agency (Pál Teleki).
- 11) The financial situation of the enterprises to be privatized should be mentioned. Some people had suggested that the enterprises should be “cleaned up” before privatization. This, however, proved to be impractical in most cases both for financial reasons and because it would have involved a lengthy and complicated process without guarantee that the enterprises could be saved without an important injection of capital by an interested investor. Thus, in many cases outright bankruptcy was chosen as the easiest and fastest solution.

In the process of privatization, the government placed great emphasis on strengthening domestic small, medium and large entrepreneurs and investors, and insisted on competition, but privatization was not revenue oriented. There were recurring tensions between the *ÁVÜ* and the Ministry of Finance (PM), which was pressing to increase revenues (in 1991, the budget expected HUF 40–50 billion from privatization – unofficially). The year 1992 was difficult for businesses because, due to the collapse of the COMECON markets in 1991, companies lost 20–30% of their markets, and, as a result, were devalued. The GDP decreased by more than 10% in 1991, by more than 5% in 1992, for a total of 17–18%. The devaluation was reinforced by the fact that privatization had also begun in the former socialist countries and efforts were being made to attract foreign working capital. Germany's investors were largely occupied with the eastern part of the country (former GDR), and in addition the global economic recession added to Hungary's economic problems.

In December 1991, the Prime Minister approved the proposal to establish a working group which aimed at creating the conditions of sustained economic growth. In June 1992, the proposals of the group, headed by the Minister of Privatization, called the *GAM* Program, were accepted by the government.

In *GAM*, among other institutional recommendations, the new emphases of the privatization policy were defined. Thus incentives were developed for demand and techniques for improving supply, and various institutions – regional development institutes, *Hitelgarancia Rt.*, etc. – were initiated. In August 1992, the Parliament adopted the new privatization laws (Nos. LIII, LIV, and LV). These set the process of privatization on a definite path based on experience, which until then had essentially been carried out taking into account other legislation. Pursuant to the privatization laws, privatization was to be carried out by two state organizations, *ÁVÜ*, which remained in its original form, and *Állami Vagyonkezelő Rt. (ÁV Rt.)*, which operated as a one-person state joint-stock company.⁶²

7.4. The special case of bank privatization

“Sound money” is the cornerstone of a healthy economy. This sounds like a “common place”. Yet, the respect or lack of respect for this premise has widely contributed to the success or failure of economic systems and policies throughout the twentieth century. In market economies, built on private property, banks also tend to be privately owned.

⁶² *Magyarország a XX. században* (1996–2000), Babits Kiadó, Szekszárd.

However governments do exercise important supervisory and control functions over the banks' activities through the Central Banks and other agencies.

It was widely recognized that the quality of the banking system would play an important role in the speed and the success or failure of the change from a planned economy to a modern market economy in the former Communist countries. Thus, bank privatization received special attention both from the Antall government and from Hungary's international partners, in this case for better or worse.

The two dominant schools of economic theory in the post-war period – Keynesianism and monetarism – approach monetary policy and the role of banks differently.

Keynesian economics was shaped not only by the genius of the greatest monetary economist of modern times, but also by the contribution of the deep banking crisis connected with the Great Depression of the 1930s. Thus, the post-war period was marked by prudence in banking supervision and by the general assumption that banking is different from other types of business activities. In contrast with the dominant doctrine prevailing until the early 1970s – especially in Britain and the United States – the subsequent “monetarist revolution” put greater emphasis on “banking deregulation” and on “self-discipline” by bank management. The virtual end of so-called “relationship banking” was one of the principal features of the new banking practice and competition.

Thus, the former Communist economies faced a two-fold challenge in the area of banking and finance. (1) They had to overcome the structures and habits of the Communist era, which were probably the most backward and non-market aspects of their economies, and (2) they had to adapt their banking system and regulations to the new international and European standards at a time when bank regulations and central bank policy were in a process of major changes throughout the world.

Under the Communist system there was a so-called “unitary” banking system with no real distinction between “central banking functions” and “commercial banking functions”. The principal role of the state banks was to manage the transfer of payments between ministries and other central decision-makers and other state controlled economic entities, such as state-owned enterprises. Usually, the banks' administrative structure was organized according to the various major sectors of the planned economy. A system of savings banks also played an important role. Their primary task was to absorb the population's savings to prevent excess spending in an economy characterized by chronic shortages of most goods.

One of the important reforms of the late 1980s was the creation of a two-tier banking system. This involved limiting of the Hungarian National Bank to traditional central bank functions and the creation of a series of commercial banks based on the National Bank's “corporate portfolio”.

The amount and conditions of credits granted by the Hungarian National Bank before the reform had little to do with traditional banking criteria, such as the ability to repay. Loans were distributed on the basis of political planning decisions. Thus, it was normal that the new banks inherited a substantial but also unequal volume of “bad debts”. Having been the rapporteur of the Bank Reform Commission appointed by Prime Minister and the principal author of the Commission’s report, Tamás Szabó with the Prime Minister’s approval charged me with the preparation of proposals for the bank privatization strategy.

From the start it was decided that bank privatization would be kept separate from the main activity of *ÁVÜ*. (In any case I had little to do with this.) It was also decided that the responsibility for bank privatization should not be assigned to the Ministry of Finance both for political and practical reasons. Finally, it is to be mentioned that at one point it was considered that a “Commissioner for Bank Privatization” should be selected (I was not a candidate) but the idea was soon abandoned as some of the candidates who were approached declined.

Individual Western governments as well as the “Group of 24” tried to help the transition to a market economy in the former Communist countries by financing the work of experts and consultants in various technical areas. While these programs had significant advantages they also had important shortcoming from the point of view of the “beneficiary countries.” These deficiencies were well known among Eastern European officials but the issue was rarely discussed openly for political and diplomatic reasons.

The problem can be illustrated with some examples that were relevant in the context of the Hungarian bank privatization program. For example in most cases the foreign financing countries or organizations selected the consultants on their own and the beneficiary administrations had little influence in the choice. Another issue was the relatively little non-earmarked financing available to carry out research on matters that were priorities for the beneficiary countries. Also it was unclear who controlled the work of the consultants and to whom they were accountable: to those who financed their work or to those who were supposed to use the results of their research.

Bank privatization was high profile work, especially in the case of Hungary, which had the reputation of being more advanced in the field of banking and finance than the other former satellite countries. Thus, when word got around that Hungary was preparing an ambitious bank privatization strategy, several important donor organizations signalled that they were setting aside important sums for the financing of Hungarian bank privatization. As will be discussed below in some detail, much of these promises turned out to be hollow and resulted in significant setbacks and delays in the Hungarian bank privatization program.

The guiding principles of the strategy of Hungarian bank privatization

The preparation of the strategy of bank privatization was a complex, time-consuming process. Part of the work was carried out in the framework of the Bank Reform Commission, most of it, however, in the Office of the Minister without Portfolio, Tamás Szabó, in close consultation with the Minister and members of his staff, especially including his Chief of Cabinet, Imre Csuhaj.⁶³ The report on the guiding principles of the bank privatization strategy was completed in March 1992. The following are some of main points and recommendations from the report.

The central assumptions of the report were that privatization was an essential component of the modernization of the Hungarian banking and financial system and thus a condition of the success of economic regime change. The strategy consisted of a two-pronged approach: (1) general principles for all banks and (2) the possibility (in fact the probability) of specific strategies adapted to the conditions and characteristics of the individual institutions. This was especially meant to be the case for the so-called “large banks”.

The report assigned an important role to the government as a “responsible owner”. This would involve not only an active participation in the preparation of the privatization of the individual banks and in the final decisions at the end of the process, but also maintaining a minimum government share in the individual banks.

Throughout the preparation of the strategy close contacts were maintained between the Minister and his staff and the senior management of the principal banks. The banks welcomed this later as an expression of more responsible ownership than the state had shown in earlier years. While these formal and informal contacts were appreciated, this did not mean that the bank managers and representatives of the owner, or the bankers among themselves, always agreed on the objectives.

On the following three issues in particular there were recurring discussions and disagreements. First of all on the timing of the privatization and on which banks should go first. Several of the bank managers believed that being first would provide an advantage to their bank and to them personally. The second point of disagreement was whether the bank managers could or should select a foreign partner independently of the selection strategy designed by the owner.

By far the most important controversy had to do with the banks’ balance sheets and with the inherited and newly accumulated bad debts. In fact, in addition to the bad debts that were the direct result of the functioning of the National Bank and of the

⁶³ Hieronymi, Otto, principal author (March 6, 1992): *Bankprivatizációs stratégia: általános irányelvek (első változat)*, Szabó Tamás tárca nélküli miniszter hivatala, Budapest.

credit system before the regime change, there was a significant addition of “freshly created” questionable credits that were the result of the economic crisis of the early 1990s in Hungary and in the former COMECON area.

Both the Report of the Bank Reform Commission and the Report on the Strategy of Bank Privatization concluded that in the interests of the Hungarian economy it was essential that the balance sheets of the banks should be “cleaned”. The general traditional expert view in Europe and America was that the banks couldn’t carry the financial burden of this cleaning operation. Should they be obliged to do so, this would put such pressure on their cost structure that they would not be able to carry out a normal banking activity. The only acceptable solution was that the state, as a representative of the country’s general interest, should assume the financial costs of the banks’ “loan consolidation”. This common solution encountered a vivid rejection both among some bankers and among the “young Turks” of the Ministry of Finance.

I remember numerous conversations with Lajos Bokros, Head of the Budapest Bank, who was particularly adamant that loan consolidation was “unjust” and it penalized the banks that were more “disciplined” and had fewer bad loans, in favor of the “undisciplined” ones. A former official of the National Bank, Bokros was an economist trained in monetary economics who later became Minister of Finance in the Horn government. Well past my involvement in Hungarian banking issues I read with a mixture of irony and nostalgia about the misfortune of the Budapest Bank’s privatization attempt. A major Western bank withdrew its offer because of the much worse state of the balance sheet of Budapest Bank than had been assumed at the start of the privatization talks.

I also remember a meeting that I had organized with a group of young senior officials of the Ministry of Finance and two or three American banking experts whose task was to explain to the unbelieving Hungarians that government-financed loan consolidation was compatible with the principles of the market economy, and it was not a return to Marxist planned economy. The American experts should have been all the more convincing because one of them had been directly involved in the drafting of the legislation designed to bail out a large number of American savings institutions.⁶⁴

⁶⁴ “The **savings and loan crisis** of the 1980s and 1990s (commonly dubbed the **S&L crisis**) was the failure of 1,043 out of the 3,234 savings and loan associations (S&Ls) in the United States from 1986 to 1995. An S&L or “thrift” is a financial institution that accepts savings deposits and makes mortgage, car and other personal loans to individual members (a cooperative venture known in the United Kingdom as a building society). The Federal Savings and Loan Insurance Corporation (FSLIC) closed or otherwise resolved 296 institutions from 1986 to 1989, whereupon the newly established Resolution Trust Corporation (RTC) took up these responsibilities. The RTC closed or otherwise resolved 747 institutions from 1989 to 1995 with an estimated book value between \$402

However, our principal ally in the loan-consolidation discussion turned out to be Alexander Lámfalussy, Head of the Bank of International Settlements. Already at the start of the loan-consolidation controversy I had told Lámfalussy about the difficulties we were encountering with the officials of the Ministry of Finance. Lámfalussy kindly wrote a personal note explaining the mechanism and legitimacy of cleaning up bad loans. When this note was not enough, Lámfalussy accepted to come for one day to Budapest to meet with Prime Minister Antall and with the Minister of Finance. This latter represented the principal obstacle to our efforts. Lámfalussy had no difficulty in convincing Antall of the need for loan consolidation especially because Antall had a high personal regard for the famous economist of Hungarian origin.

According to the guiding principles the first main stage of bank privatization should have covered the four “large” banks: MHB (*Magyar Hitelbank*), OKHB (*Országos Kereskedelmi és Hitelbank*), BB (*Budapest Bank*) and MKB (*Magyar Külkereskedelmi Bank*).

The following were the main steps:

- 1) preparation by the bank of a detailed qualitative and quantitative analysis of the bank’s structure, situation, strengths and weaknesses;
- 2) preparation of a call for individual privatization advisers;
- 3) selection of the privatization advisers;
- 4) assessment of the bank by the selected privatization adviser and preparation of a market offer;
- 5) start of the process of privatization.

It was decided from the start that the privatization advisers would be selected from among the specialized world-class investment banks. Invitations were sent to eight institutions, and four were selected, one for each of the four large banks. It was assumed that international donors would cover the high fees of the advisers. The early stage of the process went according to schedule, but unexpected complications led to significant delays.

One had to do with the promised financing of the advisers. Initially the Director at the European Community, who in the name of the Group of 24 was charged with allocating a budget for the international advisers, had second thoughts. In a phone call he informed us that the budget would be allocated for other projects and no longer available for financing the costs of Hungarian bank privatization. His explanation was

and \$407 billion. In 1996, the General Accounting Office (GAO) estimated the total cost to be \$160 billion, including \$132.1 billion taken from taxpayers.” *Wikipaedia*, January 2023.

straightforward: “The list of the eight world class investment banks contained too many institutions with ‘Anglo-Saxon names’ and too many were based in London.” When we told him that *Crédit Commercial de France*, part of the eight, was not an English or American institution, he ended the conversation and we did not hear from Brussels again.

This kind of cheap nationalism, however, was not the exclusivity of the French bureaucrats transplanted to Brussels. We had a similar sad experience with London even if it was only for the costs of a single adviser, rather than all four. One day I was informed by the Prime Minister’s office that Mr. Antall had met John Major and mentioned to him the Hungarian bank privatization issue and that Major expressed interest for a British bank to act as a privatization adviser. Shortly thereafter I received a call from London confirming this interest. I explained to the member of the British Prime Minister’s staff that the financing would be welcome but that the selection was the responsibility of the Hungarian government. Also, the privatization adviser would have to report to the Hungarians and not to London. The answer of the British bureaucrat was blunt: if we (the British government) cannot select and be in control, we will not pay for the advisor’s costs. Here went the British concept of the “free market”.

A third story has to do with the visit of an official of USAID (United States Agency for International Development). I had little direct experience in working with or for USAID but was familiar with their reputation as one of the most bureaucratic branches of the American Federal Government. I explained to the visitor that for the Hungarian bank privatization program’s schedule it was important to avoid any additional delay for the arrival in Budapest of the experts who were going to be part of a small USAID financed project (much smaller than originally promised). The official from Washington asked: “How many Hungarian banks are we going to privatize with this project?” (The “we” meaning USAID and the American government.) My blunt answer was met with surprise: “None – I replied – USAID is not privatizing the Hungarian banks. These will be privatized by Hungary, their legitimate owner.”

Regime change and privatization

A principal objective defined in the electoral program of the Hungarian Democratic Forum was the transformation of the Hungarian economy from an inefficient planned economy, where the party and the state owned and controlled virtually all enterprises, into a modern social market economy where private property and private initiative would be the central features of the economy and of the social and ultimately also of the new political order. The program recognized that in order to achieve this objective

a bold but careful approach was needed in the field of privatization. Four decades of Communism left Hungary, like the other Communist regimes, a poor country. This poverty was evident not only in terms of the level of living standards and the quality of life but also in the low real worth of the country's productive tools. The vast majority of the country's enterprises were characterized by neglect, outdated technologies and low productivity compared with the great majority of Western market economies.

The nationalizations (in fact expropriations) carried out brutally and without any compensations in the late 1940s and in the 1950s – with many of the owners and managers not only fired but also the victims of political persecution as members of the “exploiters” and “enemies of socialism and the working class” – created great disruptions and damage in most Hungarian companies. The alleged beneficiaries of the transfer of new owners, the “people” turned out to be fairly irresponsible but also frightened owners.

In 1992 the government wanted to start preparing for the privatization of the banks. The Hungarian state-owned banks were in very bad shape; several banks lost their share capital, as their portfolios contained mostly bad, uncollectible receivables, and they had accumulated economic failures since their establishment (1987). It should be added that even when the banks were founded, they were forced to take over a number of qualified loans from the Hungarian National Bank which until then also performed commercial banking functions.

As a result of the Financial Institutions Act adopted in 1991 and later taking into account the international credit rating standards, the banks had to be recapitalized, that is, they had to be consolidated before privatization because they were in fact bankrupt. This applied to the largest banks, such as *Magyar Hitelbank*, *Országos Kereskedelmi és Hitelbank*, *Budapest Bank* and numerous smaller financial institutions.⁶⁵

In 1993, consolidation had to be continued at 10 banks. At that time, credit and debt consolidation had already been carried out. This meant that the banks received the capital for bad loans in the form of government securities up to the justified limit, but they had to settle with companies that had submitted an appropriate reorganization plan or were only struggling with financing problems due to a weak capital supply (debt forgiveness, capital conversion, etc.), that is, they had to transfer a part of the capital to the enterprises. The government decision stipulated that the customs and tax authorities should also facilitate the same.

The implementation had strict conditions for the banks, but these were largely not respected due to the usual disturbances around the elections and the replacement of the bank managers by the new government formed in 1994. In this phase the banks

⁶⁵ *Magyarország a XX. században* (1996–2000), Babits Kiadó, Szekszárd.

used HUF 114 billion for recapitalization, saving 70 companies. The package directly included the financial reorganization of *MÁV* (Hungarian Railway Company) and 15 large companies, worth an additional HUF 60 billion. In the end this consolidation turned into a major economic reorganization program, saving many thousands of jobs and keeping alive many companies that are now flourishing, such as the *Tiszai Vegyi Kombinát*. In June 1994 the first major bank, *Magyar Külkereskedelmi Bank Rt.* was privatized.

Finally, liquidation was a special way of privatization. In 1991 the parliament passed a bankruptcy and liquidation law that according to many was too strict. This was done in order to recycle assets that had to be written off during the transformation of the socialist economy into a market economy. This is an indispensable option in the market economy. During the liquidation procedures assets worth about HUF 300–350 billion were transferred to the liquidation organizations and from there cheaply into the hands of the private sector.

The privatization activity of *ÁV Rt.* unfolded slowly, at first it consisted primarily in the exchange of compensation tickets for shares. In the meantime two management changes took place, finally in January 1994 Lajos Csepi became the CEO of *ÁV Rt.*, and János Hatvani Szabó took his place at *ÁVÜ*. At the end of 1993 the most significant privatization until then took place, the sale of 33% of *Matáv* (Hungarian Telecommunication Company) – 30% to foreign professional investors, 3% to foreign financial investors – for HUF 87.5 billion. In 1993 the 25% privatization of power plants and electricity providers was announced, but this was finally withdrawn due to a lack of sufficient preparation.⁶⁶

Overall, between 1990 and 1994 the privatization organizations privatized HUF 310 billion of state assets, 55% of the revenue coming from foreign investors and 45% from domestic investors. Of the domestic revenues, HUF 44 billion was cash and HUF 94 billion was the discounted part (e-loan, compensation ticket, etc.) of the buyout, i.e. 68% in total. Privatization continued to accelerate during the four years. The revenues were used for the creation of the institutions necessary for the reorganization of the economy (Hungarian Investment and Development Bank, *Hitelgarancia Rt.*), corporate reorganization, replenishment of state funds (World Exhibition, Employment, Small Business Guarantee, Agricultural Fund) and budget payments. (The highest payment was made in 1993, when HUF 31 billion, 18% of revenues, was paid to the budget.) In this period the private economy already produced

⁶⁶ *Magyarország a XX. században* (1996–2000), Babits Kiadó, Szekszárd.

60–65% of GDP. The state-owned enterprises were transformed into economic companies which helped to speed up the supply policy.⁶⁷

7.5. The Antall government's record on privatization

Prime Minister József Antall passed away in December 1993. This was a major tragedy not only for his family, friends and followers but also for the long-term future of Hungary.

The hard work, the long hours spent on the numerous complex issues that required the Prime Minister's reflection and decisions week after week, months after months would have been remarkable even if Antall had not been attacked by a serious disease. He never let his illness, the physical pain stop him from assuming his historic tasks and responsibilities. We were impressed by him and by his ability to concentrate on all the issues that we discussed with him, on which we asked for his considered opinion and judgement. Today, 30 years later his achievements appear even more impressive than they appeared to us at the time.

Antall's passing away was tragic, but Antall was not a tragic leader or personality. In many respects he fulfilled his historic role and accomplished much more than could be expected under the difficult economic and political conditions at the time of the regime change. Antall was exceptional, not only if one compares him to his predecessors or successors in the office of Prime Minister of Hungary, but also on an international level. He met the challenges as well as, or better than other international leaders in the late 1980s and early 1990s during one of the most crucial periods of modern European history.

This is my considered personal and professional opinion – it is the central theme and message of this volume. How do we then reconcile this opinion, which is based not only on the memory of the time spent with the Antall government three decades ago, but also on extensive research carried out and on reflections during the years since Antall left us and since the end of his government, along with the 1994 lost election and with the still frequent underestimation of the performance of the Antall government in specific areas and as a whole? Was the approach, were the policies and decisions of the Antall government in the area of privatization, of building a functioning market economy correct or not? I will try to answer these questions, without going into excessive or unnecessary details.

⁶⁷ Op.cit.

The first and most important issue is this: was Antall aware of the nature of the challenge, of the importance and complexity of the task of restoring a competitive market economy after Hungary, like its immediate neighbors, had missed 40 years of progress and development? The answer to this key question can only be a resounding “yes”. Antall had a thorough understanding of the nature of the Communist economic and social systems – not only in global, abstract terms, but also in all its variations across the “socialist camp”, and in particular in its “Hungarian reform version” under the rule of János Kádár and of his acolytes and successors at the top of the state and party in the late 1980s.

“*Gulyás Communism*” may have misled Michail Gorbachov, the economists of the Bretton Woods Institutions and the followers of the 1968 generation about the nature of the “Hungarian model”, but it did not mislead József Antall. He was fully aware of the limits of the various “reform” measures introduced by the Communist regime from the 1960s onward, and in particular those of the 1980s. As for the “socialist market” formula, he realized that one of its main objectives was to save power and control by the Communist *nomenklatura* in case of a real regime change.⁶⁸

Antall was strongly convinced that the domestic and international situation in the late 1980s offered a unique opportunity for a veritable regime change in Hungary and in the other Soviet satellite countries. But he also knew that until the last minute there was the danger of violent revolt from inside Hungary or from the Soviet Union aimed at stopping and reversing the whole process.

Thus, he believed and argued that the creation of democracy and a market economy in Hungary had to be broadly based on an institutional and legislative foundation in order to be irreversible. The emergence of a new middle class would be a complex and time-consuming process. Privatization was to be an essential component of this process. This also had three further corollaries. Given the run-down condition of the state-owned enterprises and the country’s general poverty, privatization should not pass through more asset destruction than the minimum necessary. The second point was the emphasis on the duality of the new enterprise-ownership structure: foreign

⁶⁸ In September 1989 I participated in a series of discussions between Hungarian officials and Western experts about the economic situation and outlook of the Hungarian economy. One of the Hungarians was Rezső Nyers, a leader of the “reform wing” of the Hungarian Communist elite. What struck me at the time about Nyers, and has stayed in my memory ever since, was his unshaken conviction even at that late date that the future in Hungary should and would continue to be shaped by the Socialist/Communist ideology, and what was going on in Hungary was not an impending regime change but a battle between the different sections of Hungary’s “legitimate political elite”, i.e. the descendants of the old Communist “proletariat”. The victory of the Horn (Socialist) – SZDSZ (Liberal) coalition seemed to confirm the validity of my bad feelings and concern when listening to the arguments of Rezső Nyers.

investors and owners alongside with Hungarian owners. This implied the (successful) encouragement of foreign direct investments in Hungary as well as the maintenance of a certain percentage of government ownership and control of the assets to be privatized.

Antall also knew and accepted that privatization was bound to be characterized by trial and error – as was also demonstrated by international developments. He also knew and accepted that privatization would not be “popular” even though it served the interests of the Hungarian population as a whole. This also meant that his government had to face and deal with recurring and largely exaggerated attacks both from the opposition parties and from inside the coalitions on account of the speed (too slow or too fast) and the conditions of privatization (too many or too few foreign/domestic new owners).⁶⁹

Privatization and the social market economy

Was József Antall more of a historian or more of a politician? Was he more of a Hungarian patriot (not a nationalist) or a modern internationalist (Euro-Atlanticist)? Was the Prime Minister more a man of action or of reflection?

These questions have been raised time and again by both his adversaries and by his followers. The answer to these three questions in my opinion is that he was all of these. He was a politician and historian, a Euro-Atlanticist and a patriot and as much a man of action as of reflection. These questions and answers are relevant for understanding the approach and record of József Antall and of his government with respect to privatization.

In fact understanding what is going on in the world – not only in one’s own country but also in neighboring or more distant regions – is a basic qualification of a responsible (and successful) politician. For many years Antall had followed not only what was going on in Hungary and what was the nature and what were the fundamental shortcomings of the Communist system, but also what was going on in Europe and the rest of the democratic world. Through reading Western books, journals and newspapers (such as the Swiss *Neue Zürcher Zeitung*), through conversations with friends and other visitors from the West, he built up a remarkable understanding and familiarity with what was happening in the “luckier part” of Europe and the world. Antall had a critical but positive view of the world. He was neither a starry eyed idealist nor was he a born pessimist or cynic. He was interested in both what

⁶⁹ Szabó, Tamás (July, 1993): *A magánosítás három éve és előzményei*, Budapest.

worked and what did not work in the West. He strongly believed that “ideas have consequences” and that the lessons learned about the contemporary Western political, economic and social systems were not “unnecessary knowledge” for someone who was deeply interested in what could or could not work on a perhaps distant day in his own, less fortunate country.

All this is to explain how it happened that Antall knew so much about the “mainsprings of the economic and social success” of Switzerland and of German, French and Italian post-war reconstruction; how much he knew about the concept and record of the “social market economy”.

Knowing about the “social market economy” came naturally to Antall in the light of what has been said in the preceding paragraphs. Yet, Antall’s familiarity with this concept and his ability and dedication to choose and promote this model for the Hungarian regime change may seem surprising to some of the readers for two reasons. In the first place, as already noted earlier in this book, there were and there still are many prejudices and misconceptions about Antall’s alleged lack of interest in economics and in economic policy. In the second place, there was and remains a high degree of ignorance (which is worse than simple indifference) about the “social market economy” and its achievements among professional economists in Europe as well as other countries that pride themselves on their high level of economics culture. This includes the specialists of major international monetary and financial institutions (e.g. Bretton Woods group) who may have heard about the “German economic miracle” but know nothing about the contribution of the “social market economy” to the post-war success of Germany and of the continental European economies. “Top-level” Hungarian economists, such as Ernő Kemenes, the President of the Hungarian Planning Office prior to the regime change, or János Kornai of the Academy of Science, for that matter, were similarly unaware of this before the regime change.

In fact, Hungary was the only former Communist country (with the obvious exception of the former German Democratic Republic) that announced its program of transformation and regime change under the concept and objective of the “social market economy”. This was essentially the merit of József Antall. This was particularly important for the development of the private economy and the record of the Antall government’s privatization policies.

The following points can highlight this conclusion.

- 1) From the start an emphasis on private ownership and private initiative were at the heart of the program.
- 2) A wide diffusion among the population of ownership titles was an essential component of this goal.

- 3) Social concern inside and outside enterprises, including private and public social security services were to be secured.
- 4) Foreign companies were also supposed to respect high standards of social services.
- 5) Banks and other financial institutions were meant to provide the promotion of savings and the diffusion of individual ownership titles.
- 6) Public and private monopolies were either to be prohibited or submitted to controls.
- 7) Competition among small and large enterprises was to be the basic operating rule of markets.
- 8) Trade flows and capital movements were to be liberalized.
- 9) Transparency and anti-corruption guarantees were to be developed.
- 10) The ultimate goal of the development of the private economy was full integration in the worldwide liberal international economic order.

By 1993–1994 many of these objectives were at least partially achieved. Hungary had become a fully functioning market economy with a high percentage of private ownership of new and existing enterprises and of growing contribution of the private sector to the total output of the economy. These results were discussed in a two-day conference held in March 1994 and organized *de facto* in memory of the late Prime Minister Antall.⁷⁰

The achievements, however, were not enough to overcome the nostalgia for life under the Kádár regime. Basically what many voters wanted was both the undeniable advantages of an increasingly dynamic market economy combined with the false security of a “planned economy” on the brink of collapse.

The period following the elections of 1994 and the return to power of the former Communist elite is beyond the scope of this book. There is, however, no doubt, that despite much contrary rhetoric both in Hungary and abroad the Antall government had accomplished the essential tasks of turning Hungary into a “normal” market economy, which encountered many problems and financial and material difficulties like other “normal” European economies also tend to face. Privatization under the Antall administration contributed decisively to this “normalization”. It may also be argued that the spirit and values that were put forward and were defended by Antall and his team – in particular in the field of the acquisition of private property and of

⁷⁰ Hieronymi, Otto and Bérci, Gyula, Editors (March 11–12, 1994): *A szociális piacgazdaság és a magángazdaság kibontakozása Magyarországon* című konferencia taulmánykötete, Konrad-Adenauer-Stiftung Aussenstelle, Budapest and Állami Vagyongyűnökség, Budapest.

the management of government-owned assets – suffered some setbacks, both under the Horn, Medgyessy and Gyurcsány cabinets as well as the more recent Orbán governments. Perhaps Antall was, after all, an “enlightened idealist”.

CHAPTER EIGHT

The Conditions of Sustained Growth: the Working Group on Economic Policy Strategy (GAM)

The prospects for success of the economic regime change in Hungary

What were the chances in the early 1990s of Hungary succeeding in its monetary and financial renewal? What were the country's overall "assets and liabilities"? What was the long-term growth outlook? What were the main policies that had to be reinforced or introduced? What were the priorities and what should be the "agenda for action"? Was there a "Hungarian model" at the time and what were the lessons that could be drawn from it for the process of economic transformation?

These questions dominated the economic policy debate in Hungary within the governing coalition and between the government and the parliamentary opposition, as well as in the public at large. They were also of highly topical interests for foreign observers and Hungary's partners in Europe and the rest of the world.

The developments in Hungary were overshadowed by events in the other former Communist countries, and in particular by the new Russian revolution and the break-up of the Soviet Union as it had existed for more than seven decades. Also, the economic and financial problems experienced by Hungary were dwarfed by the problems of countries like Yugoslavia or Romania, not to mention the republics in the former USSR. Yet, the case of Hungary, even if it was a small country in a relatively better position, was of importance for the other former Communist countries and for the OECD countries as well.

The example of Hungary showed that, even in a small country the transformation of a collectivist economy into a market economy was a complex process. In some areas it required bold and quick decisions, but it also depended on patient institution building. It involved freeing initiative and markets, and also required discipline, law and order and the respect for basic commercial practices. The freedom and property rights of all have to be respected, and not only of a small minority. A solid national currency was an indispensable ingredient of the transformation itself and for the take-off of the production process. However, successful monetary reform and monetary policies depended on the creation and the acceptance of numerous other rules and institutions without which a market economy cannot survive. The importance of political democracy and political tolerance, the maintaining of functioning institutions

for the success and the acceptance of economic transformation (and of its social costs) were also key aspects of the Hungarian example. Notwithstanding the initial results achieved, the economic outlook remained fragile also in Hungary. Beside the domestic costs of the transformation in terms of productive and infrastructure investments the loss of markets in the Soviet Union and in other former COMECON countries created a great strain on resources.

The conclusion of the research I was working on during the second year of the regime change was that in order to secure the basis for sustained growth in the 1990s, which would have helped to cope with the resource problem in the long run, for political and economic reasons Hungary needed not only private capital, but also a non-debt-creating resource transfer from the OECD countries.⁷¹

A failure to reverse the shrinking of the economy and to create the basis for sustained growth, the failure of the Hungarian model, i.e. of a country that was firmly committed to respect its external financial obligations, would have a profound negative impact beyond the boundaries of Hungary. It would be a major setback for financial discipline and for the development of the market economy in numerous countries where the starting conditions were less favorable. If Hungary, however, despite the heavy external burden and the domestic strain on resources, was successful in its financial and monetary renewal, this would have an important economic and political demonstration effect also for other countries that were trying to develop and to strengthen market economies and political democracies. This would help smooth the process of transformation (and reduce its costs) throughout the former Communist countries.

*The social market economy, the search for domestic and external balance,
and the progress of the transformation of the Hungarian economy*

In East-Central Europe Hungary was the earliest to make significant progress towards the development of a market economy. The transformation of the Hungarian economy and of the financial and monetary system, including the reform of the banking system and of the central bank, was going ahead at a good pace in 1990–1991.

The Antall government had chosen the Western European model of the social market economy as the long-term goal for the transformation and development of a modern market economy. The general objective of the government's legislative

⁷¹ For a more detailed discussion see chapter five above. See also: Bod, Péter Á. (1996): *“Financing Transition in Central-Eastern Europe, the Role of the EBRD in the Reconstruction of the Region”*, Unpublished paper presented at Webster University, Geneva.

program and of its economic and financial policies was to create the conditions for the successful development of the social market economy. This also had direct and indirect implications for the transformation of Hungary's monetary and financial system.

Despite the lively political debate between the governing coalition and the parliamentary opposition there was a broad consensus in the country about the general objective of the social market economy. It was widely assumed that Hungary was close to a breakthrough in the development of a dynamic market economy. Important tasks remained, however, at the legislative and policy levels. There was also an urgent need to reduce bureaucracy and to increase efficiency and productivity throughout the economy. Notwithstanding the progress achieved so far, there was also considerable room for improvement in the quality of banking and financial services for both companies and households.

Privatization had been progressing on various modes. The privatization programs of the State Property Agency aimed at attracting maximum foreign investments and expertise. There was also active Hungarian involvement in the process of privatization mainly by company managers (sometimes leading to ethically or politically controversial situations) as well as by Hungarian entrepreneurs. The participation of Hungarian entrepreneurs in the process of privatization should have been facilitated further as well as the stimulation of share-purchases in Hungarian or joint-venture companies by Hungarian savers and investors. (The system of so-called compensation certificates represented only a partial answer to this need.)

The government that was constituted following the free elections of the spring of 1990 pursued extremely restrictive monetary and fiscal policies from the start. As discussed in preceding chapters, a key objective of the new government was to maintain the country's international solvency and to avoid a domestic financial and monetary breakdown. These objectives were also confirmed in the three-year agreement concluded with the International Monetary Fund. And they were spelled out in the government's medium-term economic program. The positive impact of this was a balanced budget in 1990 and a sharp turnaround in the balance of payments. (This was the one and only year of a balanced budget, never repeated. The People's Republic never published reliable state budgets.) This latter was achieved largely through a remarkable export performance in convertible currencies.

The rise of prices, however, still remained too high (especially by OECD standards). This was partly due to the rapid elimination of subsidies and the adjustment of relative prices to Western patterns. The necessary reduction of subsidies contributed to the increase in prices and a sensation of economic insecurity. The continued existence of *de facto* monopoly positions (that could not be eliminated overnight in any economy)

was also a problem. Finally, the sharp turnaround in the balance of payments also contributed to inflationary pressures.

Yet, progress was achieved also in the fight against inflation. Thus, the trend of inflation was reversed in the first half of 1991. Moreover, considering the examples of other countries, the fact that Hungary avoided the threat of hyperinflation could be seen as a significant achievement. In order to assure the success of the fight against inflation, in addition to fiscal and monetary discipline, it was necessary (a) to stop further contraction of the economy and to reverse the trend of total output, and (b) to prevent a steep rise of wages.

In 1990 and 1991 Hungary made considerable progress towards current account convertibility. The aim was a *de jure* introduction of convertibility but without domestic or external upheavals. It should be noted that the exchange rate policy (involving a real but not nominal revaluation of the forint) helped slow down inflation (still in double digit).

There is a close connection between financial and monetary balance and the state of the real economy. Macroeconomic and microeconomic conditions are interdependent. A dynamic environment is necessary for successful management and for a successful renewal at the level of individual companies and banks. Institutional reform is indispensable, but for healthy banks and other financial organizations there is also a need for healthy companies, expanding markets, savings and investments. This was the spirit in which Prime Minister Antall created the Working Group on Economic Policy Strategy (*Gazdaságstratégiai Munkacsoport – GAM*) in December 1991.

At this point it may be useful to quote Professor Bod about the lack of sufficient international financial support received by the countries of East-Central Europe (ECE) in their post-Communist reconstruction efforts:

“Given the surprisingly high loss of income, output, jobs and market share during the early years of transition, resistance of the Western community to offer better terms to market access and institutionalized financial support for the countries of ECE is noteworthy... It is the private capital market which is able to mobilize resources in the range of tens of billions US\$ - under specific conditions. At present, none of the countries provide all the conditions since the systemic change has not been fully completed. Income levels and savings ratios are not high enough for sustainable growth... It is vital (therefore) to create a financial framework for the ECE countries consisting of:

- additional (medium and long-term) funds to finance infrastructural, environmental, regional and sectoral projects,
- stand-by credit lines to enhance the credit ratings of the countries and to provide cushion against private capital fluctuations.

This is necessary. It will be an investment into the future. But also investment into the investment process, for global benefit.”⁷²

8.1. Recognition of the need to create the conditions for sustained growth

Prime Minister Antall was convinced that without sustained economic growth the objectives of the regime change could not be fulfilled. To put it simply: people wanted freedom and democracy and they also wanted a higher living standard. They rightly believed that the Western economic model was superior to the Eastern, Communist model. Thus, joining Europe and the Western world had to mean an upward convergence in economic performance, a gradual but definite reduction of the gap between the “old democracies” and the “new democracies”, i.e. the former Communist countries. The Prime Minister was also aware that the closing of the gap would not happen instantaneously or automatically.

The economic crisis that the Antall government inherited from the Communist regime and from its collapse and the general resource shortage that were discussed in chapters one and five of this volume added significantly to the importance of the issue of economic growth.

For me who came from the Western world the importance of economic growth for the success of the Hungarian regime change was self-evident. One did not have to be an adept of Keynesian inflationary economic growth in order to recognize the fact that one of the principal tasks of a modern democratic government is to secure the conditions for sustained economic growth. This was certainly also the case in Germany and in Switzerland, two countries that were known for their record of price stability and were committed to non-inflationary economic policies.

I was also convinced that in Hungary depressed economic activity – stagnation or decline of investments and consumption – made fighting inflation more difficult. To a large extent inflation was the result of the economic crisis. Without the full and efficient use of the country’s productive resources – both labor and fixed capital – there was little hope to eliminate open or repressed inflationary forces.

⁷² Bod, Péter A. (1996): “*Financing Transition in Central-Eastern Europe, the Role of the EBRD in the Reconstruction of the Region*”, Un-published paper presented in Geneva, pp. 1, 10 and 12. Emphasis in the original. Professor Péter Bod was Minister of Industry and Trade in the Antall government and subsequently President of the Hungarian National Bank. At the time of the presentation of the above paper in 1996 he was a Member of the Board of Directors of the European Bank for Reconstruction and Development.

I found it rather puzzling that the evidence of the need for economic growth was not recognized by many experts not only abroad but also in Hungary. There were those who invoked the misfired attempts of the Kádár regime to stimulate the economy on the demand side which led to a worsening of the country's external payments position, further weakening the external confidence in the government's ability to manage the tense financial situation. Also, by this time many people in the Hungarian administration had developed an almost blind faith in the guidelines and instructions issued by the officials of international financial organizations. Since the World Bank and the IMF talked about austerity and fiscal and monetary restrictions as the principal components of the economic remedies for the crisis of the former Communist economies, many Hungarian experts and officials believed that talking about growth objectives was not only unimportant but outright dangerous. The "growth sceptics" were mainly to be found in the Ministry of Finance and the Hungarian National Bank.⁷³

Ever since the start of my university studies in Economics and International Relations, the rules and work of international economic and monetary institutions were important parts of the curriculum and of my academic research. Beside Geneva-based organizations, such as GATT, the Economic Commission for Europe or the International Labour Organization, already as a graduate student I had the opportunity to familiarize myself, on research trips in Europe and in the United States, with the work and the strengths and weaknesses of organizations such as the IMF and the World Bank, the Commission of the European Economic Community, the Paris-based OEEC and its successor the OECD, and with the BIS.

My principal professors at the Graduate Institute of International Studies (IHEI) – Wilhelm Röpke, Jacques L'Huillier, Robert Triffin and Michael Heilperin – had both practical experience and enjoyed worldwide reputations for their views and publications on international economic and monetary issues.⁷⁴ At the Institute we also had the benefit of the frequent visits for shorter or longer periods of professors from the USA or other European countries. The list of these visiting professors read like a "who-is-who" of contemporary international economic and monetary teaching and research.

⁷³ This was at least the case until Ferenc Rabár and Mihály Kupa were Ministers of Finance and György Surányi was at the head of the Hungarian National Bank.

⁷⁴ Among my favorite professors at the Graduate Institute I would also like to mention Professor Jacques Freymond, the Director of Institut de Hautes Etudes Internationales (IHEI), who was a great supporter of all the Hungarian refugee students at the Institute, and Professor Maurice Baumont, a famous French historian, whose professional work experience went back to the Secretariat of the League of Nations in Geneva in the 1930s.

I would like to mention here briefly two important lessons that I retained from my years at the Institute and that have served me well also in my later professional work. The first was that in studying contemporary economic, monetary, political and social issues, it is important to focus on the various levels and aspects of the developments considered, such as international/national, international organizations and national governments and policies, private sector and non-governmental organizations, etc. The second was that there is a distinction between intellectual interest, curiosity, respect for theories and applied results, on the one hand, and accepting without questioning the conclusions of the dominant doctrines, on the other hand. This lesson also includes the belief that it is right and important to both question and develop one's own ideas, even if they are not fashionable or part of conventional wisdom.

I was, of course, not the only one in the Prime Minister's team to believe strongly that sustained growth was not only desirable but also achievable. Those who shared my general views on this issue included the following (the list is far from complete): Péter Ákos Bod, Tamás Szabó, Gyula Kodolányi, Pál Tar, Béla Kádár, János Martonyi, Tibor Pongrácz and Imre Csuha.⁷⁵

8.2. December 1991: the appointment by Prime Minister Antall of a Working Group on Economic Policy Strategy (GAM)

The antecedents and the objectives of GAM

During the entire period of the Antall and Boross Administrations, from 1990 until 1994, I developed and maintained a close friendship and working relationship with Gyula Kodolányi, State Secretary and Head of the Office of the Prime Minister's Economic Advisors. Our friendship lasted for many years after the Antall years. Kodolányi also encouraged me to write articles for *Magyar Szemle* and the *Hungarian Review* and to complete the manuscript of the book I planned to write about my experience during the Antall years. Virtually every time we met he would ask me: "Otto, when will you write about *GAM*"?

Thus, I am particularly pleased to quote in the present chapter from Kodolányi's own memoir published in 2021, in which there are numerous references to our working together and to the *GAM* project in particular. Thus, for example, at one point he wrote: "As a member of the *GAM* Committee, I also became familiar with the large

⁷⁵ Until he left the Prime Minister's Office in late 1990, György Matolcsy was also part of those who shared our conviction about the need for policies favorable to growth.

scale of economic policy tools. I also talked a lot with Otto Hieronymi (a former Hungarian refugee after the 1956 Revolution), who was an expert on this economic policy thinking and who was back home from Switzerland as an Advisor at the Prime Minister's office..."⁷⁶

Beside *GAM* another issue on which I worked especially closely with the Prime Minister and also with Kodolányi was the attempt to obtain financial support from the members of the G7 countries in order to facilitate the recovery and growth of the Hungarian economy. Kodolányi remembers well how important these issues were for the Prime Minister. Thus he made some moving comments about Antall's deep concern about the negative attitude of our Western partners toward our legitimate reminders that for both material and psychological reasons successful reconstruction programs virtually always contained a component of foreign financial support. This was the case for European postwar reconstruction and the Marshall Plan as well as for the massive aid that the former East Germany received not only from West Germany but also from the other European Union countries.

As discussed earlier in this volume, in early 1991 a memorandum was prepared by a few of us, which documented the need for financial support for Hungary's efforts to overcome the economic and social legacy of the Communist regime. The relatively modest amount would have been used primarily to ease the burden of the external debt service and to start to overcome the consequences of the sorry state of infrastructure in the country. The text was prepared in Hungarian, English, French and German. Prime Minister Antall accepted to travel to Germany to meet the German Chancellor Helmut Kohl in order to hand him personally the document that we hoped would be discussed by the G-7 and be approved by the leaders of the Western Community.⁷⁷

I would like to quote again Gyula Kodolányi on the reaction of Prime Minister Antall to the negative attitude of the Western world:

"Antall was extremely depressed in 1991 when it turned out that the G-7, the group of the countries with the strongest economies in the world was not willing to respond positively to our carefully prepared request for a relatively modest amount of financial support. The text of our request was professionally excellent and the amount not significant for the G-7 in the grand scheme of things... We could not solve the fundamental strategic issue, which Antall also considered as such, the possibility of attracting resources to stimulate growth, because the Western leaders who esteemed him so much did not dare to go against the main current of economic conventional

⁷⁶ Kodolányi, Gyula (2021): *A világfa ágain*, Nap Kiadó, Budapest.

⁷⁷ This initiative was kept highly confidential.

wisdom of the time... I watched these events all the way through. I am trying to find the right word to describe them: they were in fact like a drama, a tragic drama.”⁷⁸

The creation of the Working Group on Economic Policy Strategy (GAM)

Prime Minister Antall appointed the Working Group on Economic Policy Strategy⁷⁹ in December 1991, following the completion of the study on the “obstacles to sustained growth”.⁸⁰

The large foreign debt and the heavy debt service were among the major problems inherited from the Kádár regime. With respect to the debt issue, there was agreement between the Prime Minister and some of his closest advisors (1) that Hungary must not default on the debt but (2) it would be important, in order to ease the severe resource shortage and to stimulate growth, to obtain an offer of debt reduction from the Western creditors that would not have a negative impact on our credit rating.

Everybody, however, did not share this view. As Kodolányi writes: “It turned out that there was an incredibly well organized network of people after 1990 who believed that it was a mortal sin if anyone dared to raise the issue of debt relief. I assume that the Ministry of Finance may have been one of strongholds. As I indicated, the Ministry of Finance accepted as a source of absolute truth the way of thinking of the International Monetary Fund.”⁸¹

There were profound differences between, on the one hand, those of us, including Antall, who strongly believed in the importance of economic growth, and, on the other hand, a minority, for whom austerity became a veritable mantra: “The disputes between the Ministry of Finance and the economic ministers in the government were not simply personal but philosophical disagreements... Growth supporters believed that it was possible to escape from the foreign debt trap not only by austerity but also through supporting economic growth.”⁸²

Antall knew that Hungary could not afford to antagonize the international financial institutions, even if he did not share their views on the need for growth for the success of economic transformation and reconstruction: “Antall loyally stabilized the budget. But Antall did not give up the idea of implementing the growth policy even after 1991. As I mentioned, he was deeply disappointed when it became clear that we would not receive the small-scale aid necessary for growth from the Western leaders,

⁷⁸ Kodolányi, Gyula (2021): *A világfa ágain*, Nap Kiadó, Budapest, pp.182–183.

⁷⁹ The Hungarian title was *Gazdaságstratégiai Munkacsoport (GAM)*.

⁸⁰ For more details on that project see Chapter Ten of this book.

⁸¹ Kodolányi, Gyula (2021): *A világfa ágain*, Nap Kiadó, Budapest, p. 183.

⁸² Op.cit. p.184.

for which he developed the original concept with Otto Hieronymi and the economic ministers.”⁸³

As Kodolányi also recalled: “The Prime Minister put his profound disappointment behind him. He never stopped thinking that the most important goal was to start the Hungarian economy on the path of growth. After analyzing the reason for the refusal of the G-7 with Hieronymi and the other members of his economic think tank, Antall set up a working group in December 1991 to study the conditions of sustained growth. Tamás Szabó, State Secretary in the Ministry of Finance became its devoted leader. There were two more of us providing, next to Szabó, the practical leadership on behalf of the Prime Minister’s Office, myself and Otto Hieronymi, an economist in the employment of the Geneva branch of the American Foundation Battelle, who was a member of the Office of the Prime Minister’s Advisors. Hieronymi was a committed follower of the model of the social market economy of Ludwig Erhard and Wilhelm Röpke. In addition to the three of us, Péter Ákos Bod, President of the MNB (Hungarian National Bank) and the state secretaries of the relevant ministries and other high-ranking officials worked in *GAM*. We worked from December 1991 to mid-March 1992 and met almost every week.”⁸⁴

As also noted by Kodolányi, the Working Group included Péter Ákos Bod, Tamás Szabó, Otto Hieronymi, Gyula Kodolányi, János Martonyi, Tibor Pongrácz, Etelka Barsiné Pataki, István Forrai, László Bogár, Miklós Király, Péter Szabó and Imre Csuha. Tamás Szabó, Minister without Portfolio headed the Group, his Head of Cabinet was the Group’s Secretary, and as the Prime Minister’s Adviser I was the Working Group’s rapporteur.

As noted in the preceding section, the issue of economic growth was at the center of preoccupations and internal policy discussions since before the elections and the inauguration of the Antall government. Some of the debates and their impact are discussed in preceding chapters, in particular in chapters one, two, four and five on the economic crisis inherited from the Communist regime, on the objectives of the Antall government’s economic program and on resource shortage and the debt issue.

Certain elements of these debates and reflections are mentioned here in order to highlight the antecedents and objectives of the creation of a high-level working group halfway through the Antall government’s electoral mandate.

As discussed in chapter four, the primary responsibility for the preparation of the *Program of National Renewal* rested with the Economic Policy Secretariat and the Office of the Prime Minister’s Advisors both located in the Office of the Prime

⁸³ Op.cit. p.184.

⁸⁴ Op.cit. pp. 183–184.

Minister with inputs from the various ministries. This division of tasks and shared responsibilities created difficulties when it became evident that some of the officials in the various ministries chose to ignore key elements of the Antall government's economic program. There were specific cases where the drafts submitted by ministry staffs contained passages that countered the objectives that had been clearly defined by the Prime Minister and some of his senior ministers. These problems were particularly evident with the Ministry of Finance (PM) and the Hungarian National Bank (MNB).

During most of the Communist regime – before and during the Kádár years – the organs of the State (the ministries and the Hungarian National Bank) had a subordinated role next to the true decision-makers at the various levels of the party hierarchy. It was only during the 1980s that some of the state (government) bodies began to acquire more decision-making responsibilities. This was particularly the case for the Ministry of Finance and for the Hungarian National Bank as a result of the external debt burden and the growing dependence of Hungary on the opinions of the IMF, the World Bank and other international financial bodies. Nevertheless the ultimate decision-making power belonged to the party.⁸⁵

There were several factors that led to recurring tensions between the staff of the Ministry of Finance and the Office of the Prime Minister after the free elections and the presentation by the Prime Minister of his government's economic program to the newly elected parliament. The disagreements in the drafting of the Program of National Renewal – in particular with respect to economic growth – were not the only manifestations of these tensions. The first and probably most important factor was that the majority of the Ministry's staff were disappointed that the Free Democrats (SZDSZ) had lost the elections and many of them were resentful that Mr. Antall and the MDF (Hungarian Democratic Forum) had won and were able to constitute a coalition government that did not include the Free Democrats. Combined with this anti-Antall attitude they also believed that whoever was at the head of the government, the Ministry of Finance had to be the source and the ultimate decision maker for all major questions related to economic policy. They considered the discussions and disagreements within the Economic Cabinet as a disturbing factor and as an unwarranted interference with the responsibilities of the Ministry of Finance.

The attitude of the Minister of Finance, Ferenc Rabár, seriously aggravated this problem. In his long letter of resignation published in the economic (anti-government) weekly *Heti Világgazdaság* (HVG) Rabár emphasized the difficulty he had working

⁸⁵ The designation of the regime as the "Party State" – "*pártállam*" – implies that the party is the state and not that the state rules over the party.

with State Secretary Matolcsy, the Head of the Office of Economic Policy in the Prime Minister's Office.⁸⁶

However, at the very beginning of the text published in *HVG*, Rabár admits that there was a deeper, more fundamental incompatibility between him and the Antall government. Thus, Rabár insisted that only a so-called "shock therapy" could prevent the collapse of the Hungarian economy. Adopting and implementing this harsh policy would require, according to the Minister of Finance, negotiating a common program with the opposition parties. This package, according to Rabár, would have to be accepted by a two-thirds majority of the parliament. In other words Rabár submitted an ultimatum to the Prime Minister (1) to go back on the decision not to follow a "shock therapy" (whatever the definition of the shock therapy) and (2) to disregard the agreement with SZDSZ that limited the scope of legislation requiring a two-thirds majority vote by the Parliament (the so-called "*Paktum*"), an agreement that allowed an effective division of responsibilities between the coalition government and the opposition, and the adoption of a large and ambitious legislative program required by the regime change.

The new Minister of Finance, Mihály Kupa, who started on December 20, 1990, was reputed to have acquired extensive experience on fiscal policy issues during the 1980s. He was also convinced of the undisputed primacy of the Ministry of Finance and was deeply suspicious of the staff of the Hungarian National Bank. He tended to resent critics or contradictions even on issues of detail. The Economic Cabinet was created in February 1991 and headed by the new Minister of Finance, Mihály Kupa. Also, the so-called (four-year) Kupa Program, which contained a long list of economic and financial legislation and institution building left little room for initiative for his colleagues in the Economic Cabinet.

While Mihály Kupa enjoyed the trust of the Prime Minister, the new Minister of Finance did little to accommodate his colleagues in the Economic Cabinet. Opposition politicians and the press systematically played up Kupa's alleged "professionalism" against the rest of the government. Rather than firmly discouraging these hostile tactics aimed at creating discord within the government, Kupa seemed to enjoy his approval and popularity among the adversaries of his own government.

The growing recognition in the course of 1991 of the importance of the following major issues led to the creation of the *GAM* Working Group at the end of the year: (1) the existence of numerous obstacles to sustained growth; (2) the continued resource shortage and the need for foreign non-debt-creating official or private capital inflows

⁸⁶ The Prime Minister became dissatisfied with the attitude and stubbornness of both Rabár and of Matolcsy well before October 5, the date of Rabár's text published in *HVG*.

to alleviate it; and (3) the need to redefine and accelerate the adoption of measures aimed at reducing the obstacles to economic growth.

The objective of *GAM* was to draw on the experience gained by leading officials during the first two years of the government and to create a new cohesion in carrying out the government's program. Contrary to later attacks, not only by opposition politicians but also by economists associated with the think tank, Institute of Monetary Research (*Pénzügykutató Intézet*), *GAM* was not designed as a program for growth through deficit financing.

The time schedule and reporting to the Prime Minister

The Working Group's work schedule was divided into three parts. The first part over the holiday season covered the identification of the principal obstacles to sustained growth. The second period served for the preparation by each of the members of the group of a one- to three-page note on their perception of the obstacles and of the policy proposals. The synthesis of the recommendations was divided into two lists of measures: a List A that contained measures that should be defined and implemented within three months from the moment of the adoption of the program, and List B of steps that were to be carried out over a longer period, although work on these steps was expected also to start as soon as possible.

The work of *GAM* was very much on schedule. By February 1992 several versions of the synthesis of the papers submitted by the members on the obstacles to growth and on their suggestions for solutions could be prepared.

The following are some of the key words in a memorandum prepared on January 24, 1992.

Preliminary list of the main obstacles to economic growth:

- 1) ***lack of clear political objectives*** related to growth and to the measures that the government should adopt in order to promote the growth of the Hungarian economy,
- 2) unfavorable ***foreign trade*** developments,
- 3) servicing of the ***external debt and lack of international financial support***,
- 4) general ***resource shortage***,
- 5) shrinkage of the ***domestic market***,
- 6) tensions resulting from the ***transformation of a planned into a market economy***,
- 7) privatization and ***uncertain ownership structure***,

- 8) the *run-down infrastructure and the lack of funds* for maintenance and modernization,
- 9) the poor state of Hungarian industry and the *lack of a consistent industrial policy*,
- 10) the multiple *crises of Hungarian agriculture* (drop of output and productivity, lack of capital, ownership structure, etc.),
- 11) crisis of the *construction industry*,
- 12) poor *international competitiveness*,
- 13) inefficient public administration ("*bureaucracy*"),
- 14) *legal uncertainty, poor social cooperation*,
- 15) *insufficient trained and experienced professional work force*.

In the following paragraphs I reproduce parts of a report that I submitted on March 10 to the Prime Minister on the timing and the progress of the work of the GAM Group:

"The Working Group on Economic Strategy started its work in mid-December 1991.

1. The Group's program so far has been divided into three phases:
 - a) identification of the factors hampering sustained economic growth and the potential for further contraction (December 1991 – January 1992);
 - b) identification of possible solutions and actions (February 1992);
 - c) preparing proposals for economic policy decisions (March 1992).
2. A short (15 page) decision-making report will be prepared by March 16. This will be finalized by March 25 and may be discussed at the Economic Cabinet meeting on April 1.
3. The short decision-making report of the Working Group will contain the following:
 - a) a brief overview of barriers to growth and possible actions and solutions;
 - b) a summary of economic policy proposals grouped into ten broad categories (see below). In each of the ten categories, the text (1–2 pages) will include the main problems and possible steps to be taken, together with suggestions as to who in government should be responsible for the detailed elaboration and possible implementation, and within what timeframe.
4. Members of the Group participated actively in the work. They prepared detailed notes in which they expressed their views on the obstacles to growth and possible ways forward.
5. An important achievement in itself is that over the last three months the Group has reached consensus on the following three key issues:
 - a) creating the conditions for sustained economic growth should be a top political and economic priority;

- b) there are also a number of obstacles to economic growth in Hungary that could be alleviated or eliminated by determined economic policy measures;
 - c) it is necessary and possible to develop and implement economic policy measures that will promote growth without fundamentally jeopardising the results achieved so far in terms of economic equilibrium.
6. The detailed elaboration, adoption and implementation of the measures referred to in (c) above should become an integral part of the work of the government from April 1992 onwards.
 7. The Economic Strategy Group could continue to play an advisory/discussion role in this area. At the same time, it would be useful to prepare a more detailed economic policy and strategy analysis under the responsibility and guidance of the Task Force, using the detailed analyses and proposals already made.
 8. This analysis would address:
 - a) the economic challenges and achievements of the last two years;
 - b) the current situation and the challenges facing the country and the Government;
 - c) the plans, concepts, programme and expected economic development for the next two years.
 9. This more detailed analysis, which could be completed by the end of April or mid-May, would probably attract considerable interest at home and abroad.

Strategic analysis and proposals

Brief overview

10. Economic policy so far has achieved significant successes: broad, comprehensive and irreversible economic systemic change, maintaining viability, and ensuring solvency and external economic equilibrium. Not following a so-called 'shock therapy' proved to be the right decision
11. At the same time the need for economic growth is also obvious. According to preliminary data at the beginning of 1992 the country's total production (GDP) was about 15% lower than two years earlier. This decline followed more than a decade of slow growth and economic stagnation.
12. Further stagnation or contraction would not only threaten the country's social balance, but would also inevitably limit the Hungarian economy's long-term growth potential.
13. The challenge is to define a policy that is not based on artificial demand stimulation, which would not increase competitive supply, jeopardise economic equilibrium, reduce domestic and foreign confidence and thus long-term growth.

14. Taking into account the opportunities associated with transformation, international integration and the elimination of inherited economic backwardness, a real GDP growth rate of 5 % per annum for the decade 1990–2000 as a whole, an investment growth rate of 8–10% per annum and an overall improvement in the exchange rate of 20–30% can be considered a relatively conservative target.

Obstacles to Growth

15. The constraints to economic growth can be summarised under the following headings:
 1. economic policy; 2. external economic environment; 3. problems of capital outflow (debt service); 4. real resource constraints; 5. shrinking domestic market; 6. privatisation and unstable ownership; 7. infrastructure; 8. industry, industrial policy; 9. credit and banking system; 10. agriculture, agricultural production; 11. construction, real estate and housing market, housing credit; 12. international competitiveness; 13. foreign trade; 14. social problems, social cooperation; 15. lack of expertise and knowledge; 16. regional power situations and politics; 17. state budget; 18. legal uncertainties, quality of state governance; 19. transformation frictions; 20. information systems; 21. excessive bureaucracy; 22. economic policy conflicts.
16. A key task for the government is to identify the factors and bottlenecks that hinder economic growth and to develop proposals to remove them.
17. There is a consensus within the Task Force that the proposed steps should be developed and agreed in a spirit of continuity rather than rupture: the results of stabilisation policy should not be jeopardised. In many places what is needed is simply acceleration, not new steps.
18. At the same time, however, the steps must be sufficiently decisive to produce results.
19. The steps can be summarised in the following ten groups (the draft decision report will contain a one- to two-page proposal for each group):
 - 1) INFRASTRUCTURE: (including EXPO and housing); project identification and selection, financing, decision making, fast track implementation;
 - 2) INDUSTRIAL POLICY: modernisation, enterprise and investment promotion, sectoral policies;
 - 3) BANKING: portfolio restructuring, launching privatization, building up management institutions (land credit, mortgage credit), building up the Hungarian Investment and Development Corporation into a reconstruction bank;

- 4) CREDIT SYSTEM: Credit Guarantee Fund, Reorganization Fund, use of privatization proceeds for investment leverage;
- (5) RESOURCE INFLOW: the fast-track negotiation of foreign grants offered, project development, official and semi-official capital imports formal and semi-formal involvement;
- (6) TAX SYSTEM, ENTERPRISE ENCOURAGEMENT
- (7) ACCELERATION OF PRIVATIZATION
- (8) REGIONAL POLICY
- (9) EASTERN AND WESTERN MARKETS, EXPORT STIMULATION
- (10) NATIONAL AND FOREIGN INVESTORS

Otto Hieronymi”

At the extraordinary government meeting held on May 10, 1992, the government discussed the economic policy results of the past two years and the economic policy strategy for the next two years. Subsequently, on **May 22, 1992**, a Memorandum was submitted to the Economic Cabinet on the ***Government Work Program for Creating the Conditions for Sustainable Economic Growth.***

8.3. The principal aspects of the Working Group’s Report – a strong emphasis on institution building and strengthening

The objectives, the general approach and the intermediate results of the Working Group were discussed in the preceding section. The work of the group consisted essentially in a series of discussions with the full membership or in smaller groups, in the preparation by each member of one or several notes, the preparation in several stages of a synthesis of the members’ individual inputs and of the outcome of the discussions, and the transmission to the Prime Minister and the Economic Cabinet of a final draft that emerged from this process. By the nature of the exercise there is a certain repetition of the key issues and arguments in the successive versions of the draft(s) as well as additions and deepening from one stage to the next.

The text had to be concise and “readable” in order to be useful (and used) in the government’s decision-making process. It was also important that key issues and proposals not get “lost” or “left out” in the editing or polishing process of the draft or that ideas get “sneaked in” which did not reflect the thrust of the thinking and arguments of the group. The rest of this section consists mainly of selected excerpts

from the group's report in order to illustrate the main conclusions of the group's analysis and recommendations.

“PROPOSALS FOR THE ECONOMIC CABINET FOR A GOVERNMENT PROGRAM TO HELP CREATE THE CONDITIONS FOR SUSTAINABLE ECONOMIC GROWTH

(Excerpts)

THE ECONOMIC POLICY STRATEGY OF THE GOVERNMENT

1. At the extraordinary government meeting held on May 10, 1992, the Government discussed the results of its economic policy during the past two years and the economic policy strategy for the next two years.

2. The goals of the transformation of the Hungarian economy into a market economy, the relevant requirements and measures were defined in the *Program of National Renewal* and in the *Four-Year Economic Policy Program*. One of the main goals of the economic regime change and of the construction of the social market economy is to boost economic activity and to ensure the conditions for sustainable growth.

3. In the past two years, the Government's consistent economic policy achieved significant results in ensuring financial stability and foreign and domestic trust, building the legal and institutional framework of the market economy, invigorating market competition, attracting working capital, developing private property and private enterprises, as well as in the field of privatization. The balance-of-payments results, including the growth of exports to the OECD countries exceeded all expectations. This has accelerated the integration of the Hungarian economy into the European and world markets and the development of the market economy.

4. The basic element of building a competitive market economy, maintaining social balance, modernizing and international integration of the country is curbing the shrinkage of the real economy and ensuring the conditions for sustainable, balanced economic growth. The economic system change and the rise of the market economy are the most important factors in the widespread development of more dynamic and efficient economic structures in Hungary. At the same time, the success of the market economy requires ensuring the conditions for sustainable growth: only in this way can the resources necessary to modernize the country, finance infrastructural and productive investments, and finance new efficient jobs be created, and the high economic and social costs of the structural transformation can be covered in the long

term. It needs balanced growth both from the point of view of the budget and the developing private economy.

5. These considerations do not only apply to the Hungarian situation. Economic growth in modern market economies, together with internal and external economic stability (control of inflation, financial balance) and reduction of unemployment, belongs to the basic political, economic and social objectives. The timeliness and general nature of the question is confirmed by the fact that in 1992 the most important agenda item of the economic policy cooperation of the 24 OECD countries and the seven most significant developed economies was the assurance of balanced economic growth in the OECD area and in the entire world economy.

International trust and cooperation

6. Despite the economic crisis and uncertainty affecting our region, the economic policy of the Hungarian Government enjoys general international trust and recognition, both at the official level and on the part of the private economy (banks and companies). There is also broad international agreement on two additional points: not only regarding the need for economic growth in Hungary, but also that the country's achievements so far, on the one hand in terms of the financial balance and international reserves, and on the other in the development of the market economy, are the appropriate foundation for the application of consistent policies that promote economic development and growth.

Creating conditions for sustainable growth

7. The economic policy strategy adopted by the Government focuses on creating the conditions for sustainable economic growth, in addition to maintaining and strengthening the economic and financial balance. The main guidelines and implementation of the strategy fit organically into the Government's Four-Year Economic Program. Also, one of the decisive elements of this strategy is the continued strengthening of the confidence of the country's partners – international financial organizations, financial markets and investors – in our economic policy.

8. Economic recovery and growth depend primarily on the economy itself. However, the institutional system and economic policy decisions can play a decisive role in promoting or hindering growth. An economic policy that considers the need for economic growth does not mean the conservation of the old production structure, it cannot be identified with artificial demand stimulation. The point is to speed up the

development of the competitive supply that has started in the economy, in addition to preserving external payment positions, keeping in mind the requirement of financial balance.

9. The economic policy challenge is to develop and implement steps that make it possible to create the conditions necessary for sustainable growth without jeopardizing the financial balance, and thereby strengthen both domestic and foreign trust.

Comprehensive system of measures within the framework of the *Four-year Economic Policy Program*

10. This challenge can best be met if, in accordance with the Government's policy so far, broad, gradual steps are developed and applied in the entire spectrum of ministries and economic policy. Comprehensive policies of this nature made possible the reconstruction and sustained growth of Western European countries over the past four decades. Taking into account the obvious significant differences this approach is similar to those which are currently applied by the OECD countries with respect to growth policies.

11. In order to develop and implement an effective policy, it is necessary to identify the factors hindering growth and to introduce steps that resolve or reduce these obstacles: these measures would mean, in part, speeding up policies that have already been planned or started, and in part, the development of new solutions.

12. The planned measures include, among other things: the acceleration of infrastructure projects affecting the modernization and competitiveness of the economy, involving foreign funds; the development of solutions aimed at the financial situation of bank portfolios and companies, which promote the change of structure and ownership, productive investments and job creation, and improve the functioning of the Hungarian banking and credit system; industrial and regional crisis management solutions; the speed of privatization; steps aimed at strengthening technical and human competitiveness.

13. Overcoming the obstacles to growth and fixing the directions and tools for further progress can be realized through a government-level work program that defines the division of labour and cooperation within the Government and designates the agency responsible for each step.

The objectives of the growth strategy

14. The goal of the growth strategy is not to stimulate short-term artificial demand, which then would be followed again by austerity measures and a new downturn. The goal is to realize the opportunities offered by the transition to a market economy and integration into the European and world economy both through the optimal use of existing capacities and the gradual increase of the country's growth potential. The goal aimed at is for the Hungarian economy to achieve a higher average real growth rate for the whole of the 1990s than for the Western European countries as a whole. The fact that this is a realistic and achievable goal is proven by the examples of many Western European countries in the recent and more distant past. In order to achieve the goal, it is necessary to mobilize and optimally use internal and external resources, as well as an appropriate macro-economic, institutional and structural policy. This is the fundamental task of the Government's economic strategy.

II. ACHIEVEMENTS TO DATE, RECESSION AND OBSTACLES TO GROWTH

15. During the past two years, significant progress has been made in the transformation of the Hungarian economy into a market economy, and the most important legal and institutional conditions for a market economy have been created.

Stabilization and financial balance

16. Under the difficult circumstances, the following policy measures were called for: (a) stabilization of the country's international payment situation and improvement of its convertible currency position; (b) decisive action against the acceleration of the inflationary process; (c) extensive import liberalization; (d) the reduction of production subsidies, the shift towards realistic market price and cost conditions; (e) forcing corporate adaptability, along with inevitable production cuts and liquidations; (f) "taking on" growing unemployment, creating the foundations of an up-to-date unemployment care system; (g) step-by-step strengthening of the privatization process; (h) caution in the transformation of social care systems.

Achievements

17. The Government's economic policy shows significant successes – recognized both in Hungary and abroad – in the following areas.

- (a) The country's external balance of payments has been consolidated, significant currency reserves have been accumulated.
- (b) The market change was successful and the economy successfully weathered the shock – like changes that appeared in the field of foreign trade – resulting from the collapse of the Eastern markets. A significant proportion of the companies were able to shift the market and to adapt to the changed circumstances.
- (c) Privatization progressed significantly, the number of new enterprises increased by leaps and bounds.
- (d) The inflow of foreign capital was very strong in 1990 and 1991 (in fact, this trend increased further this year).
- (e) The economy has moved in the direction of a healthier structure (recession of heavy industry with overdeveloped, backward technology, machine industry sectors unable to adapt to the market, simultaneous development of services, small businesses, small industry).
- (f) Last year, inflation was kept within the pre-planned framework, and this year the economic shrinking process was broken.

Profound structural transformation

18. Over the past two years, profound changes have begun in the structure of Hungarian society and economy. During this period, two processes could be observed in the Hungarian economy: (a) a significant boom in the production of new (small and medium-sized) private firms, especially in the field of services, and (b) a large decline in production and employment in traditional industrial companies and partly also in agriculture.

Dimensions and main factors of the recession

19. Although, due to the rapid transformation, the official statistics probably do not reflect the entirety of the economic processes, it should be noted that, according to preliminary calculations, at the beginning of 1992, the country's total production (GDP) was approximately 15% less than two years ago. This decline followed more than a decade of slow growth and economic stagnation.

In other words, new businesses, products and jobs do not (yet) fully offset the decline in production in other sectors and areas.

20. The unexpected collapse of the former COMECON markets and the restructuring accelerated by increased competition greatly contributed to production decline shown by statistics for both industry and agriculture. The necessary correction of the financial imbalances reduced domestic demand and thus also had a braking effect, especially on industrial production. At the same time, it should be emphasized that the export performance achieved above all expectations, especially in the OECD markets, had a positive effect on both production and employment levels, and slowed the pace of the recession.

21. The main factors of the economic contraction of the last two years were the following:

- (a) the “legacy” of the socialist planned economy system, including the monetary and budget restrictions necessary to ensure the macro balance;
- (b) the costs of economic system change, including markets and economic competition, price and cost structure, legislation and public administration, as well as new framework conditions and requirements established in other areas;
- (c) decrease in demand in domestic and foreign (especially the former COMECON) markets;
- (d) decline in supply and production, partly as a result of market competition and structural transformation, partly as a result of the recession;
- (e) the decline in productive investments (low capital absorption), which slows both modernization and job creation;
- (f) the lack of funds arising in connection with the declining production, the high costs of the transition, and the means and transfers necessary to restore the external balance.

Lack of resources, productive and infrastructural investments

22. The shortage of financial resources that is currently prevailing in the Hungarian economy is primarily not the result of developments at the level of international means of payment and the balance of payments. The main factors are, on the one hand, the high costs of the systemic and structural transformation of the economy, and, on the other hand, the loss of resources caused by the economic contraction.

23. One of the most significant manifestations of the recession is the decline in infrastructural and productive investments. At the same time, this is the area where economic policy measures promoting growth have the most positive long-term effects: productive and infrastructural investments increase supply and improve the

competitive position of the economy as a whole. In this area, the conjuncture and structural policy have the richest tradition and tools.

24. The memory of the wasteful investment policy of the previous economic system in Hungary (which logically led to low capital efficiency in the Hungarian economy in the past decades) is often invoked to counter suggestions for more active investment support policies. When stimulating investments (both in infrastructure and productive investments), it is therefore important to keep in mind the proper functioning of markets and competition in order to assure high capital efficiency of the new investments.

25. In Hungary, the decline in productive investments is closely related not only to the uncertainty of property relations, the high nominal and real interest rate and the decrease in demand, but also to the amortization system. As a result of inflation, the amortization base of companies becomes devalued compared to replacement needs. Based on the new accounting law, the assets are not calculated at the realistic repurchase value, but at the unrealistically low book value, the law does not allow the continuous correction of the book values, which leads to continuous inflationary asset losses. Another source of asset loss is that some of the depreciation is paid out as wages and profits. The low capital absorption capacity plays a major role in the low utilization of foreign loans and aid.

Current economic problems and opportunities for realizing the conditions for growth

26. The results achieved during the last two years in the construction of the market economy system create a suitable basis for establishing the conditions for economic growth. Promoting economic growth and ensuring its conditions are timely, as the Government's economic policy has achieved significant success in maintaining the functioning of the economy over the past two years, making the economic system change profound and comprehensive. In addition to all this, the months of 1992 that have passed so far have made it clear that a long-term solution to today's current financial and economic problems can only be found if the reserves of growth in the economy are strengthened and the national economy can be put on a growth path.

27. The most important current problems include the following:

- (a) the structural tensions of the budget, the significant and in all respects difficult-to-manage budget deficit, which is related to the protracted structural transformation

- of the public finances, the survival of large supply systems, the insufficient tax revenues in the budget, the generally lax financial discipline and control, etc.;
- (b) allocation of resources that reduces the economy's development reserves, which is directly related to the surplus in the balance of payments, which grew strongly at the beginning of 1992;
 - (c) divergence of real and monetary processes;
 - (d) the financial and economic environment that does not sufficiently support the development of enterprises, the "missing links" of the system of supporting institutions and instruments, which in turn is related to the lack of guaranty systems, the narrow range of privatization techniques that support enterprises, the insufficiency of loans provided on favorable terms, the lack of sufficient market information, etc.;
 - (e) the development of domestic investment willingness, which is the result of the low yield of productive investments compared to bank deposits, uncertainty, problems of building market relationships, insufficient information, lack of resources, etc.;
 - (f) the low level of development of infrastructure (and its slow development, except in some areas), which is one of the main obstacles to economic development today, and also hinders the further significant growth of domestic and foreign investments;
 - (g) the aggravation of employment and social conflicts, which is closely linked to the growing lack of funding for employment purposes (Solidarity Fund) and the worsening of regional economic and social problems;
 - (h) the gradual splitting of the domestic middle classes into two, which is decisively related to the continuous decline and depreciation of the large welfare systems due to the failure to transform them.

28. The creation of the conditions for economic growth and the preparation of the economic policy that promotes growth are based on the objectives defined in the *Four-Year Economic Policy Program* (improvements in the balance of payments, anti-inflation policy, action against unemployment, end of negative growth). The results of the Program so far suggest that its implementation is possible. At the same time, ***GAM represents a turning point, as it places the revival of the conditions for economic growth and the unfolding of the growth process among the primary priorities of economic policy***, acknowledging that the consolidation of the balance of payments and inflation will also require effort in the future.

The implementation of an economic policy moving in the direction of economic growth can only be successful if it is supported by both the key actors of the national economy and the most important foreign economic actors. This should place the

domestic entrepreneur, the domestic enterprise at the center of economic policy. Without it, the renewal of the economic structure, innovation, and the expansion of market demand and supply are unthinkable. In addition, economic policy must place a distinct emphasis on increasing exports, strengthening foreign market relations and international economic integration. An important condition for its success is ensuring international receptiveness – the receptiveness and willingness to support Hungary of international financial organizations and institutions.

30. The creation of conditions for economic growth cannot be limited to financial and economic areas either. A lasting shift can only be achieved if the factors of growth in the real economy are strengthened, and the human dimension of the economy also provides support for this and moves along with it. This forces a series of changes in two areas. One of the keys to the renewal taking place in real processes is technical-technological modernization, the application of new techniques, and appropriate capital transfers. In order to promote this, it is necessary to develop an innovation strategy and carry out the changes affecting the organization and assets and the financing on which it has to be based.

III. CREATING THE CONDITIONS FOR ECONOMIC GROWTH: THE MAIN AREAS CONSIDERED

31. The comprehensive economic policy steps can be classified into twelve large categories, which correspond to the definition of tasks in the resolution proposal (this list also includes many tasks already in progress, which need to be speeded up and supplemented):

1. more efficient functioning of the financial system,
2. industrial crisis management, industrial policy,
3. acceleration of infrastructure projects,
4. human resources,
5. measures affecting the tax system,
6. modernization of the banking system,
7. acceleration of the privatization process,
8. acceleration of compensation,
9. management of regional tensions,
10. handling social tensions,
11. capital imports and coordination of international support,
12. political and social support.”

(For reasons of limitation of space, the following paragraphs deal only with items 1, 4 and 5 from the above list.)

1. More efficient operation of the financial system

32. The efficient operation of the financial system is a fundamental condition for both the success of the stabilization policy and the recovery of the real economy. In modern market economies, the successful operation of the financial system is influenced both by central bank and government policies and by the market-conform operation of companies and financial institutions. In market economies, the central bank and the financial administration also have an important responsibility for building up the institutional system, ensuring its efficient operation, and managing crisis situations. In our country, during the past two years, significant progress could be seen in the development of the market economy and of the financial system. However, in this field as well, further significant tasks need to be solved, partly to strengthen and speed up the ongoing development of the institutional system, and partly to effectively deal with emerging crisis phenomena. The stabilization and recovery of the real economy requires the removal of numerous financial obstacles, which of course does not mean that only financial instruments are needed to solve the problems of the real economy.

4. Technological development and human resources

50. The foundation of economic growth is closely related to the optimal use of human resources. The chances of growth are basically determined by how we can put research and technical development and human knowledge at the service of this, and how training and education support it. The most important issues to be resolved are: the acceleration of the efficient and market-conform technical development, the coordinated preparation and early parliamentary discussion and legislation related to public education, vocational training and higher education laws, the renewal of the institutional and financial framework of research, management training, retraining of the unemployed, extensive foreign language education, dissemination of contemporary business and public administration expertise.

5. Measures concerning the tax system

51. In a market economy, the tax system plays a central role as a growth stimulator and brake, both from the point of view of the short-term economy and as part of

a structural policy that stimulates long-term business development. It is clear that economic growth is also essential to ensure budget balance. Within the Hungarian tax system, based on Western European experience, there is a need, especially at the level of taxes affecting businesses and investments, for both temporary and permanent tax rules and tax rates that contribute to producer-entrepreneurial risk-taking and stimulate investments and job creation.

52. The modification of the amortization conditions in accordance with the actual enterprise situation and the need to promote the development of enterprises should be mentioned among the urgent tasks. In addition, temporary investment tax benefits and temporary depreciation benefits could be introduced, which are proven tools of economic policy in Western European countries. (Time-limited discounts speed up decision-making.) It should also be emphasized that the financing and implementation of infrastructure investments are greatly facilitated by the tax-free interest-bearing loans and bonds issued by the Government or local governments granted exclusively for such purposes.

53. Among the other current steps to be mentioned are:

- (a) the reduction of the withholding tax payable on interest income, which indirectly promotes the reduction of bank interest rates;
- (b) examination of the economic and social aspects of the possible transition to two-rate VAT;
- (c) tightening of tax accounting and control measures; and finally
- (d) reducing the marginal rate of income tax and negotiating payments with business organizations.”

Some of the important parts of the report that are not mentioned in the preceding excerpts are discussed in earlier chapters dealing with the resource shortage, privatization and banking and monetary issues.

8.4. The group’s recommendations become government policy

As noted earlier, *GAM* benefitted from the start and throughout its duration from the Prime Minister’s keen interest and support. Mr. Antall’s interest in the project and the importance he attached to its progress worked as a strong stimulus for each of us individually and for all of us as a coherent group. The close interaction among the members was also furthered by the fact that, with one or two exceptions, all the

members were strongly committed to the person of the Prime Minister and to the policies of his government.

In order to complete the process and to achieve the goals of *GAM* a number of important political and administrative steps had to be navigated. From the start in December 1991 until the early weeks of 1992, the discussions and the preparation of the various draft texts mentioned above, information about the process and the results of the project was kept within a well-defined small circle: essentially the Prime Minister and the members of the Working Group.

The Ministers whose departments were represented within the Group were of course aware of its existence and work. They were entitled to inquire about the progress of the work but there was no diffusion of the intermediate results to the individual departments before the preliminary report was completed.

Thus, the first step in the political/administrative process mentioned above was the transmission of the Proposals to the members of the Economic Cabinet and the discussion of the report in a meeting of the Cabinet. The fact that all the senior members of the Economic Cabinet had not taken advantage of the possibility of obtaining intermediate information about the progress of the group's work was illustrated by the case of the Minister of Finance.

As I was told, Mr. Kupa was "surprized" and even "vexed" by the scope and in-depth character of the results of the Group's work that were submitted for discussion in the meeting of the Economic Cabinet. Allegedly he said: "I thought that *GAM* was only about the question of how to obtain financial support from abroad." Once he was reassured that *GAM* was not aimed to replace the government's four-year economic program but to complete and reinforce it, his concerns abated. Subsequently, for better or worse he continued to show relatively little active interest in the project.

Following the approval by the Economic Cabinet the next important step was to inform the elected representatives in the government's parliamentary majority – in the Hungarian Democratic Forum and the other two coalition parties – and to obtain their explicit approval and support. This process included an extraordinary meeting of the Hungarian Democratic Forum (*MDF*) Fraction outside Budapest as well as an extraordinary meeting of the full government. Beside the Prime Minister, Tamás Szabó and Péter Bod played a particularly active role in these meetings. I would also like to mention here the active role played by Gyula Kodolányi and Imre Csuha in the diffusion of the results of the Working Group.

The discussions with the parliamentary group had a special importance as there had been concern among some members of both *MDF* and the other coalition parties that the government was not putting enough emphasis on economic growth. Thus the *GAM* recommendations could be integrated into the government's economic policy

program rather smoothly, without major resistance at the level of the coalition parties or at the administrative level.

However, the communication policy about *GAM* was less than satisfactory. This was due partly to some comments by one or two members of the Working Group, which clashed with the majority views and objectives. A more important problem was the distraction following the scandal provoked by some anti-Semitic comments by István Csurka.⁸⁷ The Csurka affair had nothing to do with *GAM* and economic policy in general, but it obliged the Prime Minister and the leaders of the Hungarian Democratic Forum to concentrate on the “Csurka cancer” rather than on informing the broader public of the importance of *GAM* and of its expected impact on the success of the economic regime change. On August 20th, an important day of commemoration of St. Steven (*Szent István*) and the founding of the Hungarian Kingdom eleven hundred years earlier, the Prime Minister had planned to focus in his major public address on economic issues. Unfortunately this did not happen.

8.5. How important was GAM?

In this concluding section the importance of *GAM* is discussed from the perspective of the following four issues and objectives: (1) the conditions for economic growth and the main obstacles to growth; (2) the creation of legal and administrative rules and structures required by a modern market economy; (3) international credibility and impact and European Union membership; (4) regime change and the foundations of a social market economy in Hungary.

The conditions for economic growth and the main obstacles to growth

The first result of the *GAM* process was the recognition that the central objective of the Hungarian economic policy was assuring the conditions of growth. This was not only

⁸⁷ István Csurka (1934–2012) was a Hungarian nationalist politician, journalist and writer. After the 1956 revolution he was recruited as a III/III agent. In the early 1990s he was among the first to reveal his informant’s past. He alleged that he signed the declaration of recruitment under a great deal of pressure at the time when he was subjected to internment. In 1993 he was excluded from the Hungarian Democratic Forum (of which he had been a founding member) because of anti-Semitic allegations and unjustified attacks against the leadership of the Forum (including Prime Minister Antall). After his exclusion from the Forum he founded the right-wing party “Hungarian Justice and Life Party” (MIÉP), which he presided until his death. Csurka was opposed to Hungary’s joining both NATO and the European Union.

an economic issue. The long-term overall success of the regime change was dependent on the success or failure to create the foundations of a more dynamic economy. It was essential to move the economy from the vicious circle into which it had been locked for many years, into a virtuous circle of higher investments, higher savings and greater efficiency and improved living standards. The *GAM* project identified a broad range of domestic and external obstacles to growth. Some of them were resource related, but many of them were due to the lack of the proper institutional and regulatory structure necessary for the functioning of a dynamic market economy. Economic growth does not depend on government decisions. In fact government decisions and interventions can be a brake on growth. This, however, does not mean that government policy, the public sector do not have an important role in the performance of a national economy. Hungarian and international surveys showed that *GAM* did have a positive impact on the growth of the country's economy even if it was not fully recognized by the general public.⁸⁸ According to the Head of the Office of the Prime Minister's Advisors: "The growth program was launched during Iván Szabó's term as Minister of Finance, and it brought GDP growth very quickly in 1993, but too late from the point of view of the elections."⁸⁹

*The creation of legal and administrative rules and structures
required by a modern market economy*

The "Proposal for The Work Program of the Government for the Creation of the Conditions of Sustained Economic Growth" was submitted on June 18, 1992, under the signature of the Minister without Portfolio, Tamás Szabó. The document was more than 40 pages long.⁹⁰ It contained 44 specific items for decisions and action by the government. The tasks listed in the document included the drafting of texts for legislative or administrative rules and decisions, as well as the creation of new governmental executive or supervisory bodies. For each task, beside the deadline, it was indicated which Ministries or other government offices were responsible for the preparation and the carrying out of the required action. Some of the tasks included in

⁸⁸ The objective of *GAM* was to create a medium and long-term improvement in Hungary's growth potential and not a short-term fine-tuning of economic activity. In fact, "fine-tuning" economic upturns according to political agendas and electoral timetables, however tempting politically, is often an illusory goal.

⁸⁹ Kodolányi, Gyula (2021): *A világfa ágain*, Nap Kiadó, Budapest, p. 182.

⁹⁰ "Proposal for a Work Program of the Government for the Creation of the Conditions of Sustained Economic Growth" June 18, 1992. The original Hungarian title was: "Előterjesztés a Kormány részére: kormányzati munkaprogram a tartós gazdasági növekedés feltételeinek megteremtésére."

the *GAM* report and in the program adopted by the government in the summer of 1992 represented measures that had been proposed and decided upon previously in 1991 or in the first half of 1992 but were not completed or needed a deepening or acceleration or a revision while many others were outright innovations.

Imre Csuha, who was Chief of Cabinet of Minister Tamás Szabó and Secretary of the *GAM* project, kept a close score of the progress and the respect of the deadlines defined in the June 1992 *GAM* proposal and government decision. A few weeks before the May 1994 elections he confirmed to me that over 90% of the tasks defined in the resolution led to concrete measures by the Ministries and other Offices designated in the text. Thus, the work program adopted on the basis of the report of the *GAM* proposals turned out to be one of the most comprehensive coordinated action plans of the Antall government.

This assessment also corresponds to the opinion of Gyula Kodolányi:

“We worked on the concept and looked for, from the perspective of the various government agencies and for each part and every sector of the economy, the points where, through the transformation of regulations and institutions, growth can be initiated and the conditions of the growth of a modern market economy can be created. We identified the necessary political measures to achieve these goals. This was called for since during the first year and a half of the Antall Administration government action had to focus primarily on crisis management. ***The proposals of the GAM Commission actually formed the economic program of the regime change developed in detail for sectors.*** The interest of the Ministry of Finance (PM) was only affected by the implementation of the banking reform and financial operation control institutions... Iván Szabó joined the government as the pro-growth Minister of Finance, and serious growth began. ***The tragic thing is that the public cannot immediately evaluate these trends, but if we look at the data, a serious growth started in the Hungarian economy in 1993, and this was connected to the fact that Iván Szabó and the entire government approved certain parts of this program and started it.***”⁹¹

International credibility and impact and European Union membership

I believe that the work and proposals of the *GAM* committee were important not only from a domestic political and economic point of view, but they also had an important

⁹¹ Kodolányi, Gyula (2021): *A világfa ágain*, Nap Kiadó, Budapest, p. 184–185. Emphasis added.

international dimension and impact. This assessment was confirmed to me during numerous conversations over the years with former members of Antall's team.

From an international point of view the following were some of the most important aspects:

1. *GAM* represented both continuity and innovation in the development and implementation of the economic policies of the Antall government.
2. The program was genuinely "national" or "Hungarian", but without any elements of protectionism or nationalism.
3. The program was based on the specific requirements of the Hungarian economy at the time of regime change, but both the objectives and the institutional and legislative aspects were close to the structure and experience of modern European market economies.
4. In many respects *GAM* was also an important experience that helped prepare Hungary for the negotiations for membership in the European Union and for fulfilling the requirements of the *acquis européen*.
5. *GAM* was also the expression of a thoughtful and balanced approach to policy-making or of "good governance". It was in sharp contrast both to the policies pursued and the conditions prevailing in several of the East-Central European countries in the 1990s.

Regime change and the foundations of the social market economy in Hungary

As discussed throughout this volume, for Antall, from the start there was a close connection between the objective of creating a liberal parliamentary democracy in Hungary and the model of the social market economy as the framework for developing the government's economic and social policies. This was true for the detailed program published in September 1990 as was equally true for the *GAM* project and the government program developed on the *GAM* proposals two years later.

The significance of the concept of the social market economy for the objectives and record of the regime change in Hungary was also highlighted in the program of a two-day conference organised by the office of Tamás Szabó in March 1994. The program of the event focussed on two key objectives of the transformation of Hungary during the Antall years: (1) creating a dynamic market economy where private initiative and private property would prevail over government ownership and control and (2) laying the foundations of a social market economy in which, beside private enterprise and

competition, there is a balanced division of responsibilities between the private sector and the public sector, between individual and private interests and the public good.

The speakers included numerous associates of József Antall as well as speakers with an international background (including senior officials of major international companies present in Hungary and experts on the European experience with the model of the social market economy).

Minister Tamás Szabó in his opening statement pointed out the importance of the June 1992 government program (*GAM*) under both headings (social market economy and the private economy) as well as some of the key conditions for continued success in the reconstruction and transformation of the Hungarian economy: discipline, hard work, competition and freedom of initiative, and a reliable and respected legal system.

Péter, Á. Bod, President of the Hungarian National Bank, in his presentation under the title “Financial Stability, Private Property and the Expansion of the Private Economy” gave a detailed analysis of the need for financial stabilization in order to secure the basis for growth and modernization of the Hungarian economy and the policy pursued by the government and the Hungarian National Bank since the start of the regime change. While describing the numerous challenges, including the debt issue, he also listed the achievements, as, for example, the remarkable growth of private savings.⁹²

In the light of the strong emphasis in the *GAM* program on the role of the legislative and institutional basis of growth and of the social market economy, the contribution to the program of the conference by the Chairman of the Economic Committee of the Hungarian Parliament, Gyula Takácsy, has to be mentioned here. The title of his presentation was: “The Creation of the Legislative and Institutional Conditions of the Social Market Economy during the Last Four Years”. In his paper Takácsy gave an enlightening summary of the very large number of new laws, changes in existing laws, other legislative decisions, etc. adopted by the Hungarian parliament between May 2 1990 and March 1, 1994. The fact that during these four years the continuity of the governing coalition could be maintained without a breakdown of the coalition and/or dissolution of the parliament was one of the greatest political achievements and legacies of the late Prime Minister. In his concluding remarks Takácsy rightly called the record of this four-year legislative cycle not only a historic result and a thorough

⁹² Bod, Péter Á. (March 1994): “Pénzügyi stabilitás, a magántulajdon és a magángazdaság kibontakozása” in: Hieronymi, Otto and Bérci, Gyula, Editors (March 11–12, 1994): “*A szociális piacgazdaság és a magángazdaság kibontakozása Magyarországon*” című konferencia tanulmánykötete, Konrad-Adenauer-Stiftung Aussenstelle, Budapest and Állami Vagyongyűnökség, Budapest.

and lasting change from dictatorship to democracy but also a good basis for Hungary to join the European Union.⁹³

Among the numerous speakers, the last two I want to mention in order to illustrate the wealth of information presented and the complexity of the two main issues discussed are the President of the Hungarian Statistical Office, György Vukovich, and the Managing Director of the Hambros Bank Ltd, London, Sir Adam Ridley.⁹⁴

György Vukovich showed the gradual expansion of the share of private ownership in the Hungarian economy from the 1980s through to 1993. While some form of private activity was always tolerated under the Communist regime (e.g. the “micro-estates” that produced a disproportionately large part of the food supply, repair-shops, etc.), the control over the economy remained in “public hands” – essentially party officials – to the very end of the regime. The reforms introduced in the 1980s allowed new loopholes in this party control. However, instead of creating a true private market economy, they introduced new distortions and opportunities for corruption, in many cases for outright stealing of public property. This added to the statistical assessment and comparison of what was public and what was truly private enterprise. Real changes began only with the end of the Communist system. Without trying to summarize the analysis and presentation of the dynamics and multiple forms of private initiative and private ownership, I would like to conclude this paragraph only with a reminder by Dr. Vukovich, one that is particularly relevant in the context of the discussion of *GAM*: the importance of the up-to-date legal and institutional structure and the acknowledgement that practices in the acquisition and management of private or public property would not be tolerated by the courts. This is the most important guarantee for the proper functioning of the social market economy.

Under the title “Privatisation and a Dynamic Private Economy: the Experience of Western Europe and the Challenge for Hungary and Central Europe”, Sir Adam Ridley

⁹³ Takácsy, Gyula (March 1994): “*A szociális piacgazdaság törvényes és intézményes feltételeinek megteremtése az utóbbi négy évben,*” In: Hieronymi, Otto and Bérci, Gyula, Editors (March 11–12, 1994): “*A szociális piacgazdaság és a magángazdaság kibontakozása Magyarországon*” című konferencia tanulmánykötete, Konrad-Adenauer-Stiftung Aussenstelle, Budapest and Állami Vagyongyűjtemény, Budapest.

⁹⁴ Vukovich, György (March 1994); In: Hieronymi, Otto and Bérci, Gyula, Editors (March 11–12, 1994): “*A magángazdaság térnyerése Magyarországon*”, In: *A szociális piacgazdaság és a magángazdaság kibontakozása Magyarországon* című konferencia tanulmánykötete, Konrad-Adenauer-Stiftung Aussenstelle, Budapest and Állami Vagyongyűjtemény, Budapest.

Ridley, Sir Adam (March 1994): “Privatisation and a Dynamic Private Economy: the Experience of Western Europe and the Challenge for Hungary and Central Europe”, In: Hieronymi, Otto and Bérci, Gyula, Editors (March 11–12, 1994): “*A szociális piacgazdaság és a magángazdaság kibontakozása Magyarországon*” című konferencia tanulmánykötete, Konrad-Adenauer-Stiftung Aussenstelle, Budapest and Állami Vagyongyűjtemény, Budapest.

provided an overview of the then still short history of privatization in Europe and the world. According to Ridley, the general trend of privatization began in Britain in the early 1980s. France followed the British example in the second half of the 1980s, and soon the trend became global involving more and more OECD (Western) economies and a growing number of developing nations. A noteworthy point is that the switch to private from public ownership occurred in both Britain and France in the wake of a recent massive wave of nationalizations. In his paper Sir Adam insisted not only on the overall and macro-economic benefits of private ownership over bureaucratic public management, but also the social and societal dimensions of the spreading of ownership titles (in particular company shares) among the general population.

Prime Minister Antall and the importance of GAM

From a distance of 30 years it is difficult to transmit the sensation we all felt at the time of the death of Prime Minister Antall in December 1993. Not only the personal, private loss that each of us lived differently, mostly in silence without trying to explain or compare, the rational loss, the loss for the country, for the world and for the ideas and objectives that we believed in and shared. It was also the loss of something that we implicitly or explicitly knew that we must cherish until the end of our lives, the loss of something that will never happen again.

At first I wanted to conclude this section and this chapter with some more details about the participation of the Prime Minister in the various stages and aspects of the *GAM* project. I wanted to recall more discussions, more issues and decisions, more published or un-published evidence that the cause of the success of the economic regime was very close to both his heart and mind. Finally, I decided to stop here and to move on to other chapters. I think I have been able to convey already to the readers: *GAM* was important to the Prime Minister and he saw it as a job well done. This was and remains the essential memory from this project for all of us.

CHAPTER NINE

External Relations: Joining the European and Atlantic Communities

9.1. The collapse of the Communist empire and the peaceful end of the Cold War

There can be no doubt about who bore the responsibility for the outbreak and seemingly endless duration of the original Cold War that started in the second half of the 1940s and ended in the late 1980s. Despite the ups and downs of American–Soviet relations and of the so-called *détente*, at no time was it certain that it would actually be over by the end of the 20th century or even during the first half of the 21st century.

Without the profound changes that took place during the 1980s in the Soviet Union, the liberation of Eastern and Central Europe from Communist dictatorship could not have happened. These changes were also decisive in ending the Cold War.

Authoritarian and totalitarian regimes are built on a combination of exercise and misuse of power and ideologies developed and imposed in order to justify the oppression of people by the ruler and his followers. Free speech and criticism of the regime are severely punished by brutal arrest and prison, torture and frequently by death. The most complete totalitarian regimes in the 20th century were the various iterations of the Communist regimes and National Socialism and the various so-called fascist regimes. Hungary, like many other countries in Europe as well as in Asia, Africa and Latin America, unfortunately has had direct experience with both kinds of barbarous and inhumane systems.

Hungarians also knew from direct experience how difficult and often quite impossible it was to escape from these oppressive regimes: both individually (as refugees) and for a country as a whole (through regime change) and how ruthlessly such attempts were punished. Experience has also shown that international help to support such opposition and to help achieve freedom from totalitarian regimes often took only the form of promises, or if it was actual support (including military action), more often than not, it was not effective enough and failed to achieve the objective of creating a true alternative, i.e. a free and prosperous system.

In fact, the regime of János Kádár and its masters in Moscow could afford, after several years of terror in the wake of the 1956 revolution, to ease up somewhat on the mental and physical oppression of the population convinced that Hungarians had

learned their lesson and become too smart to risk a new uprising against the foreign occupation and the one-party rule over all the essential aspects of society.

The Communist political system – implemented and maintained by force in the Soviet Union and its satellites, in China, Cuba, Yugoslavia, and several other countries in the world – was a basically inefficient and morally and ethically corrupt system, which could not have survived for any length of time if the citizens had had the free choice to reform it, abolish it and to replace it with a liberal democracy.

The Western liberal democratic system may have shortcomings, but in its contemporary form, as it developed since World War II in Europe and the rest of the Western Community, it is vastly superior to Communism and other types of one-party dictatorships.

Thus, fundamentally the Soviet Union and the Soviet Communist Empire collapsed not because any particular problem created some economic difficulties. If the cause had been a question of economic or administrative malfunctioning then the regime would have disappeared much earlier. In fact the system collapsed not because there was a refusal to introduce valid reforms – as had been the case virtually ever since the Russian October Revolution in 1917 – but because of the hope to introduce reforms without a real understanding of the functioning of Western democracies and market economies. On this account both Gorbachev and his archrival Boris Yeltsin, and their respective leading followers had serious shortcomings.

Historians have not been kind either to Gorbachev or to Yeltsin. While their task – i.e. carrying out a successful transformation of a totalitarian political and economic system into a modern democracy and a market economy – was enormous, they also had to contend with the backlash of the conservative forces of the Soviet dictatorship. The backlash did occur – not only in August 1991 but also later, in multiple phases and under multiple forms. Putin's rise to power was one of the most important among those stages that culminated in his wars of aggression started in 2014 and 2022.

One of the important qualifications for being a good political leader is to understand that the future – for one's own country or for its international environment – is not predetermined once and for all. Also one must not think that, among the various scenarios of the future, the one that is the most favorable for your cause is necessarily the one that will most likely happen.

József Antall, who in my opinion was not only a good political leader but also a great statesman with a unique sense for Hungarian history and politics, but most importantly also for European and world politics, understood that there could be a backlash in Russia. If such a backlash was going to occur – as both Russian and European history taught us that it might – it was vital for Hungary not to be left out once more “on the wrong side of history”.

Those of us who were close to him admired this quality of historical judgement evident in his decisions, speeches and writings or in simple conversations. We came to understand the historic dimension of his mandate for Hungary. Many foreign leaders shared the impression we had. We hoped that this would consolidate international appreciation and sympathy for Hungary for years to come.

9.2. A unique historic opportunity to join the Euro-Atlantic Community

European integration and the emergence and consolidation of the Western Community have represented the most important positive developments in the history of international order. These two developments have been closely related from their start in the second half of the 1940s and have been mutually re-enforcing each other during the ensuing years and decades.

The United States played a key role in the launching of these converging trends, but without the active participation of European and other democracies (among these latter the role of Japan has to be especially emphasized) the outcome would have been much more uncertain.

The three essential features and achievements of European integration and of the “virtual” Western Community⁹⁵ can be summed up under three headings: (1) members are liberal democracies; (2) they are market economies with an effective social protection; (3) they have effective collective security against external and internal threats. As a result of this solidarity there has been *de facto* perpetual peace among the members of the Western Community, and war among the members has become unthinkable.

The strength and achievements of the Western Community and of European integration helped deter direct or indirect threats from the Soviet Union. There is no doubt that the success of the Western model and of the liberal Western international order played a decisive role in the end of the Cold War and of the Soviet Communist Empire.

Antall understood very well that the victory of the Western domestic political model and of the liberal democratic international order would allow the *de facto* expansion of the geographic scope of the virtual Western Community. This was going

⁹⁵ On European integration and the Western Community see: Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

to offer a unique historic opportunity also for Hungary. From the early 20th century onwards, for most of the following decades, Hungary was largely prevented, either through its own faults or decisions or through the decisions of other countries, to be a fully recognized member of the West. This was a particularly tragic situation during the post-war decades, which saw, as mentioned above, the take-off of European integration and of the Western Community.

According to Antall, for Hungary to become a member of the Euro-Atlantic Community was in the material, spiritual, political, cultural, social and strategic interests of the country. He was not over-idealizing Western countries or Western values. He was familiar with the current and past shortcomings of the West. Yet for him there were no valid arguments for hesitating about the choice of becoming or not a member of the Euro-Atlantic Community. Membership was an absolute priority that corresponded to the supreme interests of Hungary.

There was no naivety or oversimplification in this attitude towards the West. A thorough understanding of Hungarian history, of its geographic situation, of the hidden or open threats that were part of the traditions and inclinations of the country's neighbors, made it evident that becoming a full part of the broader West was the right option.

Antall also knew that although the scope of the West expanded, membership was not automatic. There were written and unwritten conditions. There was also potential opposition in some countries and some political groups based on prejudices or on real or apparent conflicts of interests. This was normal – it was part of the game of politics. It was, however, not an obstacle that an intelligent and reliable approach by the Hungarian government would have any difficulty to overcome.

At this point some important issues have to be mentioned that arose in the early 1990s, in the second half of the 1990s and shortly after the turn of the century, and finally problems that emerged during the last 15 years.

The outbreak of new crises in Eastern Europe.

The end of the Cold War and of the Warsaw Pact and of Soviet domination in Eastern Europe did not lead everywhere to an adhesion to the Western model of liberal democracy and integration. As in the case of the former members of the Soviet Union, an anti-democratic, anti-Western backlash was a possibility that the leader of a country like Hungary had to take into account. Negative, anti-democratic, anti-European and ultra-nationalist outbreaks were also possible in some of the smaller or medium-sized countries of Eastern Europe. This again required political and strategic foresight and readiness to protect Hungary from these developments when

they actually did happen. The prime examples were: the case of Romania where the phony regime change affected the rights, the freedom and security of the Hungarian minority; Czechoslovakia a country that was broken into two by a Czech and a Slovak nationalist leader, and where there was also a negative impact on the Hungarians whose future was insecure; and obviously Yugoslavia, a federation that not only was broken into pieces by Milošević and his fellow Croat and Bosnian dictators, but also witnessed the invention of “ethnic cleansing” and the first genocide on European soil since the Second World War.

The leaders of the West were first too busy with the details of the agreement about Germany and events taking place in the Middle East in order to deal promptly with these preventable developments in Central and Eastern Europe. We are still paying the price for this neglect. In many parts of Eastern Europe there is only a phony democracy and in some places only NATO soldiers (including Hungarians) can manage to prevent the locals from murdering each other for some wild nationalistic reasons.

Who is qualified to be a member of the European Union and NATO?

As already mentioned, Prime Minister Antall believed that the primary objective of Hungarian foreign policy had to be securing his country’s membership in the European Union and in NATO.⁹⁶ Although in institutional terms joining NATO and the European Union were separate processes, the two were fundamentally linked both in Hungary and in the decisions of the “old members” of the Atlantic Alliance and of the European Community. Membership in these organizations brought both benefits and costs and new responsibilities. In political terms the conditions for EU membership were defined at the 1993 Copenhagen Summit of the European Union (the so-called Copenhagen criteria).⁹⁷

⁹⁶ Antall, József (July 17 1993) “At the Summit Meeting of the Central European Initiative”, Budapest, in Jeszenszky, Géza, Editor (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antall Foundation, Budapest, pp. 335–348 Antall, József (July 20, 1993): “Hungary’s Foreign Policy Guidelines”, Budapest, in Jeszenszky, Géza, Editor (2008): *József Antall, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antall Foundation, Budapest, pp. 341–348.

⁹⁷ The following are excerpts from the EU Council Decision of June 21–22 1993:

“Relations with the Countries of Central and Eastern Europee

A. The Associated Countries

- i) The European Council held a thorough discussion on the relations between the Community and the countries of Central and Eastern Europe with which the Community has concluded or plans to

“Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate’s ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.”

Important among the Copenhagen criteria was the ability and willingness to adopt the so-called *Acquis Communautaire* and integrate it into the candidate country’s legal and institutional structure.⁹⁸

conclude Europe agreements (“associated countries”), on the basis of the Commission’s communication prepared at the invitation of the Edinburgh European Council.

- ii) The European Council welcomed the courageous efforts undertaken by the associated countries to modernize their economies, which have been weakened by 40 years of central planning, and to ensure a rapid transition to a market economy. The Community and its Member States pledge their support to this reform process. Peace and security in Europe depend on the success of those efforts.
- iii) The European Council today agreed that the associated countries in Central and Eastern Europe that so desire shall become members of the European Union. Accession will take place as soon as an associated country is able to assume the obligations of membership by satisfying the economic and political conditions required.

⁹⁸ The *Acquis Communautaire* contained 3,000 directives and some 100,000 pages in the Official Journal of the European Union to be transposed. It demanded a lot of administrative work and immense economic change, and raised major cultural problems – e.g. new legal concepts and language consistency problems.

Acquis Européen

The European Union (EU) *acquis* is the collection of common rights and obligations that constitute the body of EU law, and is incorporated into the legal systems of EU Member States. The EU *acquis* evolves continuously over time and includes:

the content, principles and political objectives of the EU Treaties;
any legislation adopted to apply those treaties and the case-law developed by the Court of Justice of the European Union;
declarations and resolutions that are adopted by the EU;
measures in the fields of common foreign and security policy and justice and home affairs;
international agreements that the EU concludes, and agreements concluded among the Member States themselves with regard to the EU’s activities.

Candidate (applicant) countries are required to accept the *acquis* before they can join the EU. Derogations (exceptions) from the *acquis* are granted only in exceptional circumstances and are limited in scope. The *acquis* must be incorporated by candidate countries into their national legal order by the date of their accession to the EU, and they are obliged to apply it from that date.

The challenge of interpreting European and Western values

A worrisome development of the last two decades has been the growing ideological division within and between Western democracies about the correct interpretations of Western values and written or implicit societal rules and obligations. To call this phenomenon a split between “conservatives” and “progressives” or “modernists” and “traditionalist” is an oversimplification. The origin of these divisions is as much “interest-driven” as it is “legally or ethically” defined. It is one of the most dangerous centrifugal forces that most of the member states of the Western Community have to face today. Whether it is in Hungary or in the United States, in France or Britain, populist politicians have systematically used ideological provocation to undermine the foundations of Western democracy and of European integration and the Western Community.

9.3. József Antall: a great international statesman

The modern theory of international relations recognizes the close relationship between the domestic dimension of political objectives and political order and the quality of foreign policy and international order. József Antall was not only a great Hungarian statesman; he was one of the great international statesmen of his time. How did Antall qualify for this epithet?

The *József Antall Building*, inaugurated in 2008, is one of the main buildings of the European Parliament in Brussels. It honours the first Prime Minister of Hungary “after the return of democracy”. It is situated near the buildings that carry the names of Paul-Henri Spaak, Altiero Spinelli and Willy Brandt. It is probably the single most important monument dedicated to Antall’s memory. This distinction was rightly chosen. It recognizes that within a short political career Antall has earned his place as a great parliamentarian and a great European next to the founding fathers of the new Europe.

Antall has to be recognized not only as a great European but also as a great Atlanticist. Thus, for example, the “Hungarian Foreign Policy Guidelines” of 1993 stipulated: “Our most important aim is to achieve access to the European Union and to NATO within this decade.”

Wolfgang Schäuble, one of the main architects of German re-unification, wrote a very thoughtful essay under the title “József Antall – A Hungarian and European”. Schäuble pointed out the significance both for Europe and Hungary of Antall’s strong belief in the importance of creating the appropriate legislative, legal and institutional basis for the regime change and the consolidation of liberal democracy and human

rights in the former Communist satellites of the Soviet Union, including what used to be the German Democratic Republic.⁹⁹

The foreign policy of Hungary during the Antall years was a success story. This was largely the merit of the foreign policy genius and hard work of the Prime Minister. However, Antall's foreign policy team largely defined also contributed significantly to this important outcome. This was also the area where Antall inspired and directed the members of his team most successfully. This was my perception already 30 years ago and it remains my strong conviction today.

Based on my personal recollection, Antall's core foreign policy team included about half a dozen people: Géza Jeszenszky, Gyula Kodolányi, Péter Ákos Bod, Pál Tar, János Martonyi, and György O'sváth. Of course, there were several other people who were involved at various moments in what might be called foreign policy related tasks and issues.

The quality of Antall's international statesmanship can be assessed on the basis of various sources and from various perspectives. A first important and rich source is to be found in his speeches and writings. A second major perspective emerges from the speeches and articles prepared by foreign leaders and officials about Antall and about his character and achievements. A third source are the numerous articles and books written by members of Antall's team about the Prime Minister and about various aspects of the Antall years. These usually contain important elements related to international relations and foreign policy. Last, but not least, one has to consider the large number of meetings, in Hungary or abroad, which Antall had with foreign leaders and other officials and his participation in numerous conferences of international organizations. These visits and discussions – some of which took place on Antall's initiative, sometimes on the initiative of foreign partners – led to valuable contacts and to confirm Hungary's image as a new democracy and as a country firmly committed to international cooperation and to upholding peace and political freedom and human rights.

In a text entitled "József Antall and the World", Géza Jeszenszky provides a detailed history and analysis of Antall's foreign policy philosophy and achievements. This text, together with Péter Bod's article "József Antall Prime Minister", published in the same volume, provides valuable information for all those interested in modern Hungarian and European history.¹⁰⁰ As Jeszenszky points out, the early 1990s, the

⁹⁹ Schäuble, Wolfgang (June 2, 2005) "József Antall – Ungar und Europäer", Berlin, in Jeszenszky, Géza, Kapronczay, Károly and Biernaczky, Szilárd, Editors (2006): *A politikus Antall József – az európai úton*, Mundis Magyar Egyetemi Kiadó, Budapest.

¹⁰⁰ Jeszenszky, Géza, Kapronczay, Károly and Biernaczky, Szilárd, Editors (2006): *A politikus Antall József – az európai úton*, Mundis Magyar Egyetemi Kiadó, Budapest.

“years following the fall of the Berlin Wall”, were a complex period in international relations offering opportunities but presenting also numerous unexpected foreign-policy challenges. Decisions made at the time were going to have positive or negative long-term consequences.

Antall’s approach to these opportunities and challenges could be summed up as follows:

- 1) ***Hungary must work hard to seize the opportunity of becoming and remaining a respected member of the international community.*** Antal was fully aware of how much Hungary had suffered in the past from the negative perception among foreign leaders and in the general public in many countries about its values and traditions. The change of regime and the liberation from the weight not only of the era of Communist rule, but also of the two world wars and of the inter-war period, offered a precious opportunity for Hungary to become a “normal” member of the international community, without any reservations or negative qualifier. The responsibility for achieving such a stature rested essentially with the government and its head. The perception in the media was only one aspect of this, and often not the most important one. Many politicians among Antal’s contemporaries in Eastern Europe or in other parts of the world may have received more attention in the press, but in the long run did more harm than good for their countries’ reputation because of their policy errors or personal behaviour, or both. For example this was true for Václav Klaus, various French ministers and prime ministers, Gerhard Schröder, Margaret Thatcher or even Tony Blair. One need not mention the extreme nationalists, like Milosevic or Tudjman. In answer to an opposition politician’s complaint in parliament that “compared to the past there was relatively little news in the international press about Hungary”, Prime Minister József Antal gave the right answer: “the fact that they do not write about us shows that we are doing our job...” It is true that there had been at least three periods during the preceding 150 years when Hungary was at the center of public attention in Europe as well as in the United States, and the Hungarian people were recognized and celebrated for their heroic fight for democracy and independence. This was the case following the bloody suppression in 1849 by the troops of the Austrian and Russian monarchs of the Hungarian fight for freedom

Jeszenszky, Géza: “Introduction: József Antal and the World” in Jeszenszky, Géza, Editor (2008): *József Antal, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antal Foundation, Budapest, pp. 15–48. Bod, Péter A.: “József Antal, Prime Minister of Hungary”, in Jeszenszky, Géza, Editor (2008): *József Antal, Prime Minister of Hungary, Selected Speeches and Interviews, (1989–1993)*, József Antal Foundation, Budapest, pp. 49–65.

and a liberal republic; as well as after November 4, 1956, when Soviet troops re-occupied Budapest and Hungary and re-imposed a bloody-handed Communist regime governed by János Kádár; and finally in 1989–1990 when Hungary played a major (often underestimated) role in the collapse of the Communist system in Europe.

- 2) ***Membership in the European Union and in NATO is vital; they are convergent rather than competing objectives and there is no valid alternative to either one of them.*** Newly regained national identity and national sovereignty are important values and assets that have to be carefully preserved. Nationalism, protectionism, anti-Europeanism and anti-Americanism, ethnic and religious prejudices have to be rejected equally forcefully. One need not elaborate on how insecure and unstable Hungary's international situation would be today if it were not a member of NATO and the European Union.
- 3) ***Correct relations with Russia are important but there is no room for arrangements that would suggest that Hungary belongs in the "Russian zone of influence" or that it occupies a "neutral" position between "East and West".***
- 4) ***Relations with other East-Central European countries require special attention. Initiatives like the creation of the Visegrád Group are an expression of historic ties. At the same time there must be no confusion at home or abroad between the countries that were responsible for the murderous war and massive human rights violations in the region.*** Relations with neighboring countries are both important and complex for all countries. This was and remains true for Hungary. Antall was fully aware of this and had no illusions that all the East Central European countries would be systematically well intentioned towards each other. Among the major problem areas the following can be mentioned here to illustrate this issue: (1) the legacy of the Treaty of Trianon and the situation of the Hungarian minorities in the surrounding countries; (2) the legacy of the decisions by the Communist regime, such as the Bős–Nagymaros dam; (3) shortcomings of the political transformation in several of the former Soviet satellites; (4) and most worrisome, the criminal behaviour of the old and new power structures not only in the various parts of the former Yugoslav Federation but also in Romania and Bulgaria.
- 5) ***Hungary should be ready to offer its good offices to help promote peace, democracy, human rights and international cooperation also beyond the boundaries of Europe. Maintaining good relations with Israel is an essential objective.*** The period since the end of the Second World War has witnessed an exceptional increase in the number of international organizations and in the scope of international action and cooperation. During the Cold War the effectiveness

and credibility of many international organizations was constrained by the authoritarian systems that prevailed not only within the countries of the “Eastern” or Communist Bloc, but also in many of the so-called “Third World” countries. With the end of the Cold War there was at least a temporary improvement. This positive development was offset by the outbreak of numerous new conflicts and so-called “humanitarian crises”. This has created a new demand for political and humanitarian engagement also by smaller states for humanitarian and development assistance and cooperation across the globe. The expansion of the action of so-called non-governmental organizations has been a key dimension of this development. This has required human resources and political and humanitarian vision not only by governments but also by “civil society”. The position and reputation of relatively small countries, such as, Finland, Norway, Sweden, Switzerland and Austria should be an example for Hungary in this context.¹⁰¹

- 6) ***The Hungarian government should be ready to defend the country’s legitimate values and interests. Aggressive nationalism and protectionism are not among them.*** Values and interests are the principal interdependent factors influencing domestic and foreign policies and for assessing the failure or success of the various policies followed by a government. One of the main functions of the political process in a democracy is to identify a country’s main values and interests and to establish the relative importance or hierarchy among them at any given time. Constitutional rules and principles are among the most important values on which a broad consensus has to prevail. Their interpretation may still be the subject of debate. Upholding interests involves not only benefits but often also considerable costs. These costs are not always spelled out in advance or are seriously underestimated. While Antall believed in the importance of patriotism, he gave a modern interpretation to this concept. “Liberal parliamentary democracy” is the best term for defining the basis of his political philosophy and political action.¹⁰²

¹⁰¹ On the role of humanitarian action and of humanitarian values see: Hieronymi, Otto (2002): “Political Order and Humanitarian Values in the 21st Century” in Hieronymi, Otto and Jasson, Chiara, Editors (2004): *Humanitarian Values in the 21st Century*, Refugee Survey Quarterly, Volume 21, Number 3, 2002, Oxford University Press and UNHCR, Oxford and Geneva, pp.126–134.

¹⁰² On the issue of “values and interests” see chapter two in Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma

9.4. Securing Hungary's place and role in the new post-Cold War world

June 26, 2023

In the middle of the year 2023 – three decades after the end of the original Cold War – the world is once more in the midst of a Cold War that opposes the forces of authoritarian evil to the Western concept of freedom and democracy.

The objective of this section is not to try to build scenarios of the duration and outcome of the current “new Cold War” nor to write the detailed 30 year history of the “post-Cold War world” and Hungary's place in this history. The objective is to identify only some of the key features of this new age and Antall's perception of how Hungary and Hungarians ought to relate to what he saw as important features of the then emerging “post-Cold War world.”

My reflections on the question raised in the title of the present section are organized around five interdependent themes: (1) international order and war and peace; (2) the future of the Western communities; (3) globalization, economic growth and social progress; (4) knowledge, education, identity and migration; (5) small countries, peace and the quality of life.

1) *International order and war and peace:* The following are a few issues and developments that marked the international order that emerged after the end of the Cold War and which have remained relevant for Hungary over the years. A first one is that ***peace and democracy did not become universal features of international order.*** A new division of the world appeared: one side that was characterized by respect for international law and human rights, and another side that was torn apart by internal conflicts and humanitarian crises.¹⁰³ A second issue was that ***regime change in Russia was far from fully successful as witnessed by the coup of August 1991 and the dissolution of the Soviet Union*** the following December.¹⁰⁴ A third issue was the ***positive and successful response to the Iraqi occupation of Kuwait*** led by the United States under the aegis of the United Nations.

¹⁰³ Hieronymi, Otto (2006): “Conflits Asymétriques: l'Ordre Politique National et International et le Respect des Règles et des Valeurs Humanitaires”, in *Actes des Journées Internationales : Conférence d'Ethique Militaire*, Ecoles de Saint-Cyr Coëtquidan, pp.293–312.

¹⁰⁴ Already in August 2021 Ian Bond wrote: “Thirty years after the coup that triggered the Soviet Union's collapse, Russia is ruled by the heirs of the plotters, not their democratic opponents. Why? The August 1991 coup by hard-line conservatives against the reformist Soviet president, Mikhail Gorbachev, ended in failure after three days. But three decades later, modern Russia's political system owes more to the *putschists* than to the Russian democrats who defeated them. What can the West learn from what went wrong?”

2) *The future of the Western communities:* Initially there was hope that the principles that inspired European integration and the broader Western Community would become the blueprint for a new universal international order: “From the Western perspective the story of the Cold War was the building and defence of liberal democracy. From the Communist perspective it was the upholding of the exclusive rule of the Communist party and preventing, through force and terror, the penetration of democratic and liberal ideas that could “contaminate” the populations under Communist rule. The end of the Cold War was brought about by the superiority and victory of liberal democracy over authoritarian and totalitarian Communist ideology. The actual or at least potential spreading of democracy after 1990 was one of the most hopeful aspects of the “collapse of Communism” – an event that many had considered as one of the two or three most important positive developments of the last 100 years.”¹⁰⁵

Euro-scepticism and anti-Western propaganda aimed at denying the universal validity of the liberal democratic order. “Theory, before and after Tocqueville, and past and present experience have taught us that there is no valid alternative domestic political order to a dynamic functioning democracy. This conclusion is based on the positive features and performance of democracies in “good times and bad times” and the negative record of the alternative political systems.

The decline of freedom in the world, the decline in the number of free countries noted in the 2019 *Freedom House Report*, continued in 2020. The conclusions of the authors of the latest *Freedom in the World* study are dramatic indeed. At the beginning of the 21st century, less than three decades after the complete bankruptcy of the greatest totalitarian and authoritarian ideology and experiment, the defenders of democracy are on the defensive again. Once more it is the politically correct thing to say, that “democracy is not the best system for all countries” (this time as much for pseudo-religious as for economic or ethnic or racial reasons). Is it not today’s conventional wisdom that “if you are not rich (“developed”) enough” you are not ripe for democracy? Are Iraq, Afghanistan, and Pakistan, the “Democratic” Republic of the Congo, Somalia and Sudan, Belarus, Cuba and North Korea not sufficient proof that the suitability of democracy for all countries is a dangerous illusion, and isn’t it true that to expect the “spreading” of democracy to non-democratically governed peoples is the contemporary form of Western imperialism?

¹⁰⁵ Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

“Democracy today is beleaguered but not defeated. Its enduring popularity in a more hostile world and its perseverance after a devastating year are signals of resilience that bode well for the future of freedom.”¹⁰⁶ I believe that the authors of the Freedom House report are right to affirm their faith in the strength of democracy and in the commitment of President Biden to uphold freedom and democracy at home and abroad: “A litany of setbacks and catastrophes for freedom dominated the news in 2020. But democracy is remarkably resilient, and has proven its ability to rebound from repeated blows.”¹⁰⁷

- 3) **Globalization, economic growth and social progress:** Globalization has contributed to increased efficiency and growth in the world economy. By the 1980s and early 1990s its shortcomings also became increasingly evident. These include an excessive “short-termism” and reliance on short-term finance and financial speculation and a growing disregard for social safety for the disadvantaged great majority of the population.¹⁰⁸ The great inequality that can be observed by now in most countries, including the highly developed market economies, is not only a major social and moral problem but could also lead to growing political instability. The recurring monetary and financial crises that unbridled globalization have engendered cause of extensive wealth destruction. The fact that the 2008–2010 crises did not lead to a collapse of the entire international financial and monetary structure was as much the result of luck as it was the work of official and private “experts” and decision makers.
- 4) **Knowledge, education, identity and migration:** As noted already, the “big lie” was an essential component of all authoritarian regimes. Also, the systematic distortion of knowledge, science and education is one of the inherent weaknesses of unfree political systems. Technology diffusion has been one of the strengths

¹⁰⁶ Op. cit.

¹⁰⁷ Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

¹⁰⁸ On monetary issues and globalization see: Hieronymi, Otto (1998) “Agenda for a New Monetary Reform”, in *Futures*, Vol. 30, No.8, pp. 769–781, Pergamon, Elsevier Science Ltd.; Hieronymi, Otto, Editor (2009): *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, Basingstoke; Hieronymi, Otto (2007): “The Spirit of Geneva and Globalization” in Hieronymi, Otto and Intag, Kathleen (Editors): *The Spirit of Geneva in a Globalized World*, Refugee Survey Quarterly, Oxford University Press, Volume 26, Number 4, 2007, pp. 274–305; Hieronymi, Otto (2008): « Les Responsabilités des Gouvernements et des Entreprises à l’Epoque de la Finance Globale », *Conference Presentation*, Modena, 14 March 2008, Unpublished Manuscript.

of the liberal political order. It has also contributed to the victory of the Western model over the Soviet Communist system.¹⁰⁹ The use of the terms “information society” and “knowledge-based society” is more or less equal with the spreading of the term “globalization”. Although by the 1980s and early 1990s the development of the information society and of globalization had already reached considerable momentum, no one could have predicted the proportions they would reach in 30 years. This is particularly true for the worldwide web, social media and related areas dominated by the so-called “big tech”.

The creation and diffusion of modern technologies began about 200 years ago. During this period access to modern basic technologies was a condition of economic success. Today the access to state-of-the-art technologies is a condition of political and economic survival. At the time of writing this we do not know for example the scope and role of “artificial intelligence” and how it will affect the future political and economic order in the world. (It should be mentioned that already in the early 1990s “artificial intelligence” was known as a “promising” new technology, for example, in the banking sector. However, it did not fulfil its initial promises for quite a few years).

Identity and migration were also related to knowledge and globalization. József Antall knew about the importance of migration both in the past and for the future. What was going to be the principal “migration” problem for Hungary in the future? Too many Hungarians emigrating to the West (brain drain)? Too many refugees and immigrants arriving from the Third World? Multiple identity or refusal to integrate and assimilate? The following quotes from a Hungarian Review article help reflect on these issues: “What are the limits for the number of refugees and immigrants that a country can absorb? Is it the number or proportion of foreigners in a country’s population? Such a simple rule of thumb would give truly “unrealistic results” as a comparison of Hungary and Switzerland clearly shows. In Hungary the “foreign-born” population currently represents 4.5% of the total. Yet, the government and especially the extreme right opposition argue that the “boat is full” (the term the Swiss used to justify the rejection of many refugees during the Second World War) and that Hungary cannot afford more refugees and does not need more economic migrants. In Switzerland currently the foreign-born represent 28.3% of the total population. In 1999 it was “only” 21.4% – an increase of seven percentage points in about a dozen years. It is true the Swiss

¹⁰⁹ Hieronymi, Otto (1987): “Introduction”, in Hieronymi, Otto, Editor, (1987): *Technology and International Relations*, Macmillan, London, pp. 5–8; Hieronymi, Otto (1987): “Reflections on Technology, International Order and Economic Growth” in Hieronymi, Otto, Editor, (1987): *Technology and International Relations*, Macmillan, London, pp. 69–95.

are “concerned”. They feel that this upward trend should not continue without interruption. However, the majority of the population condemns xenophobia and believes that asylum is not only part of the law, but also of Swiss values and traditions.

In fact, there is much evidence that the “absorption capacity” of a country is a function not only of numbers, but even more so of the quality of the integration and assimilation of migrants and refugees in their new host communities. There is a widespread realisation that a globalised world cannot function without successful migration. At the same time, there is also a significant contrast to the multilateralism and reciprocity of trade negotiations and liberalisation. Immigration policy is firmly based on the interests of the potential host country, and in most cases represents unilateral and at best bilateral policies. With the exception of the free movement (and migration) of the citizens of the European Union within the EU, there is no significant example of states delegating or reducing part of their sovereignty with respect to immigration.

- 5) ***Small countries, peace and the quality of life:*** For most of human history, small countries were “inferior” (or at least felt so) *vis-à-vis* large ones. They had to fear constantly for their freedom and security. Attacks against small countries by larger and more powerful ones were the “normal” state of affairs. The attempts to create a system of “universal collective security”, first by the Covenant of the League of Nations, and then under the Charter of the United Nations, have not fully succeeded in providing security for small countries against aggression by large ones. This has led many historians and experts in international relations to argue that effective collective security where small countries are as safe as large ones, although desirable, is impossible to realize. I have been convinced for many years now that this “realist” theory is incomplete or outright wrong because it does not take into account a major positive exception: the experience of the Western Community and of European integration since the late 1940s.¹¹⁰

¹¹⁰ On collective security and perpetual peace among the members of the Western Community see chapter four of Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma In an article entitled “The Western Community and the position of small countries” Alexander Vautravers, a Webster University colleague, argues, like many of us, “that European small states – including the neutral countries – have been the main beneficiaries of collective security and cooperation during the Cold War.” This, of course, is similar to my line of thinking, which goes well beyond the security dimension: i.e. in no previous period of history has it been so good to be a small country as has been the case for the small democracies in the post-war Western Community. Completing his above statement Vautravers

Since the 1950s the quality life of small countries in Western Europe and in the Western Community at large was superior to that of larger countries. This was partly due to the security advantage they enjoyed but also to the relatively high political and societal cohesion that could be observed in most of them compared to the frequent social tensions in the major European countries like France, Italy or the United Kingdom. Although self-inflicted religious and linguistic tensions were also present in some of the small countries, such as Belgium or Ireland, the smaller countries, with Belgium and Holland in the forefront, became the most convinced advocates of European unity. At the same time, the small countries felt equally strongly that the United States was as important a partner in helping to maintain their peace and freedom as their larger European partners.

Thus, it was no accident that from the 1950s onward the focus of European integration was primarily economic and that at the level of political values, of security and peace, the broader Western and Atlantic framework had priority and ultimately was found sufficient. If one can affirm that at no time was it so good to be a small country in Europe as it has been the case since 1950s and that ultimately the small European countries were the most important beneficiaries of the new Western order – this was due to both the Atlantic link and to European integration. In fact, Atlantic and European integration were part of the same process, a process that has led to profound changes not only in institutions and policies but also in people's values and identities. By far the most important new tradition has been – and one that people have been taking for granted for quite some time – that *war between countries belonging to the Western community has become unthinkable for the vast majority of the citizens of the Western world.*

“asks if this still holds true after the 1990s, and if this collective security has extended – or should do so – beyond Europe?” Vautravers pointed out the unique nature of NATO and of its historic achievements: “NATO has been successful in building a Western peace and a Western security identity. NATO is unique in its legal framework, with a provision for automatic collective defense of any one of its members (Atlantic Charter, Article 5.). This disposition is clearly in favor of small states, whose defense arsenal and lack of strategic depth puts them even more at risk than the greater military powers. Beside the East–West (Cold War) and the Franco–German dimensions, the position of the small European countries should be mentioned. Throughout history, and in particular during the first half of the 20th century, small countries had little weight in European affairs and they tended to be the victims either of aggression or of neglect by their larger and more powerful neighbours. The freedom and the security of small countries thus became a central issue and also a key test of the quality of the new international order. After 1945 there was a strong current of thought that the issue of peace between the former enemies and the security of the small countries could be solved only through a United Europe.”

CHAPTER TEN

The First and Second Battelle Reports

10.1. How did I get involved: the opportunity of a lifetime

As an economist and political scientist I had done extensive research and forecasting work on economic, political, industrial and technological developments in Europe and the rest of the world. Through a lucky coincidence, Swiss officials invited me in the autumn of 1989 to tell them what I knew and thought about the economic situation and outlook of Hungary. After the meeting, the Swiss government agreed to sponsor a (relatively small) research project on the evolution and transformation of the Hungarian economy. The results of the research were to be transmitted to Hungary: to the opposition and the government side. The outcome was the “First Battelle Report”.

This project became for me, in personal and professional terms, an “opportunity of a lifetime”. At no time could I have dreamt that one day I would be able to provide professional input into the policies and process of regime change in Hungary, from planned economy and Communist dictatorship to democracy and the social market economy.

This book is about regime change in Hungary and the role and contribution of Prime Minister Antall. As mentioned earlier, my analysis is based not only on readings but also to a significant extent on my personal experience and work during the Antall years. While this is not a personal memoir, it may be useful for understanding its perspective and conclusions if some information is included on my personal background, education and professional experience prior to the late 1980s.

I was born and raised in Hungary and managed to escape from the country along with another 200,000 refugees after Soviet troops crushed the 1956 Hungarian revolution. Up to then I had lived in various parts of Hungary (primarily in Budapest) with the exception of five months, which I spent as a nine-year-old child in Switzerland thanks to the Swiss Red Cross. Thus, my basic life experience was shaped by having lived under two totalitarian regimes, through the Second World War, and subsequently in free liberal democratic countries where I finally settled.

I have souvenirs of the events and atmosphere of the years 1945–1947, and the hope that Hungary could become a free and normal country. I also knew from personal family experience that these hopes were illusory and were going to be crushed by the

Communists' full seizure of power in 1948, the year of "complete regime change", the "*fordulat éve*" to describe it by the term used by Mátyás Rákosi, Hungary's "mini-Stalin". This was a regime change that led to a world of prisons and fear everywhere, the kind of fear and terror that had prevailed in Hungary from March 1944 to the spring of 1945. Contrary to what some people believe, we remember once we have grown up what we saw and lived through in our childhood and youth.

The memories shaping my life also included, of course, the 1956 revolution and its aftermath both in Hungary and in the Western free world. At the time, Hungarian refugees were welcomed with open arms in most Western countries. They continue to be remembered even today, although since then the world has seen countless crises and millions and millions of refugees. The slogan of the students in Zurich who received and welcomed Hungarian refugees in 1956, "*Niemals vergessen*", "we will never forget" turned out to be true.

I completed my university studies (*licence* and doctorate) mostly in Geneva, in International Relations and International Economics. My main "mentor" was Wilhelm Röpke, himself a former refugee from the Hitler regime and one of the "intellectual fathers" of the concept of the "social market economy". I heard about Röpke the first time from my father in 1955 in Budapest, after he was released from prison where he had spent close to five years on essentially trumped up charges. My father was a convinced anti-Nazi and anti-Communist liberal, whose knowledge and democratic views of Hungary and the world helped shape my own life-long anti-totalitarian and pro-democratic convictions.

Between 1964 and 1970 I taught Economics for a year at a university in the United States and was an International Economist at a leading New York bank. My main responsibility at the bank was to follow closely economic, monetary and political developments in Europe and several other major countries, and also included banking reform in various European countries, international trade (including the Kennedy Round) and European integration. Eastern Europe (including Hungary) was part of the scope but was of limited direct interest. My work in New York provided a unique view and experience of how the world works and how to gather, handle and transmit information to top management in industry and finance. For example, leading bankers from major banks in Germany or France would call me up or come to meet me when visiting the United States to ask me about economic and political developments in their own countries and what I thought about changes in policies and the political landscape in the countries and regions where they themselves lived and worked.

One of the most memorable of my encounters was with the former German Chancellor Ludwig Erhard, who contacted me through German diplomats in New York in order to borrow material on the economic situation and outlook in the Federal

Republic.¹¹¹ Erhard, the father of the “social market economy” and of the German economic miracle, was on a trip across the Western Hemisphere. I had the opportunity to meet him for two long, friendly conversations at the beginning and the end of his trip. We spoke less about the current situation than about the social market economy and about the late Wilhelm Röpke, who had been a close friend and adviser of Erhard, and whom Erhard considered as the most important intellectual influence for his own thinking and policies after the Second World War.

In the summer of 1970 I joined the Geneva Research Center of the Battelle Memorial Institute, an American foundation that had been the first to develop the concept of “contract research” – research carried out for public or private sponsors. The results of the projects, which sometimes could last several years, with teams that could include more than a dozen scientists, were confidential and rarely made public. In Geneva I was a Senior Economist and responsible for Economic Analysis and Forecasting. My main geographic area was Europe, but during my 25 years with Battelle I worked in as many as 50 countries. The Battelle motto was: we work for the benefit of mankind. The sponsors (the clients) paid for our work but the Battelle Foundation made no profit and did not advertise. As for my work in Hungary between 1989 and 1993, Hungary did not pay the costs, but the results belonged to Hungary.

10.2. The Office of the Prime Minister’s Advisers (*Miniszterelnöki Tanácsadó Testület*)

I met József Antall for the first time through the Swiss Ambassador during the weeks that I was doing research on the Battelle project on Hungary. I did not imagine at the time that I was meeting the future Prime Minister of a free Hungary. However, I was immediately impressed by his personality. I saw him as someone who was open-minded and very knowledgeable, with a firm but balanced judgement about the future of Hungary as part of Europe and the Western World. He was the kind of person who generated trust, someone you hoped to meet again. He was both low-key and exceptional.

Antall and his associates liked the outcome of the Battelle study, both the general approach and the conclusions and recommendations. It was on the basis of this assessment that Antall told me that he would like to see me as one of his international advisers. He told me this informally in January 1990, and confirmed it in writing

¹¹¹ The 1968 volume of the *Annual Report on the State and Outlook of the German Economy Jahresgutachten des Sachverständigenrates für die Deutsche Wirtschaft* 1968.

after the elections. I was very glad and interested because of Antall's personality and values, and because I was fully aware of the importance of the challenge at a historic moment not only for Hungary but also for the world as a whole.

When we spoke in January, I was at first a little incredulous. I thought that Antall may have wanted to be nice and would soon forget our conversation. But Antall meant what he said, and I learned later that as a rule he always meant it when he suggested or promised something. Antall's associates knew him already better than I did at the time. They began to accept me as a *de facto* adviser, as part of a small group or team.

Being an international (personal) adviser of the Prime Minister was not a "job" in an administrative sense (although I received a letter of appointment signed by the Prime Minister). I received no salary and the relationship could be revoked at any time by either side. I remained a full time employee of Battelle. Yet, for the next three and a half years the bulk of my time and intellectual efforts were devoted to my work as an adviser to Prime Minister Antall. This relationship was not broken until the premature death of the Prime Minister in December 1993.

The framework and administrative support for what became an intensive and demanding activity were provided during the first two years by the Office of the Prime Minister's Advisers (*Miniszterelnöki Tanácsadó Testület*) located on the third floor of the parliament building not far from the Prime Minister's office. The Head of the Office was Gyula Kodolányi, State Secretary and Foreign Policy Adviser of the Prime Minister. When the Office of Advisers was dissolved, I continued my work from the Office of the Minister without Portfolio, Tamás Szabó, with whom I also developed a close working relationship.

10.3. Commitment, friendship and hard work

Gyula Kodolányi in his memoirs published a few years ago describes the role and functioning of the Office of the Prime Minister's Advisers without giving a systematic or full history of this unique and dynamic institution. He lists the members of the two groups who were attached to the Office (me included) and gives illustrations of some of their work and how they contributed to decision making with information and recommendations at the level of the Prime Minister and of his government.

In the rest of this section I would like to mention briefly some of my work during those years. The nature and outcome of my work as adviser are also discussed in several chapters of this book, including section five of the present chapter, which deals with the Second Battelle Report.

The most important activity can be described as “developing and maintaining contact and collecting and exchanging information” with people in the government, in the various ministries and other agencies, as well as in the private sector. Before each of my visits to Hungary I had a list of meetings planned for my stay. The number of people and meetings tended to increase, sometimes three or four fold, during my actual stay in Hungary. Usually these meetings consisted of one-on-one in-depth conversations/discussions that followed a certain flexible pattern: (1) specifying how much time the person I was meeting could reserve for our discussion (as well as how much time I had); (2) defining what were going to be the key issues of our discussions (from both my point of view and from the host’s point of view); (3) discussions/assessment of the general situation and outlook in relevant areas (my conclusions and suggestions and the reflections of the person I was meeting).

My research experience of several decades (beginning with study trips in America and Europe during my university years, and then in New York and finally at Battelle) taught me that such informal but structured in-depth discussions with “true experts”, i.e. people who were closely involved with analysis and decisions, are a unique way both to understand what is going on and to allow people to reflect on your own opinions and judgments. These exchanges are based on trust and intellectual probity. The objective is not to exchange “secrets”, but to deepen and broaden jointly the thinking on issues that sooner or later may become ripe for important choices and decisions.

These discussions also helped me to identify or to confirm the importance of specific concerns and developments on which I could suggest a deeper and more systematic questioning or even specific measures. Thus, the second major category of my work was to prepare short texts/memoranda (not too many and never too long) for the attention of the Prime Minister and/or selected members of his Economic Cabinet. One of the fundamental lessons to be learned for advisors or researchers is that you must never inundate the persons you work for with endless memos and other texts. If you cannot distinguish between the essential/original and the secondary/commonly known, how can you expect that the target of your verbosity will have the time and patience to do so? More detailed background information and documentation could then be called for in a second stage of the process.

My activities also included participating in and/or taking responsibility for the “output” in various committees or working groups (for example, the Bank Reform Commission) as well as detailed research and report writing (for example, the *Second Battelle Report*), which may have involved other participants (such as, work on the *Legacy of 40 years of the Communist Economic and Social Regime*).

Our work was marked and driven by a commitment that we all shared: a belief that we were working for the common good of the Hungarian people. We all knew that

this work, these months and years were among the most significant, most meaningful aspects of our lives. We all tried to work hard to accomplish as much as we could in the limited time at our disposal. There was a spirit of commitment and friendship that was our principal source of energy. I believe that all of us will continue to remember this spirit until the end of our lives.

10.4. What was the first “Battelle Report” about?

The Battelle Report was one of three research projects that were undertaken at about the same time on the outlook of the Hungarian economy. The other two were the so-called Blue Ribbon Report and the *Híd Jelentés* (Bridge Report).

The following were the members of the group who provided advice and inputs for the study (some of whom joined the group only after the Budapest meeting):

Peter J. Bull, Société Générale Strauss Turnbull Securities, London; Emilio Fontela, Professor, University of Geneva and University of Madrid; Otto Hieronymi, Battelle Geneva Research Centers, Geneva,; Alfonso Jozzo, Banco San Paolo di Torino, Turin; Nicolas Krul, Geneva and Ménerbes, France; László Nagy, President, Jacobs Suchard Foundation, Geneva; Wilhelm Nölling, President, Landeszentralbank Hamburg; Jean-Pierre Roth, Director, Swiss National Bank, Zurich; Tsuneaki Sato, Professor, Nihon University, Tokyo; Robert Solomon, Brookings Institution, Washington, D.C. ; Miklós Szabó-Pelsőczy, President, GlobalConsult, Bedford, New York and Budapest; Paul Tar, Banque Nationale de Paris, Paris; Franz-Josef Trouvain, Chief Economist and Executive Vice President, Deutsche Bank, Frankfurt.

Lord Peter Bauer, a Member of the British House of Lords was also a participant in the Budapest discussions and gave me a written input. Although he agreed with the thrust of the study’s conclusions, he asked me not to include his name in the list of contributors since he usually preferred not to appear in similar “collective lists”.

Our report was completed in early January 1990, and it was in the company of the Swiss Ambassador, a personal friend of the future Prime Minister, that it was handed to Mr. Antall, the first person to receive a copy. The study was a “gesture” by the Swiss government to Hungary as a contribution to the thinking about the country’s future (at first we did not yet use the term “regime change”). The report was primarily destined to be read by the new leaders, but it was also handed to some of the officials of the outgoing regime.

In the late spring or early summer of 1990 the text was published in book form, both in the English original and in a Hungarian translation. Neither the English version, published by the Battelle Memorial Institute in Columbus, Ohio, nor the Hungarian

version, published by the magazine *HVG* in Hungary, enjoyed a very large readership. However, because of my position as the Prime Minister's Adviser, I (together with my employer, Battelle) enjoyed a certain notoriety in Hungary in the coming months and years. It was good that the report was available in print for whoever wanted to know about our original recommendations for Hungary.

The report was prepared with the help of a group of Western experts listed above (some of whom were of Hungarian origin). The approach, the bulk of the research, the drafting and the final text were my personal responsibility alone.

The final title of the report was *HUNGARIAN ECONOMIC, FINANCIAL AND MONETARY POLICIES: PROPOSALS FOR A COHERENT APPROACH*, a title that corresponded fairly well to the actual content of the study (as did the title of the Hungarian version, *A magyar gazdaság megújulása nyugati szemmel*).

The rest of this section contains some of the ideas in the text as well as some personal comments on the role of the study.

The principal objectives of the report

“The study was undertaken on the initiative of Battelle-Geneva with the financial support of the Swiss government. The report was prepared by Battelle-Geneva with the active participation of a Western group of experts. The members of the Group, who participated in a personal capacity and not as representatives of their respective organizations, include a broad spectrum of national backgrounds and professional experience.”

The principal objectives of this project (were):

- 1) to present a brief independent analysis of the economic, financial, monetary and social prospects of Hungary;
- 2) to provide a critical review of the policies being followed and envisaged in Hungary;
- 3) to consider briefly the precedents and the policy models that could be followed in the transformation of the Hungarian economy;
- 4) to identify the short- and long-term domestic and external risks and opportunities;
- 5) to formulate policy recommendations for Hungary and its foreign partners for the successful transformation and modernization of the economy in order to achieve sustained growth and rising living standards and to allow Hungary to meet its external obligations.

The aim of the study was not to prepare an academic analysis or a consensus report. While there was broad agreement among the members of the group on the principal

issues and recommendations, the project leader alone was responsible for the final wording of the report. The Swiss government was not responsible for the form, the contents or the recommendations of the report.

The original idea for a brief independent analysis dealing with the Hungarian economy and with the need for a coherent policy approach was formulated following a round-table discussion hosted by the Hungarian government in Budapest at the end of September 1989. This meeting on the current economic situation and policies of Hungary also included about a dozen Western experts who participated in the discussion in a private capacity. The 1989 round-table discussion followed two earlier seminars, hosted by the Hungarian National Bank and the Hungarian Academy of Sciences in 1986 and 1988 at Szirák Castle, which dealt with the evolution of the international monetary system. Several of the Western participants at the Budapest Round-Table had also attended the Szirák meetings.

The discussions in Budapest showed that it would be useful for present and future Hungarian decision-makers to have available an independent outside assessment of the prospects for the Hungarian economy, and of recommendations concerning the short- and long-term priorities for economic, financial and monetary policies in the domestic and international area. Furthermore, there was also considerable need for information and systematic analyses of the Hungarian economy in the OECD countries and for independent recommendations for policies to be followed in regards to Hungary. In addition to the discussions and to the information obtained at the Budapest Round-Table, the report drew on a series of in-depth discussions with Hungarian experts and opposition leaders and economists in late November and early December 1989, on conversations with experts and officials in a number of OECD countries and international organizations, as well as on an extensive documentation on the Hungarian reform debate and on the Hungarian economy.

Principal challenges, risks and opportunities

There were numerous indications that in the 1990s, both domestic and external circumstances were going to be favorable for the development of a free social, political and economic order in Hungary, which could provide the basis for sustained growth of the Hungarian economy. Such an opportunity was at the center of the aspirations of the vast majority of Hungarians since at least the late 1940s. Along with wide-ranging liberalization in the domestic sphere, there was an unhopd-for chance for Hungarian political independence and for close international cooperation.

At the same time, the situation in the OECD countries was also exceptionally favorable for Hungary. In fact, there was a strong convergence of the “political and

moral” interests and of the economic and financial interests of the industrialized countries in the future success of Hungary. Moreover, the nature and the renewed momentum of European integration could help Hungary overcome a number of external problems and traditional friction points.

This did not mean that success would come automatically. There were only a few ways of doing things right, whereas the scope for policy errors was virtually endless. There was a need for staying power and continuity as well as flexibility. Yet, it was the thesis of the report that the chances of success were real. If the right policies were to be pursued in Hungary and abroad, the Hungarian case could bring major economic, political and social rewards beyond the country’s borders.

It was important that the historic and unhopd-for character of the recent, on-going or impending political changes not be underestimated. For decades Western leaders, economists and businessmen, and most Hungarians, saw such changes as the preconditions of a successful economic reform.

Two types of major political uncertainty remained:

- 1) political destabilization in the Soviet Union and in Eastern Europe; and
- 2) difficulties with the political transformation in Hungary, parliamentary instability and the lack of consensus about the future of the country.

By the end of the 1980s the Communist economic system, which had never enjoyed real popular support, was thoroughly discredited. Consequently, there was broad agreement in Hungary both about the need for fundamental changes and about the general direction and nature of these changes.

Economic reform in Hungary had great potentialities but also faced some formidable challenges. It could bring living standards closer to what a highly capable and industrious people could achieve. But some of the necessary changes went counter to strongly entrenched and powerful interests. Substantial economic reform was to be a much more complex and long-term process than political reform.

The difficulties of economic reform were exacerbated because for more than 40 years people had been subjected to extensive state control and had no, or only very limited, experience of a market economy. The dangers arose because unsuccessful or unacceptable reforms could not only have resulted in economic hardship, but could also have invited social and political backlash. Nevertheless, there were good chances that the 1990s were going to become a period characterized by sustained growth, rising living standards, an accumulation of savings and private property, as well as an improvement of the quality of life.

Since many of the crucial economic indicators were either at a very low level, or were distorted, a change in the economic climate and in the basic objectives and

policy framework, and the introduction of the appropriate incentives throughout the economy, could bring about relatively important and visible productivity improvements and growth of output. Quantitative improvement could be obtained from a more efficient use of resources. This would be boosted by qualitative changes resulting from a stable and predictable political, economic and social framework and from a more market-oriented supply of goods and services.

Cutting back on waste would reduce the shortages in the economy. Since there was no “saturated demand” for most products and services, there would be few problems in “creating new markets” provided there was an effort to seek customers and to satisfy them.

Trial and error (and failure) are part of the economic process. Among the most serious defects of the socialist economy were the proclivity to subordinate efficiency and welfare to ideology, and the tendency not to recognize or admit errors or failures. The larger the project, the greater was this reluctance and its cost. The efficient “early-warning system” and “continuing surveillance” provided by the market reduce the weight and costs of endeavors that are unsuccessful. One of the most encouraging and positive features of the market economy is the possibility to start again.

This, however, did not mean that there was unlimited room for social and economic experimentation. The long-term goals and the basic framework had to be clearly defined, even if the day-to-day policy decisions could not be decided in advance. Economic reform and economic policies take time to achieve their full impact. The temptation to succumb to constant “economic tinkering”, which characterized socialist economic reform and management, had to be avoided both by Hungarian leaders and decision makers and their Western counterparts and advisers.

The starting point: the need to overcome pessimism itself

Although the international situation in the early 1990s was characterized by rapid change and considerable volatility, the favorable domestic and external constellation that Hungary was facing could have been hardly imagined as recently as six or twelve months earlier.

Notwithstanding this unexpected and un hoped-for situation, many of the analyses and comments in Hungary on the prospects of the Hungarian economy were marked by profound pessimism. This is true both for officials and intellectuals outside the government. The numerous publications, articles, interviews, speeches, radio and television programs in Hungary were preoccupied with the country’s immediate, as well as long-term economic outlook. In this respect, the situation seemed to have worsened considerably, even if compared with as recent a period as the autumn of 1989.

Several developments contributed to this underlying pessimism:

- the general uncertainty at the political level;
- the decline or stagnation of the real incomes of large portions of the population;
- the announcement of a severe austerity program;
- the widespread realization of the debt problem and the fear of its impact on Hungary's chances of modernization and growth;
- the latent or open fear of the failure of the reform programs in the Soviet Union and of a backlash, which would also affect Hungary;
- the slow rate of change in the "real economy" in contrast to the freeing of the debate and to the substantial changes "on paper";
- the substantial price increases of basic goods (meat, rents, transportation) and growing inflationary fears;
- the fear of unemployment;
- a feeling of inadequacy due to the general "technology gap" between Hungary at the time and the OECD countries;
- the apprehension that the "old rulers" or the *nomenklatura* were trying to save their privileges and were manoeuvring not to relinquish their power;
- the proliferation of opposition parties and the vocal dissensions among their leaders;
- the apprehension of the "new rules" of the market economy and the fears of adjustment;
- the rescinding of foreign-exchange travel allowances;
- the constant warnings of economic difficulties and pessimistic comments of the government about the general economic situation.

One of the main sources of pessimism was the lack of a coherent vision about the future economic order in Hungary. There was wide-ranging debate, but also confusion about the challenges, the external and domestic opportunities facing Hungary and about the policies required to take advantage of these opportunities. The speed with which the ruling party appears to have moved from "reform socialism" towards an apparently "orthodox monetarist" economic philosophy, and the haste with which it was pushing fundamental legislation through parliament added considerably to the lack of orientation of Hungarians about the possibilities and advantages of economic reform.

While outside observers also shared a sense of confusion, there was a general perception among them that Hungary stood a better chance to succeed in its attempt at gradually becoming a dynamic market economy than was the case for several of the other Eastern European countries, and especially for the Soviet Union.

This was partly due to the record of pragmatic attempts at economic reform since 1968 and more recently at political reform. Despite the partial and piecemeal nature of many of the economic measures and the numerous errors committed, throughout the 1970s and 1980s Hungary compared very favorably with the quality of economic thinking and economic management in the other socialist countries. The presence of a well-educated middle class, with a still existing commercial culture, distinguished Hungary even then.

The fact that momentous political and societal changes were taking place without a domestic and external economic and financial breakdown (and without the related extreme social hardships and waste that accompany them) also spoke in favor of the future success of the Hungarian economy.

Despite the obvious shortcomings of the various reform programs and the numerous errors of economic management, the “Hungarian example” played a major catalytic role in the deep political, economic and societal changes that were taking place in the Communist world. The example of a certain limited economic freedom and of a certain economic rationality (and ultimately the limited results of partial reform) had an influence on thinking at the time in the Soviet Union, as well as in the other Eastern European countries.

Whereas in Hungary there was no change yet (January 1990) in the parliamentary majority and no change of government, Hungary was the only Eastern European country where the preparations for the first free elections in well over 40 years were carried out in an orderly manner and where no mass demonstrations and disruptive strikes had been necessary to force the ruling party to envisage abandoning political monopoly and sharing power.

Moreover, notwithstanding the obvious domestic and external economic difficulties that the country had to face, even (early 1990) Hungary stood out as the Eastern European country able to avoid economic, financial and social breakdown. Despite the evident signs of increased inflationary pressures, there was no inflationary explosion and no veritable flight into goods and Western currencies. The Hungarian authorities rightly recognized that a “dollarization” of the Hungarian economy would not be an auspicious beginning for either the domestic market economy or for the independence and external creditworthiness of the country. They were also eager to maintain the country’s international credit standing. Maintaining the integrity and the continuity of domestic policy-making and of a minimum confidence in the national currency could be seen as a major potential asset for the future. The “tabula rasa” or “scorched earth” approach to economic reform would have been bad economics and its advocacy by some was based largely on a misreading of history, and especially of the evidence of post-war reconstruction in Western Europe.

However serious the short and long-term external and domestic challenges of transforming and modernizing the Hungarian economy, it was not a “broken-down economy” – in terms of production, of inflation, of the supply and availability of goods, of foreign trade and the balance of payments, and at the time also of social peace and consensus.

The present authorities and the future parliament and government would have to work hard to maintain external and domestic confidence. It was also in the economic and political interest of the Western economies to do their best not only to help Hungary overcome short-term difficulties, but also to cooperate in the country’s long-term development.

The task was huge. The economic structure remained inefficient and often obsolete, and there was considerable “resistance to change”, or apprehension at the risks inherent in change, in all sectors of the economy – in industry, in agriculture, in services and especially in the bureaucracy. People resisted giving up old or newly acquired positions and privileges and many of them, especially in offices, found it difficult to change ingrained ways of doing things.

Qualitative changes had to be swift and evident. The design and implementation of reforms had to follow a gradual but consistent path. One of the main criticisms that can be levelled against the (last Communist) government was the haste with which it was trying to push through some of the structural reforms of the economy.

In the economic climate at the time and during the ensuing period of transition, it was essential to point out the need to take the fight against inflation seriously. The economic and social hardships, which the continuation of the already high rate of inflation and especially the possible threat of runaway inflation would have created, could hardly be overestimated. Nor should the memory of the post-war Hungarian inflation (which statistically exceeded even the great German inflation of the 1920s) be taken lightly or forgotten. At the time this inflation was widely perceived as preparing the ground for the Communist economic takeover by wiping out the money savings of the entire population. If a political backlash was to be feared (in 1990) it could have been connected with the hardships created by inflation.

At the same time, there was evidence that despite the debate about privatization, relatively little had been done to help deepen and expand the already existing private economy in Hungary, i.e. the so-called grey or shadow economy. Reducing the obstacles to the growth of this genuine and spontaneous entrepreneurship (including the correction of the lack of availability of credits from which it had been suffering from the start) was as important a task as the planned privatization of state-owned companies (which often involved the sale to other state-owned firms or state-owned banks).

There was considerable emphasis in the Battelle Report, as in the general debate on the reform and prospects of Hungary and the other Eastern European countries, on monetary and financial problems and measures.

Yet, the most fundamental changes had to take place on the “real side” of the economy – in terms of “who commands in the economy?”, bureaucrats and party officials, or the markets, consumers and entrepreneurs; in terms of production structures, incentives, increased mobility, motivation and productivity of labor, the reduction of red tape, the diffusion of modern technologies and the effective protection of the environment, competition and veritable and broadly-based private initiatives.

The experience of numerous countries in the 1970s and the 1980s had shown again that inflation and monetary disorders have a negative impact and domestic and external stability a positive one on economic performance. But economic history also demonstrated that without important changes on the “real side” of the economy, without new incentives and motivations, fiscal and monetary discipline become sterile austerity, which by itself cannot create the basis for sustained and balanced growth.

It was important to emphasize, in Hungary and abroad, the character of the historic opportunity both for Hungary and for the Western world. There was a unique convergence of domestic and international interests in the success of the transformation of the Hungarian economy and the creation of the basis of sustained and balanced economic growth in the 1990s. This had to be the underlying theme of the new government’s economic program and the theme of international economic cooperation.

Principal conclusions and recommendations: an agenda for action

For two decades Hungary had undertaken the most systematic attempts to reform the socialist economic system. Hungary was also the first among the Eastern European countries to recognize the futility of only partial reforms, and the first to embark on a course of a peaceful but radical break with an economic order imposed from the outside 40 years earlier. The conclusion of the Battelle Report was that, on the whole, the on-going mutation in Hungary and the policies of the OECD countries towards Hungary were on the right track. While some (major) corrections were required, there was an urgent need to bring the key issues more sharply into focus and to reinforce the main lines of change.

Economic and social policies had to be closely tailored to the situation and the structure of each country. There were important differences in the situation and the structural problems of the Eastern European countries. Thus, in formulating the economic policies of Hungary and of the OECD countries, it was important to keep in mind the specific conditions in each country with respect to both internal

structures and policies and macroeconomic equilibrium. Applying identical policies in Poland, Hungary or in the GDR would have been economically erroneous, socially and politically counterproductive. This, however, does not mean that the successful transformation and integration of Hungary, and the other Eastern European countries, could have been carried out in isolation, on a bilateral basis, without an efficient multilateral approach. The example of the major contributions in the 1950s of the OEEC and of the European Payments Union can be remembered in this context.

A coherent program had to be defined and adopted as early as possible in 1990 to assure the successful transformation of the Hungarian economy into a dynamic market economy in the 1990s. Such a program had to take into account the progress achieved and set clear goals and priorities for action in Hungary and its relations with the OECD countries. It had to be based on a realistic and pragmatic approach, contain a careful evaluation of the risks and rewards involved and a commonly agreed timetable. There was as much need for caution as for bold decisions.

The conclusions of the report were formulated in five sets of interdependent recommendations. It was necessary to start planning on them simultaneously at the earliest possible date. They were addressed to the Hungarians and to decision makers in the OECD countries with a sense of urgency.

- (1) THE LONG-TERM ECONOMIC AND SOCIAL GOALS AND POLICIES FOR HUNGARY (“A GRAND DESIGN”) HAD TO BE CLEARLY DEFINED, AND IT WAS NECESSARY TO SEEK THE BROAD AND SUSTAINED SUPPORT OF THE HUNGARIAN PEOPLE FOR THEM.

This “Grand Design” had to set out clearly the long-term objectives for the Hungarian economy and the major steps that had to be taken to reach these goals. It had to distinguish between the basic characteristics of the system, the institutional changes and policy instruments required, and the initial policy measures that had to be adopted. It had to conform to the aspirations of Hungarians, and it was going to contribute to the success of this “Grand Design” if it took into account the lessons from the economic and social success of the OECD countries since the Second World War. Thus, Hungarian leaders could find inspiration in particular in the Western European tradition of the “social market economy” (not to be confused with the “welfare state” or with “democratic socialism”) and in the policies that had been responsible for the growth performance and confidence in Europe in the 1980s, which followed an extended period of slow growth and widespread “Euro-pessimism”.

- (2) AN INTEGRATED TASK FORCE OF WESTERN AND HUNGARIAN OFFICIALS COULD BE SET UP AFTER THE ELECTIONS IN MARCH AND THE FORMATION OF THE NEW GOVERNMENT.

The main objective of this temporary task force could be to help organize the cooperation between the OECD countries and Hungary, and assist in the transformation of its economy and its integration into the European and international economy. Its mandate and mode of operation could be patterned after the post-war OEEC. While its tasks were to be focused essentially on Hungarian problems, it could be closely integrated with the on-going and increased effort of cooperation between the Eastern European countries and the rest of the world.

(3) THERE WAS A NEED FOR A HUNGARIAN-INTERNATIONAL LONG-TERM INVESTMENT AND DEVELOPMENT BANK TO ASSURE THE OPTIMUM UTILIZATION OF THE RESOURCE TRANSFER TO HUNGARY.

This new bank was to be jointly set up by OECD governments, creditor banks, the Hungarian government and the Hungarian National Bank. The first two groups could have temporary majority control. Its principal task was to contribute to the efficient macroeconomic and microeconomic use of the resource transfer to Hungary, which was being envisaged through private and official channels. The bank could also play the role of a counterpart fund. It could closely cooperate with the new Bank for European Reconstruction and Development, with other international organizations (IMF, IBRD, IFC), foreign governments and banks. The creation of this bank, to be carried out simultaneously with the reform of the Central Bank, was seen as a key element in the overhaul of the Hungarian financial system.

(4) PLANNING FOR A COMPREHENSIVE LONG-TERM NEGOTIATED DEBT-ADJUSTMENT PROGRAM.

The central objective of the debt-adjustment program, as of the other recommendations, was to contribute to the successful transformation of the Hungarian economy and to the creation of the conditions for stable and sustained growth. Such a program, to be negotiated with the new authorities, was to be in the interests of both Hungary and its foreign private and official creditors.

(5) COMPLETING AND CORRECTING THE REFORM PROGRAM (MONETARY, BANKING AND FINANCIAL SYSTEMS, PRIVATE AND PUBLIC PROPERTY) AND THE ADOPTION OF A CREDIBLE LONG-TERM ANTI-INFLATIONARY PROGRAM

The government's latest austerity program dangerously added to inflationary pressures through sharp price rises in basic commodities and services. A long-term anti-inflationary program had to be adopted, which was not to be limited to macroeconomic (monetary and fiscal) policies. In an economy where markets were far from functioning efficiently, an anti-inflationary policy had to contain effective price and wage surveillance. A central element was the transformation of the Hungarian National Bank into a modern central bank, autonomous with

respect to both the government and the parliament. It was also important to promote private initiative, competition and genuine private capital formation. It was essential to assure the efficient management of the numerous state-owned companies. Privatization had to be recognized as a complex process, to be carefully managed and to be carried out over a number of years.

The objective of the five main recommendations, as of the rest of the report, was not originality as such. In fact, they fitted into the general trend of thinking in Hungary and in the OECD countries with respect to the Hungarian situation. This, however, did not diminish the urgency of implementing them.

The Mainsprings of Economic Prosperity since the 1940s

The preceding 40 years had been a period of historically unequalled growth and spreading of prosperity throughout most of the world economy. Among the main factors responsible for this exceptional performance, the following deserve particular emphasis:

- 1) the gradual freeing of the movement of goods, labor, capital and services among the principal trading nations and increasingly also among the so-called developing countries, which led to an unprecedented degree of international economic, financial and technological integration and to great improvements in resource allocation;
- 2) the effective working of competition and markets and the fairly full utilization of productive resources, which were bolstered by the discipline and the market opportunities and specialization, as well as joint financing provided by international economic integration;
- 3) the rapid and largely unhampered diffusion of new and modern technologies at the level of product design, production techniques, as well as efficient methods of organization and management (including the adoption of advanced „sectorial models” in manufacturing, agriculture and services); and finally,
- 4) the development of a close network of regional and world-wide international economic cooperation and joint management at the official and private level, along with improvements in policy insight and techniques.

It was generally assumed that these four factors would continue to provide a strong stimulus to economic growth also during the 1990s and beyond, not only in Western Europe, but throughout the world economy. It was also generally agreed that one of the principal brakes on the economic development of the countries of Eastern Europe during the previous 40 years had been their inability to participate fully in the above developments.

Economic isolation and economic nationalism carry a very heavy price even for the largest countries. However, international economic integration did not imply that countries, whether large or small, should have to surrender their national identity or the control over their resources and prosperity. Economic integration did require, at the policy level and at the level of households and companies, an attitude of both competition and of cooperation and solidarity.

*Hungary and the Western European experience
with the “social market economy”*

Successful international economic integration requires appropriate domestic policies. The report concluded that the experiences that were most directly relevant for Hungary were those of the Western Europe countries, both in the immediate post-war reconstruction period and during more recent decades.

There were several reasons for this conclusion:

- 1) Firstly, because the reforms and policies had been generally successful and continued to be successful. They had been largely responsible for the spectacular economic achievements of the preceding 40 years as well as for the equally remarkable individual freedom, social promotion and stability achieved during this period in most of these countries.
- 2) Secondly, the European countries had become the most open economies in the world. They reached this degree of openness gradually through agreed programs in the European Community, EFTA and other groupings to reduce economic barriers to trade and investment and to promote and facilitate greater competition and economic dynamism. In this process, they also had to face and continued to face complex domestic and external trade-offs. On the whole, they succeeded in maintaining their national identities and internal structures, while accepting an unprecedented degree of cooperation and integration of their economies and in many areas of decision-making.
- 3) Thirdly, both the small and large European economies were, for the most part, open to external experience or external models, and they also remained flexible in this respect. During the more than 40 years, European economies and European companies were learning from overseas experiences, in the United States and Canada, or in Japan and Korea, and they were to continue to do so.
- 4) Lastly, the general aspirations of most of the Hungarians pointed towards such a “Western European model”. However great the differences may have been in 1990 at all levels between Hungary and the various Western European countries, the European experience was likely to be the most easily accessible in terms of political, cultural and social affinity.

The most successful experience and model of economic reform and economic policies common to the Western European countries could be best described under the term of the “social market economy”.

In view of the widespread (and often unqualified) use of this term in the Hungarian election campaign and in order to avoid confusion, it had to be pointed out that the social market economy is fundamentally different in its objectives and instruments from the various forms of socialism, including the concept of the “socialist market economy” (an idea that had been used up until the end of the 1980s in the Eastern European countries, and in particular in Hungary, to describe partial reforms of the socialist economic system). Nor is the social market economy identical with the “welfare state”, a concept that tends to emphasize redistribution or distribution of wealth and income often at the expense of the level, the efficiency and the composition of output. This did not imply, however, that there was no broad consensus about the main aspects of the “social market economy” between most socialist and conservative parties in Western Europe by 1990.

The “social market economy” is an open and liberal market economy based on the principles of economic freedom, individual effort and private property. It differs, however, from the pure 19th century concept of the market economy. It recognizes that the market cannot fulfil all economic and social functions properly, and that some markets do not work efficiently. Thus, there is an important division of labor between the market and the state. The state (at the national, regional or local level) has to assume some important functions, not only to assure genuine, fair and effective competition and, thereby, the proper working of markets, but also to assure social justice (which is not an attempt to create equality or an egalitarian society) and to help correct distortions, which may result from competition and from the functioning of markets.

This division of labor between the state and the markets has to be organized in a pragmatic manner according to the specific conditions and preferences of each country, and it is subject to change under the influence of different economic conditions and political preferences. In Europe, beside the national it had also an increasingly Europe-wide dimension. An example of the flexibility and adaptability of the concept was the trend in the 1980s of deregulation and of privatization in Western Europe.

The social market economy had to be seen as a combination of

- 1) stability: political freedom, the rule of law and a stable legal framework, monetary stability, the protection of savings and of private property, a balanced social security and the prohibition of the abuse of political as well as economic power, and
- 2) change and flexibility: implying the competition of people, ideas, products and companies; a permanent need to adapt to constantly new circumstances, not only

at home but in the world economy; the need to be attentive not only to one's own needs and desires, but first of all to what others in the market need and require; the absence of permanently acquired market positions that are economically no longer justified.

Initially, the expression “social market economy” (*“die soziale Marktwirtschaft”*) was used to describe the reforms and policies adopted by the Federal Republic of Germany following the currency reform of 1948. Although Germany was the most articulate and the most successful example, the basic concepts were present also in the economic policies of most of the other, large and small, Western European countries. While originally the basic concepts and the policies that it implied were subject to political controversies, by the 1980s they had become common for economic policies throughout Western Europe.

The concept of the “social market economy” was of more than historic interest. It described not only the reforms and policies adopted in the late 1940s and 1950s, but also the fundamental orientation of modern economic policies in Western Europe. It was not an exaggeration to say that if democracy and federalism were among the main features of the new, post-war political tradition of Western Europe, “the social market economy” represented the mainstream or the new European tradition in the area of economic policies. It was the expression of the belief that economic freedom is an essential part of political freedom.

The relevance of the concept for Hungary was confirmed by the fact that important elements of the “social market economy” could be identified in the economic program of parts of the opposition (*Magyar Demokrata Fórum* – Hungarian Democratic Forum).

It was the main conclusion of the Battelle report that the concept of the “social market economy” was the best suited model for the successful economic and social transformation, modernization and long-term growth of the Hungarian economy and for its integration into Europe and the world economy.

Selected relevant aspects of the “social market economy”

In contrast to Keynesian economics, to orthodox monetarism or to Marxism, the concept of the “social market economy” does not lend itself well to “textbook” definitions. While it does have a strong theoretical foundation, it also has an important empirical dimension.

The basic objective of the social market economy is to promote economic efficiency through economic freedom and autonomy, through the free exercise of the right to produce and to consume within or outside the national borders. “Economic freedom”,

however, does not imply the right to abuse this freedom or “economic power”, at the expense of society as a whole or of consumers, actual or potential competitors.

For the correct working of the social market economy explicit as well as implicit rules of behavior have to be respected by all participants in the economy. The respect for law and order in the private and in the public spheres of society is considered as essential. While both anecdotal evidence and statistics show differences in the degree of this “respect” (by the state and by the private sector) among the various countries concerned, the rule of law, as distinguished from the dominance of private interests or of political power, is the basis of the social market economy. The transparency and relative stability of this basic framework are a major factor in the success of the social market economy.

A key objective of the social market economy is to promote economic prosperity as widely based as possible (in terms of incomes, savings and private property). This diffusion of prosperity is based primarily on eliminating discrimination and artificial obstacles to personal and private initiative and creating conditions of “equal chances for equal effort and performance”.

Solidarity, social cohesion (respectful of freedom) and social peace are among the fundamental features and objectives of the social market economy. Private or public “help for self-help” is an important aspect of the basic concepts. In that sense, fair market conditions, active social policies and sectoral and/or regional policies (as well as measures in favor of small and medium-sized companies) are an integral part of the social market economy. They include active supervision and, if necessary, corrective measures in favor of the underprivileged and of the “victims of the market economy”. Avoiding or reversing the “pauperization” of large or small segments of society is an essential dimension of the social market economy.

The role of the state and of the public sector

The principal role of the state in this concept is to create and assure the necessary framework and rules for the efficient and equitable working of the market economy (*conditions cadre* in French, *Rahmenbedingungen* in German).

State intervention (this concerns both the government and Parliament) should be “market conform” (a concept defined by Professor Wilhelm Röpke), i.e. it should promote, as much as possible, the sound functioning of markets and avoid any serious erosion of the discipline and rationality of markets. Only where markets function inefficiently or in a way that causes serious harmful consequences should there be official interference. Where markets do not function fairly, however, the initiative for the necessary “correction” must not be left to the private sector alone.

The social market economy is not one of “weak” but of limited government. This principle had been summed up in the past: “as much market as possible and as much state as necessary”. Maintaining monetary stability, the promotion and the protection of the real value of private sector savings are among the key tasks of the public sector. The protection and the careful management of public property is also one of the essential tasks of the state. This implies a careful and transparent management of public spending and receipts. The government, central and local, is responsible for the public good and not for the defense of the privileges of private groups or individuals.

Creating the basis for effective competition is an urgent task. This includes the control of excessive concentrations of economic power and the promotion of small and medium-sized companies, which are among the tasks of the state, as are the provision of basic infrastructure and the protection of the environment. The fulfilment of these tasks, however, must not lead to irrational or anti-economic policies (e.g. large “prestige projects” in the name of promoting infrastructure or breaking up companies under the ideology of smallness).

The behavior of the state in a social market economy is characterized through a balanced approach to the use of economic policy instruments – no extreme monetarism while neglecting fiscal policy, no extreme fiscal rigor combined with monetary laxness and financial speculation. Finally, to sum up, one of the main tasks of the government is not only to create the conditions allowing for the efficient functioning of markets, but also to help assure the social and political acceptance of the market economy.

Western European experience (in the 1980s): a “balanced growth policy”

In the 1980s there was a sharp deceleration of economic growth in Hungary. It was an economic, social and political imperative to reverse this trend. Without sustained and balanced economic growth, neither domestic nor external equilibrium could be achieved. Also, the chances of transforming Hungary into a successful market economy depended on sustained economic growth.

Some feared that the lack of growth during the 1980s had also weakened the country’s potential for growth during the next decade. This pessimism was not shared by the Battelle report. If the appropriate microeconomic and macroeconomic policies were to be adopted, and if there was sufficient political and economic stability in the country, the chances were good that Hungary could achieve sustained and balanced growth during the 1990s, with a corresponding increase in living standards.

The likelihood of economic growth in Hungary could be illustrated by the experience of the Western European countries, which in the 1970s and the first half of the 1980s had experienced a similar slowdown or loss of momentum and which

led to the widespread “Euro-pessimism” and to the belief in a “permanently reduced rate of growth in Western Europe”. By 1990, “Euro-pessimism” belonged to the past. European economies had been growing at a satisfactory rate for several years, and business, labor and government were again confident about the medium and long-term outlook for the European economies. There were several factors responsible for this remarkable improvement. Favorable external developments played a role. But the principal credit belonged to the convergence of balanced macroeconomic and structural (meso-economic) or microeconomic policies throughout Western Europe.

The 1980s witnessed a redefinition of the role of government in the economy, reducing its weight but increasing the efficiency of its action at the same time. As important was a reduction of the barriers to the free initiative of individuals and companies – a greater willingness to take risks but also greater opportunities to enjoy the benefits of economic success and performance. The principle that “efficiency begins at home” became widely recognized.

Nevertheless, companies, regions as well as countries all benefited from the general improvement in the European economic environment.

One of the main fallacies of the traditional “development economics” had been the assumption that radically different economic policies had to be followed according to the level of income in various countries. Thus, even if one had to insist on the much more important structural adjustments to be accomplished by the Hungarian economy in the 1990s than was the case in the OECD countries in the 1970s and 1980s, the policies which allowed a return to growth in Western Europe were still relevant for Hungary.

The following aspects of these European policies had to be recalled:

- 1) a balanced policy approach and a certain gradualism in both macroeconomic and microeconomic policy measures;
- 2) a long-term determination to fight inflation through checking both domestic and external sources;
- 3) a gradual, but determined approach to reducing budget deficits and excessive taxation levels (the task of cutting back subsidies, transfer payments and excessive corporate and personal taxes was carried out over a number of years);
- 4) a closer control on public spending and, in particular, the elimination of prestige projects of dubious economic value;
- 5) a tighter control of the management of public enterprises and policies to transfer them gradually to the private sector, to make them more profit conscious and profitable and more responsive to their customers;
- 6) relatively tight monetary policies (but not an exclusive reliance on orthodox monetarism), restoring the „price function” of interest rates for both savers and borrowers;

- 7) attempts at deregulation, de-bureaucratization, and at making it easier to innovate and do business;
- 8) policies favorable to exports, but at the same time avoiding competitive devaluations;
- 9) promoting exchange rate stability with the help of the European Monetary System;
- 10) active sectorial policies (in industry, agriculture and services), which also implied an extensive participation of national, regional and local governments (as well as the European Community) in the restructuring and the gradual closing down of excess capacity and inefficient sectors and companies;
- 11) an active labor market policy, involving retraining, tax incentives, etc. to increase labor mobility and to ease the social burden of redundancies without massive transfer payments;
- 12) promotion of labor peace, the cutting down on strikes and excessive wage settlements, and introduction of modern, often labor-saving management and production techniques;
- 13) an active technology policy, directed at promoting both research and development and the diffusion and valorisation of modern and new technologies; and finally,
- 14) the announcement of the creation of a true „internal market” in Europe by the end of 1992, aimed at stimulating competition and increased efficiency through the deepening and consolidation of the achievements of 40 years of European and world-wide economic integration.

10.5. Growth and institutional reform: the Second Battelle Report

The Objectives of the “Second Battelle Report”

The initial work on what was going to be the “Second Battelle Report” started in September 1990 as a research and consulting follow-up to the study that had been carried out by Battelle on Hungarian economic policies, with the participation of an international group of experts, at the end of 1989 and in early 1990.

Like the first study, the second project also benefitted from the financial support of the Swiss Confederation. Its objective was to make a further contribution to the debate on the process of transformation of Hungary into a dynamic market economy.¹¹²

¹¹² Hieronymi, Otto (December 1991): *Domestic and External Aspects of Financial and Monetary Reform in Hungary: Creating the Conditions for Sustained Growth* (“The Second Battelle Report”), Battelle Europe, Geneva.

The study was carried out under quite different conditions from those of the first one. By the time I started working on it I was already active as a Personal Adviser of Prime Minister Antall and the issues raised in the research were closely related to the lessons learned during the first two years of the Hungarian regime change. They also reflected some of the major themes of our work and preoccupations with the evolution of the domestic situation and the external environment. The conclusions and recommendations and the text of the final report were prepared more as inputs for our work for the Prime Minister and the economic members of his cabinet than for distribution to a broader readership.

As Project Leader and author of the report during the research I benefitted from numerous in-depth discussions with Hungarian officials and other Hungarian and non-Hungarian experts. Among the many people who contributed to the ideas contained in this report Pál Tar should be mentioned in particular. However, I was alone responsible for the methodology, the analysis and conclusions of the final report. Neither the Hungarian nor the Swiss government were in any way responsible for any part of the text.

Summary of some of the key issues raised in the study

The report argued that Hungary had made remarkable progress in the transformation of its economy from a “liberal socialist economy” into a “dynamic social market economy”. The Hungarian government rightly rejected a so-called “shock therapy”: the transformation since the spring of 1990 was nonetheless radical and deep going and the break with the collectivist economy was irreversible. In the early 1990s there was widespread international confidence in the government’s economic policies and in the country’s long-term economic prospects.

Still, Hungary’s economic situation remained fragile because of the high cost of transformation and modernization, and, not the least, because of the unexpected collapse of the markets of its former main trading partner. There was an urgent task to halt and reverse the shrinking process by opening new markets, by providing incentives and encouraging investments and by easing the strain on resources also through a limited non-debt-creating official resource transfer from the OECD countries.

Economic, monetary and financial structures and institutions were changing very rapidly in Hungary. The objective of the Second Battelle Report was to focus on Hungary’s monetary and financial renewal and in particular on its impact on the country’s chances of success in developing a dynamic social market economy and in achieving sustained growth during the 1990s. There was in fact a very close

connection between monetary and financial renewal and sustained growth. In a shrinking or stagnating economy the prospects for monetary stability were greatly diminished. Similarly, a stable national currency and safe and efficient monetary and financial institutions were recognized as the prerequisites of sustained growth in a market economy.

It was generally assumed in 1991 that Hungary was close to a breakthrough in the development of a dynamic market economy. Important tasks remained, however, at the legislative and policy levels. The importance of fiscal and monetary discipline had to be stressed. However, it was the conclusion of the report, that to achieve the goal of lasting domestic and external balance and sustained growth, fiscal and monetary demand management were not enough. Greater attention had to be paid in the future to supply-stimulating measures than was possible until then. There was also an urgent need to reduce bureaucracy and to increase efficiency and productivity throughout the economy. It was necessary to strengthen the banking sector, and despite the progress already achieved there was also much room for improvement in the quality of banking services.

The Second Battelle Report was organized around four major themes: (a) the task of completing the development of the social market economy, and the on-going search for domestic and external equilibrium; (b) the need to create the conditions for sustained (export-led) growth and financial renewal; (c) the strengthening of the financial and monetary system; (d) domestic and international measures to stimulate productive and infrastructure investments.

(1) COMPLETING THE DEVELOPMENT OF THE SOCIAL MARKET ECONOMY:

- Fiscal reforms and increasing the efficiency of the public administration
- Reform of social services
- Pursuing the process of privatization
- Protection of private property and encouragement of savings
- Social safety network
- Controlling inflation
- Promoting international integration and a stable currency

(2) CREATING THE CONDITIONS FOR SUSTAINED GROWTH:

- Incentives for private initiative
- Providing resources for an effective industrial policy
- Reorganization and assuring effective management of state-owned companies
- Providing incentives for export-oriented industries and investments
- Further encouragement of foreign direct investments

(3) STRENGTHENING THE FINANCIAL AND MONETARY SYSTEM

Implementing and completing the new legislation concerning the banking and financial sector

Strengthening the banks' balance sheets

Improving the quality of banking services

Improving the banks' manpower and technical resources

Developing the domestic capital market

Furthering the international integration of the financial and banking sector

Bank privatization

(4) DOMESTIC AND INTERNATIONAL MEASURES TO EASE THE STRAIN ON RESOURCES AND TO STIMULATE PRODUCTIVE AND INFRASTRUCTURE INVESTMENTS

Providing incentives for modernization and productive investments

Defining a dynamic, long-term infrastructure development program

Creation of a new long-term investment and development bank

Providing non-debt-creating resource transfers in favor of Hungary beside direct investments

Developing an international interest-payments insurance system.

CHAPTER ELEVEN

The White Paper on the Legacy of Four Decades of Communism

11.1. The Prime Minister's suggestion and sense of history

As a historian Prime Minister Antall was very much aware of the weighty legacy left over from the years Hungary had spent under the Communist system. His knowledge and awareness of this legacy was not only "theoretical" or "book knowledge". It went beyond the understanding and experience of the average Hungarian who had to live and struggle with the problems and limitations of daily life under the "party-state", as the Kádár regime was euphemistically called by many.

Beyond this experience, which Antall shared with his fellow country men and women, he had experience gained directly from his position as the head of government during the years of the regime change. Through his work every day he encountered the consequences of the four decades Hungary had been under Soviet occupation and Communist rule. The most important challenge in the change of regime was how to overcome the social, economic and societal impact of the Communist system.

He believed that it was in the public interest to try to make an assessment of this legacy. Such an analysis would be of interest not only for future historians. It would be destined as much for the average citizens as for scholars and professional observers of political and economic developments.

Antall thought that such a project should not be carried out by a single author looking at the legacy from the outside. For such a work there would be time later. What Antall had in mind was a project undertaken during the time of his administration, which would benefit from the direct experience of officials who were dealing with the consequences of the legacy in their work.

This explains why a relatively large number of specialists were asked to participate in the project as members of a group of authors. The Prime Minister suggested that I should lead this group and coordinate the project as the Head of an Editorial Committee. The project was ambitious both in its scope and because of its tight time schedule. It raised enthusiasm but also jealousy and resentment and refusals to cooperate by the traditional anti-Antall quarters within the public administration.

The positive reactions, however, largely outweighed the negative ones, and the drafts produced by the members of the group provided enough input to prepare a draft

volume of 500 pages. This was the good news. The bad news was that the volume was never published and the results of the study were never diffused; they never reached the target audience that József Antall had hoped for. The circumstances and reasons for this unfortunate outcome are described later in this chapter.

11.2. A large and dedicated group of participants

This section consists of three parts. The first one reproduces the original structure of the study as it was presented in the project proposal in the spring of 1993. The second part consists of the list of the members of the Editorial Committee and the group of authors. Part three is the English translation of the Introduction of the draft volume that was made available to the members of the team on February 1, 1994.

General approach, information and the structure of the project

The method chosen was a combination that allotted individual responsibility to members of the group for specific issues and chapters, and to the team for the conclusion and the synthesis of the principal results.

As for information on 40 years of the Communist regime, we were confronted by three questions: Does the information (qualitative and quantitative, descriptive and analytical) exist? Where can we find it relatively easily? How useful and reliable is what exists and what we can find?

There was, of course, much more material than we could use and/or was useful for the project. In fact one had to remember the well-known paradox of the socialist regime with respect to information. Common sense would suggest that in a planned economy information would be plentiful and correct so that all the managers and workers could fulfil the targets contained in the “plan”. The socialist reality was just the opposite: most information related to the economy was handled as a state secret, and most of the discussions of policy and the economic situation were conducted in an abstract, ideological jargon with as little true information as possible.

I conducted numerous discussions both with the individual members of the group and with other experts and officials. In the course of the research I “discovered” some of the traditional problems that researchers encounter when they try to locate information in large government departments or in major corporations.

Even in the case of information that has been published or made available to the public in other forms, it may be extremely difficult and time-consuming to identify and locate it. I have learned through decades of research on several continents that

proper and user-friendly cataloguing is not the strength of large organizations. I would like to mention three examples in order to illustrate this problem. The United States government – the executive and legislative branches – produce a great many publications the content of which is part of the public domain. At the same time, it is very difficult and often impossible to learn what is available and where on a specific issue. The Commission of the European Union sponsors large amounts of research and reports on all the subjects that are relevant for the work of the EU. This material, most of which is in principle available to the public, often serves as inputs in the decision-making process of the various bodies of the EU. As in the case of the American administration, finding the material on specific topics within the Commission or other branches of the Union is a major challenge. Finally, I would like to mention an example from the corporate world. A very large international company (which shall remain unnamed) with branches and offices in many countries on five continents entrusted us with building an economic model on a sectoral issue. The model required statistical inputs of information available in the company's offices across the world. One of our tasks was to visit a series of offices of the company in Europe, North and South America and Asia in order to meet officials who provided us with the necessary information. To try to obtain the same information through the company's own internal channels would have been less productive.

The successive stages of the information revolution have created miracles in the field of research. Yet, despite the incredible possibilities of the internet search engines all the problems I mentioned here have not been fully solved yet. It is probable that the development of artificial intelligence (AI) will not make them disappear completely in the future either. The main issue is that the quality and volume of information depend on “what you put into it”. If the knowledge and experience of those who actually are involved is kept out of the “information” for personal or ideological reasons, the most important task of the researcher will be to fill in the gaps and recreate the missing pieces.

The following text shows the projected structure/table of contents of the planned study. As should be clear from this text no formal model was to be built and the approach could be called a “descriptive/analytical” one. There is also a balance between the global characteristics of the regime and sectoral developments.

The Economic and Social Legacy of Four Decades of Socialist Regime in Hungary

Structure of the Study

Part One: The Essence of the Socialist System and the Differences from the Evolution of Free European Societies

Chapter One: The nature and the consequences of the disruption of 1947–1949, the main characteristics of the socialist regime in Hungary.

Chapter Two: The development and the principal features of the free European and international economic systems

Part Two: Overview of the Legacy Prevailing in the Society as a Whole, in the Economy and in Selected Key Areas

Chapter Three: The situation and evolution of Hungarian society

Chapter Four: Social conditions and system, demographic evolution, the conditions of families, health, housing, environment

Chapter Five: The structure and the spirit of the State and of public action, the limits of rights and arbitrary justice

Chapter Six: Planned economy, expropriation of private property, lack of competition, political imposition and control of economic decisions, dominant role of the Party in economic policy, artificial prices, low productivity and waste and inefficiency

Chapter Seven: Economic growth and stagnation, forced savings, shortages and waste, the economic situation of the population, capital shortage and misallocation, the recurring domestic and external disequilibria, suppressed and open inflation, inconvertible currency

Chapter Eight: The accumulation and the burden of the external debt

Chapter Nine: Increasing economic backwardness, dramatic deterioration of Hungary's international comparative economic position, worsening competitive position and the consequences of the dysfunctional price system and of the "socialist international division of labour"

Chapter Ten: Distorted and insufficient technological progress, waste of human resources, politicized management, discouragement of innovation and sanctioning of private initiatives, political rather than efficient training of workers and engineers alike

Chapter Eleven: Main sectoral legacies in industry (including armaments) and agriculture, services, commerce, finance, infrastructure

Part Three: The Conditions for Realizing a Social Market Economy in Hungary,
Results Achieved so Far and Future Tasks

Chapter Twelve: The creation of the legislative and institutional framework

Chapter Thirteen: The societal, macro- and micro-economic costs of the
regime change and results achieved so far

Chapter Fourteen: The tasks of Hungarian economic policy-makers and the
long-term prospects of the Hungarian economy

A highly qualified and dedicated team

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The preceding two lists show the members of the Editorial Team and authors who had accepted to participate in the project. The main characteristics of this group can be summed up as follows.

First of all, the single most important common characteristic shared by all of them was the conviction that the Communist regime had been a disastrous development for Hungary and that the legacy of that oppressive system was a heavy burden in the process of regime change.

A second point was the high academic, political and administrative qualifications they held and the high levels of responsibility they assumed in their respective activity. The group included several Cabinet Ministers, State Secretaries, the President of the Hungarian Central Bank, the President of the National Statistical Office, the Rector of one of the country's leading universities, etc.

A third aspect was the diversity of their life and work experience and the broad range of the organizations they were associated with in the early 1990s and previously.

The Introduction of the draft final report of the project

The easiest way to provide an overall view of the outcome of the study discussed here is to include an English translation of the Introduction of the draft volume, which was prepared at the end of the research.

“THE LEGACY OF FOUR DECADES OF COMMUNISM

An attempt to assess the economic and social legacy of the four decades of the socialist system in Hungary

INTRODUCTION

This study represents an attempt to provide a comprehensive account of the economic and social legacy of the Communist system.

The main aim of the analysis of the “legacy” is not a chronological description, but to recall the impact of socialism on the development of the Hungarian economy and society in the last four decades, the situation of the country at the beginning of the economic and social system change, and the consequences, challenges and difficulties of the legacy of the past system for the present and the future.

Some people argue that today it is too late or too early to prepare and publish such a study. Some say that it should have been done earlier, in the period immediately after the change of regime. Memories would have been fresher and we could have

been better prepared for the difficulties of the transition. But the subject has not lost its relevance today, perhaps even more so than three years ago, as the gravity of the legacy has been demonstrated in all areas. This volume is not a substitute for a more detailed and in-depth economic history of the period discussed here, which will be an important task for future researchers.

This book is not a theoretical study of the nature of the socialist system, nor is it a mere description of the Hungarian economy. It deals with the economic and social distortions that have developed over the past four decades and their consequences. The system has been wasteful and profligate in its use of the country's wealth and human resources. The artificially constructed and maintained industrial, corporate, commercial and financial structures, the labor market and the distribution systems have not met the requirements of a free society and a modern economy. Their crisis and their partial collapse contributed significantly to the inevitably high costs of economic and social systemic change.

The analysis deals first of all with the economic and social consequences and legacy of the Communist system. Given that the economic system was first and foremost a consequence of the Soviet occupation, an expression of a political theory and will, the political dimension of the issue could not be ignored.

The approach has focused on, among others, the following aspects:

- a) What was the essence of the socialist system imposed on the country, even in its most liberal Kádár era, and how did it differ from a system that the country would have freely chosen?
- b) The consequences of the 1947–49 turn to Communism (*fordulat*). In other words, what it meant that the Hungarian economy had been deprived of a historic opportunity and was forced by the Soviet Union and its local servants to move the country in the opposite direction from the one in which the economies and peoples of Western Europe and many other nations of the world had started?
- c) The balance sheet of the four decades in its entirety and in its various sub-areas, the achievements and limitations of reform Communism. How much has been attained and how much Hungary is lagging behind?
- d) The burden of the legacy on the transformation, on the present and the future. What is needed, what tasks must and can be solved in order for the country and the economy to successfully overcome the legacy of four decades?

The analysis of the past four years is not covered in detail in the study. But it is mentioned in many places.

- a) The difficulties that have been experienced since the change of regime have been largely the result of the socialist system and its collapse.

- b) The need for radical economic regime change (and the high economic and social costs and difficulties that this entailed) was due to the fact that for four decades the country had been operating and structured under an economic system imposed from the outside.
- c) An important factor behind this lag and the high cost of the changeover was that the Hungarian economy was not able to participate fully in European and international economic integration for political reasons.

In dealing with this topic, we have not only considered the purely Hungarian issues or historical aspects. An international perspective was also necessary: it is not only a question of forcing domestic economic, social and financial structures and processes into artificially forced paths, but also of excluding positive international influences.

The volume is divided into three parts: (1) an overview of the heritage and development of Western Europe, (2) a more detailed analysis of the heritage in the main social and economic fields, and (3) a brief presentation of the main challenges and achievements of the implementation of the social market economy.

Work on the project started in the spring of 1993. A large number of experts from the political and social spheres, from the administration and from research institutes were involved in the work, in the collection of material, in the drafting of the texts and in the editing of the volume.

This volume does not claim to be a polished scientific work. Probably no one who participated in this work would agree with all the analyses and conclusions of this volume. But we believe that it is worth publishing it in this form rather than waiting months, perhaps years, before a comprehensive, final, more polished account of the ‘legacy’ of socialism can be produced.

The study should not be regarded as a “political pamphlet”. If it has a political, ideological connotation – as all honest economic policy analysis does – it can be expressed in a single sentence: the volume reflects the authors’ shared conviction that the “socialist” economic and social system of the past four decades was a failed, costly, wasteful system, and that the political and economic regime change that occurred four years ago finally opened the way for Hungary to catch up with the community of free developed countries.

Ottó Hieronymi
Chairman of the Editorial Committee
Budapest, 1 February 1994”

Additional comments about the results

The 500 pages long draft volume has the chapter structure defined at the start of the project. The original work plan also contained with the list of chapters the individual assignments for the research and drafting. A “principle of redundancy” was applied in the work plan: for each chapter and topic several members were signed up and each member of the group could participate in the work on more than one topic and chapter. This was done for two reasons: in order to take into account the multiple interest and experience of each member of the group and to assure that all subjects were going to be covered even if for unforeseen reasons some of the members could not fulfil their tasks. Thanks to the commitment of the members of the group, but also of the application of this redundancy principle, the draft volume contains the 14 chapters as it was originally projected.

Among the principal results I would like to mention here only the following four. (1) The attempt to assess and present the weight of the legacy has to be based on an understanding of the essence of the Communist regime. (2) The nature and working of the regime have to be compared to the Western European model that had assured freedom and prosperity and that Hungarians were brutally prevented from adopting. (3) The Communist system was wrong from the start and it is erroneous to claim that its collapse was due to “policy errors” or external events. (4) The best way to deal with the legacy is to secure Hungary’s full integration into the European Union and the Western Community of free countries and to build a Hungarian version of the social market economy.

11.3. Time pressure, computer and software complications and changing priorities for some (*“isn’t the draft too critical?”*)

It is common for complex and ambitious research projects to be carried out in several phases, as this was also the case for study on the legacy of the Communist regime. *De facto*, the project consisted of three stages: (1) a first phase of organization and research, (2) a second stage of drafting of a final report, and (3) a final phase of editing, preparing for publication and printing and diffusing the published volume. The project was terminated at the end of phase two and we could never move into the concluding publication stage.

Probably the single most important reason for this was time pressure. Both the organization of the project and the carrying out of the research took more time than originally expected. The material was abundant but it required considerable time and

effort to sift through and to make it directly usable in the study. The time problem also had other dimensions. The year 1993 was a complex period rich in political and personal developments for all of us involved in the project. Thus it was not surprising that we were unable to move rapidly into the drafting stage of the project.

There was also a technical or computer problem. In 1993–1994 at my work place in Geneva we still used “Word Perfect” for writing our texts and storing information. By then, the software in use in Budapest (i.e. virtually by all the other members of the Group and by the administrative staff, including my secretary in Hungary, contrary to my secretary in Geneva) was “Microsoft Word”. They were right in the long run: “Word Perfect” lost out to “Word”. As for me I will always remember as a nightmare the enormous waste of time and effort (and often a loss of precision) that was generated by the task of conversion, back and forth between the two incompatible softwares.

The passing of the Prime Minister in December 1993 brought a break and a great sadness into all our lives. The project did not lose its purpose and meaning but there was a feeling of emptiness and of confusion that we all had to overcome. The elections were approaching and around us some people began to show that they had new and different priorities. When the draft volume was completed at the end of January 1994, the copy-editing was not perfect. This could have been corrected with a relatively minor effort.

There was, however, another type of critique that startled me and that I rejected. One or two of the readers (or were there more than two?) argued that the conclusions of the study were too severe: the authors were allegedly too severe with the previous regime. It was decided, (“they decided”?) that “this was not the time to publish such a sharp criticism of the legacy of the socialist regime.” (!) Thus stage three – publication – was postponed, or rather, cancelled.

11.4. Spring of 1994: too late for publication (?)

Was the spring of 1994 really too late for publishing the report? There was a dual answer to this: yes and no.

The *positive answer meant*: the subject did not lose its relevance because of the delay in completing the study. In fact with the arrival into power of the Communists’ successor party *MSZP* (Hungarian Socialist Party) under the leadership of Gyula Horn and of their coalition partners *SZDSZ* (Union of Free Democrats, the party that used to be radically anti-Communist back in the 1980s), the analysis and conclusions would

have been of great interest in the years to come for Hungarian readers. The example of the publication in March 1994 of the report on the conference we had organized on privatization and the social market economy showed that relevant publications could be published before the elections.

The *negative answer meant*: by March 1994 the project and its conclusion did lose the material and political support and human resource inputs that had allowed it to start initially and that carried it through its first two stages.

11.5. With hindsight the study was not only relevant but also original and to the point

That we were not able to edit and publish the final report has left me with a sense of failure. Yet, I believe with hindsight that the project was worth the effort. It was good that we started it and produced a detailed and original assessment of the legacy of the Hungarian experience with the Communist system. The study and its conclusions were a reminder that nostalgia for the Kádár regime was an irrational sentiment. The project could also serve as a warning that new generations may have to face a recurrence of the tragedy that took place in Hungary through the imposition from the outside of a corrupt, inefficient and wasteful economic and social regime.

CHAPTER TWELVE

The Values of József Antall

12.1. A modern thinker and man of action

The last one hundred years have been an extremely challenging period in human thought: a period of great achievements for the benefit of humanity and one of what can only be called “criminal thinking”. There were countless examples and inducements for positive actions, models of actions in the interests of the common good, and actions that were individually or collectively negative and even criminal acts.

Mr. Antall was both a “modern thinker” and a “man of action”. The combination of these two features determined who he was and what he accomplished. Like all important political leaders, Prime Minister Antall was a complex person. It was his complex personality that allowed him to win the contest for the highest office in his country at a crucial moment in modern history and to assume the responsibilities inherent in this position. Reflecting on his personality close to the end of this book should further help us in understanding the magnitude and unique importance of his contributions to the success of the regime change in Hungary.

How to define a “modern thinker”?

People who did not know József Antall – or if they have heard about him from his enemies – may be astonished by my brief, two-word definition of his admittedly complex personality: the late Prime Minister was a “modern thinker”.

This definition goes especially counter to the prejudices of two seemingly opposed and incompatible groups: (1) those open adversaries who called him “old-fashioned”, behind his time, pretending that Antall wanted to turn the clock back and wanted Hungary to return to the semi-feudal conditions of the 19th or early 20th century; people who claimed to have a monopoly on knowing and preaching what was “modern” and what was not; and (2) a second group from an opposite camp, who were or claimed to be Antall’s true followers and who were nostalgic for the more questionable aspects of Hungary’s political and social traditions and past. These people felt nostalgic for Miklós Horthy and his semi-dictatorial regime and were hoping that Antall shared their aspirations.

Well, Antall did not. He was equally far from both groups and both types of misconceptions exactly because he was a modern thinker. What distinguished Antall from so many of his contemporaries was not only his constant desire to know and understand the world as it was in the past and in the present, but also how this knowledge was relevant for understanding what the future might and should bring.

As a “modern thinker”, Antall developed a keen sense of the evolution of society, especially since the 19th century, in Hungary, in the region and in the world at large, and of the impact major thinkers, political leaders and scientific and technological factors had on this evolution. He was aware of the complexity of wealth and power, and of the importance of understanding sources and manifestations of economic and political success and failure of societies at different times and in different parts of the world. His thinking had an important humanitarian and social dimension. Peace, freedom, tolerance, public health and justice were high on his list of political objectives. He had a deep compassion for people who were persecuted, including refugees. One must never forget that Antall could never accept moral or political compromises when it came to the totalitarian ideologies and regimes of the 20th century, such as, Communism, National Socialism, including the various manifestations of anti-Semitism and aggressive nationalism. Understanding the importance of the post-war success of European integration and of the Western Community was an essential element of his political perception.

Thus, I believe that Antall was primarily concerned with how regime change could help Hungary make the best of the positive features of modern society and overcome its risks and shortcomings. Learning from both positive and negative lessons and models from the past was part of modern thinking and had to be distinguished from blind faith and nostalgia for the past.

Was Antall a “man of action”?

My answer to this question is also a strongly affirmative “yes”. Antall was a courageous, determined and effective “man of action”.

I believe this even if I am fully aware that there are several reputable dictionary definitions of a “man of action” One is that a man of action is “someone inclined to act first and think later”, another, opposite one is that a man of action is “a man of deeds, a person who acts and gets things done”.

Anyone who is familiar with Antall’s life and with his relatively short political career has to agree that the first definition was not relevant for him but that the second one – a man of deeds, a person who acts and gets things done – well describes his personality and achievements. Those who remember Antall know that it was not his

habit to act without thinking. This, however, was not a sign of undue hesitation or of fear to make (sometimes unpopular) decisions or of reluctance to face the consequences of his decisions. In some respects the definition of a “stoic” – a definition from the Hellenistic period of *a person who can endure pain or hardship without showing their feelings or complaining* – could be applied to Antall’s personality.

I would like to illustrate my conclusion that Antall was both a thinker and a man of action – and a *stoic* the more complex and demanding a situation was – with three short examples.

The first example was Antall’s rise to the top of the Hungarian Democratic Forum. This was the expression of an “action” in the best sense of the word, action not only in his personal political interests but also in the historic national interest of the entire country.

The second decisive action started with the winning of the election, continued with the *pactum* and culminated with the definition and implementation of a program that led to the transformation of Hungary into a modern, liberal parliamentary democracy,

The third, and perhaps the most courageous and “stoic” one, was standing up against internal tensions within the *MDF* and the coalition that were inspired by ideas and ambitions that could have become a threat to the democratic legacy of his government. The importance of this successful action – at a time when the government had a large agenda to complete before the next elections – can be understood when one compares the Prime Minister’s firm stand *vis-à-vis* Csurka and his entourage and their burgeoning anti-Semitism and populism with the moral *laissez-allez* shown by one of Antall’s successors towards the same Csurka.

12.2. Western and Hungarian framework

In trying to recall and to understand Antall’s personality, one has to consider both the Hungarian and the Western dimensions. This duality comes through in Antall’s writings, speeches and his entire professional life and political career. It is implicitly or explicitly hinted at or described in the best texts written about him by some of his close associates, by some members of his family, as well as by some foreign political observers or political leaders. This duality was essential at the time of the Hungarian regime change. This was one of the key factors that allowed Antall to become and to be remembered within a relatively short time as a “world-class statesman”.

What was Antall's Hungarian/Western duality about?

Understanding this duality is not always an easy task, neither for Hungarians nor for non-Hungarians. For many Hungarians, after decades of Communist and populist rule, the Western Community still appears distant and its values are not fully internalized. At the same time for many non-Hungarians the language and the country's complex history present difficulties to understanding.

The Hungarian dimension

Antall was at ease being Hungarian. As for so many of his compatriots with a wide reading background, his ties and his love to Hungary were the strongest and most evident through the language of this small country. This love came through multiple channels: a very broad range of reading (in which there was a fair proportion of 19th and 20th century poetry), speaking and teaching, writing and listening. Antall was not only a great teacher and a good speaker, he was also an exceptionally good listener, listening in formal and informal discussions and conversations, in the theatre and in political *fora*.

Antall was aware of both the richness and the limitations of the Hungarian language, which had become a fully operational, modern language only in the first half of the 19th century, but then with an explosion of world-class lyric and epic geniuses. Antall also knew that some of the great Hungarians whom he most admired did not fully master the Hungarian that was spoken or written at their time. They preferred Latin, French or German for "cultural" or "official" interchanges, and for personal and everyday communication may have used one or several of the languages and dialects spoken in their villages and towns: Serbian, Slovakian, numerous dialects of German, Armenian, Yiddish, Turkish, Romanian, Italian, Roma (Gypsy), Polish or Slovenian to mention only the obvious ones.

What Antall loved perhaps as much as the language was the history of Hungary across the ages, and the tales of the lives and deeds of the "great Hungarians", their struggle for survival, their thoughts and contributions to the culture of the time. Some of this was legend, some of this was true. They all helped create a blend of people who had come from the East, from the vast expanses of Asia to Eastern Europe, and who for a thousand years felt and claimed that they were the bulwark of Western civilization against the waves of attacks that threatened to destroy the achievements of the West (and at times did so). But Antall was not a "geo-political" fanatic. He knew and never forgot that some of the most devastating attacks in the 20th century against European and Western values, lands and people had come from the heartland of the West.

And then Antall knew the people, he knew Hungarians from all walks of life. He knew their habits, their virtues and prejudices, their ability to do good but also to commit collective crimes. Antall had a deep desire to help his people find freedom and to reach the road to a better life. Antall honestly loved Hungarians, but he was intelligent and experienced enough not to have loved all Hungarians all the time. Also his wisdom and political insights made him immune against accepting any visions of Hungarians as a “tragic people”, or as a people “superior” to others who live nearby or faraway.

Finally, and this is probably the most important, Hungary was Antall’s homeland. Antall had travelled but never lived abroad; he had not fled his country, was not a refugee, not a stateless person; he did not have double citizenship. But Antall knew very well from his own experience and from the experience of millions and millions of people in Hungary and in the world, that “homeland” can be and has been time and again in the 20th century a shifting and uncertain concept. A homeland is supposed to protect you within its borders and out in the world. But the opposite can occur and did occur in Hungary more than once in Antall’s lifetime. Your own government instead of protecting you persecutes you without any valid reason; it locks you into your “homeland” as into a cage or a prison, not for a day, not for a week, but possibly for a lifetime, and if it depended on the regime for the lifetime of your children and their grandchildren as well. Antall knew that this was not an imaginary threat, a nightmare from which it is easy to wake up. His most important wish as a person and as a politician was that this distortion of the concept of homeland should cease forever in Hungary. The success of regime change before it happened and after it was achieved was that Hungarians at home would never have to fear their own government, and Hungarians living or travelling abroad should not have to fear or be ashamed of the political regime back “home”.

The Western dimension

I read Alexis de Tocqueville’s *Democracy in America* for the first time (in an English translation) when I was 18 years old, in February 1957, in Klagenfurt, where I had arrived as a refugee before Christmas in December 1956. Two years later when I was a student of International Relations and Economics in Geneva at the Graduate Institute of International Relations, I was happy and proud that I was the only student in Yves Collart’s history class who recognized the excerpts he read to us from Tocqueville. I mention this not only because this book has remained for me a source of encouragement and inspiration for the rest of my life, but because I believe that Tocqueville’s book also shaped Antall’s views of America and of liberal democracy and his general political philosophy. How relevant this book was in early 1957 for

a young Hungarian refugee and how relevant it remains today almost two centuries after it was first published can be shown by a brief quote. At the end of the first volume of his famous book, arguably still the best study about both democracy and about the United States, Alexis de Tocqueville came to an important conclusion that proved to be truly prophetic for most of the 20th century:

“The conquests of the Americans are...gained by the ploughshare; those of the Russian by the sword. The Anglo-American relies on personal interest to accomplish his ends and gives free scope to the unguided strength and common sense of the people; the Russian centers all the authority of society in a single arm. The principal instrument of the former is freedom; of the latter servitude. Their starting point is different and their courses are not the same, yet each of them seems marked out by the will of Heaven to sway the destinies of half the globe.”

The outcome of this competition, foretold by Tocqueville, between free and unfree political orders, and between the two principal actors of this struggle, is that democracy based on free participation in the political process of responsible citizens and respect for the rights of both large and small communities should become the universal domestic political system. This is in the interests of each individual country and of the international community at large. Regimes and movements based on monolithic and intolerant political and religious extremism, and on ethnic or nationalist intolerance, represent a danger first and foremost for those who are misled or coerced to live by these doctrines, and not only for those who are excluded or against whom they are ostensibly directed.¹¹³

Democracy is a complex, demanding political order that has been put into effective practice only relatively recently – little over 200 years ago – if one considers the long history of humanity of several thousand years. There is a large range of different types of democracies, but there are some basic common features that have to be present in order to deserve the designation “democracy”. In fact, today the term “liberal democracy” corresponds best to people’s general concept of democracy.

Theory, before and after Tocqueville, and past and present experience have taught us that there is no valid alternative domestic political order to a dynamic functioning democracy. This conclusion is based on the positive features and performance of democracies in “good times and bad times” and the negative record of the alternative political systems. Antall’s “Western orientation” before and after 1990 was due to his commitment to the model and the cause of liberal democracy and to the concept of

¹¹³ Hieronymi, Otto, Bensky, Daniela and Stoyanova, Teofana (2008): *“What Future and Domestic Political Order for Europe and the World”*, Spiralli, Milano.

political communities based on the principles of liberal democracy. The 20th century witnessed the systematic destruction and disintegration of large and small political communities and the creation and emergence of countless new ones. Some of these proved to be fragile or outright failures and would easily break down under relatively weak or minor external or internal pressures, with often dire consequences both for the people directly concerned, their neighbors and sometimes for the entire international community. The list of failed states, broken down alliances, and of “communities” created or bolstered by violence, ethnic or racial cleansing and oppression, is a long one – with many new entries in the last several decades. The outstanding examples of successful community building in the 20th century were the Western Community and European integration following the Second World War. Antall believed that these ought to remain the essential pillars also in the future of the liberal democratic international order.

The Western Community and the Western liberal international order are inseparable from the rules and principles of liberal democracy. The principal share of the credit for the spreading and consolidation of the domestic and international political orders based on these principles belongs to America. The fact that Hungary could achieve its freedom and independence in 1990 more than 40 years later than the more fortunate Western part of the European continent was to a significant extent due to the efforts and achievements of the United States.

12.3. A liberal-conservative internationalist

The terms “liberal”, “conservative” and “international” or “internationalist” are among the most frequently used political terms today, both among specialists of political discourse and the general public. As a result there is not only a wide range of interpretations of the concepts they are supposed to cover, but also frequent misinterpretation to the point that in some context these terms are used by some people to describe the very opposite of the original meaning of the term. This is the case in particular when the prefix “neo” is attached to words to create “neo-liberal”, “neo-conservative” and even “neo-international”.¹¹⁴

Are the terms “liberal” and “conservative” mutually exclusive? I do not think so. I believe that in a broad sense, we can argue that the late Prime Minister was both

¹¹⁴ On the origins and evolution of liberalism and conservatism, see the recently published twin volumes by Edmund Fawcett: Fawcett, Edmund (2018): *Liberalism. The Life of an Idea*, 2nd Edition, Princeton University Press, Princeton, and Fawcett, Edmund (2020): *Conservatism. The Fight for a Tradition*, Princeton University Press, Princeton.

a liberal and a conservative, besides having been a true internationalist throughout his life. Calling him both liberal and conservative does not mean that he switched philosophical or ideological sides at various moments of his life. In fact, as all those who had been close to him know that József Antall was exceptionally steadfast in the key values that he held from a relatively young age until the end of his life.¹¹⁵

The reason for my choosing this dual designation had to do with the lack of precision of the terms “liberal” and “conservative”, the radical changes that occurred in both liberalism and conservatism recently and in the more distant past, and, last but not least, the fact that there are some key common or complementary elements in classical liberalism and conservatism, elements that tend to be ignored or discarded by the extreme ideologues of the two camps.¹¹⁶

Friedrich von Hayek is recognized as one of the greatest liberal thinkers of the 20th century. Hayek was proud to be a liberal. The title of one of his well-known shorter essays was “Why I am not a conservative?” Hayek rejected all schools of thought that do not recognize the validity and the importance of change and see the world around us as immobile, as frozen forever in one shape and place. Yet, some of Hayek’s major theories and writings also contain some elements that are considered as “conservative” in the best sense of the term. In my opinion the three volumes of *Law, Legislation and Liberty* are a good illustration for this thesis. Another 20th century example is Raymond Aron, the French philosopher, political scientist and journalist. Aron was considered a conservative, especially in the French context. Yet he was also one of the most committed defenders of the liberal political and economic order.¹¹⁷

Major schools and trends of thought usually have multiple sources and places of origin. Their geographic diffusion is often accompanied by new national additions and modifications, sometimes to the extent that in one country the term may mean the exact opposite of its meaning in its country of origin. This was for example the case with the term and concept of “liberal” in Britain and the United States.

Antall’s conservatism may be summed up as respect for the constitution and for parliamentary democracy. Antall respected and was interested in 18th and 19th century

¹¹⁵ The *magnum opus* of József Eötvös, one of the most important books on political philosophy by a Hungarian scholar, remains highly relevant in the 21st century more than a century and a half after its first publication (in German): Eötvös, József (1996): *The Dominant Ideas of the Nineteenth Century and their Impact on the State, Diagnosis*, Volume 1, Atlantic Studies on Society in Change No. 87, Columbia University Press, New York.

¹¹⁶ On Hungarian liberalism see Tökécsky, László, Editor (1993): *Magyar liberalizmus*, Századvég, Kiadó, Budapest.

¹¹⁷ On Hayek and liberalism, see chapter two in Hieronymi, Otto, Principal Author and Editor (2023): *Quo Vadis Europe? Where are Europe and the Western Community Going Seven Decades after the Start of European Integration and the Creation of the Atlantic Alliance?* Aracne Editrice, Roma.

thinkers (including Abraham Lincoln, the first leader of the Republican Party to be elected President of the United States) as well as in the ideas that were at the foundations of the post-war liberal Western domestic and international order.

12.4. Idealism and realism, patriotism against nationalism

Since well before the first half of the 20th century the mostly widely used distinction between the two main opposing trends of political theory and of the theory of international relations has been the one between “idealism” and “realism”. In fact, according to the textbooks on political theory, this distinction is several centuries old.¹¹⁸ According to most authors the founding father of the realist school was Niccolò Machiavelli, the Florentine diplomat and philosopher. The origins of idealism go back to the age of enlightenment of the 17th and 18th century. My favorite title in this context is Kant’s timeless work on *Perpetual Peace*.¹¹⁹

Idealism in political thought and practice received a strong boost in reaction to the destructions of the First World War. The Wilsonian concepts of collective security and self-determination and the creation of the League of Nations were hopeful efforts. They did not succeed, however, in preventing the rise of poisoned ideologies and political regimes (Bolshevism, Fascism and National Socialism) and the “failure of the peace”. While realists claimed that this was an inevitable development because of the inherent weakness of “political idealism”, already during the Second World War and then in its aftermath, “idealist” doctrines and policies mixed with a dose of realism created the conditions for the emergence of the Western Community and of European integration. The victory of the Western model over the Communist system was also an expression of the validity and in many respects superiority of idealism over ultra-realism.

The disasters brought into the world by the two world wars had been closely linked to the emergence and spreading of aggressive nationalism. Combatting nationalism was one of the key objectives of those who helped create the Western

¹¹⁸ See Fergusson, Yale H. and Wausbach, Richard (1988): “The Vicissitudes of Norms and Theory: Realism and Idealism”, in: *The Elusive Quest. Theory and International Politics*, chapter four, South Carolina University Press, Columbia, S.C.

¹¹⁹ On Western thought, see Baumer, Franklin Le Van, Editor (1978): *Main Currents of Western Thought*, Yale University Press, New Haven and Watson, Peter (2000): *A Terrible Beauty. The People and Ideas that Shaped the Western Mind*, Phoenix Press, London; on Kant see: Bohman, James and Lutz-Bachmann, Mathias, Editors (1997): *Perpetual Peace, Essays on Kant’s Cosmopolitan Ideals*, MIT Press, Cambridge.

Community and European integration. The rejection of nationalism, however, did not imply that legitimate patriotism should also be rejected. Patriotism was and remains compatible with multiple identities within the national communities and the broader liberal communities to which democracies belong. Thus, the awareness of the clear distinction between nationalism (negative) and patriotism (positive) was one of the hallmarks of József Antall's political philosophy and value system.

12.5. The values of Antall: a legacy for Hungary, Europe and America

The values that can be attributed to József Antall represent an important legacy for current and future generations not only in Hungary but also in Europe and America.

Legacy for Hungarians

As Prime Minister during the key period of the regime change, the most important legacy of Antall's values for the Hungarian population are the success of the regime and its irreversibility: Hungary as a free, liberal democracy, which is part of the Western Community, and country that must never be tempted or pushed into becoming an authoritarian system again, was seen by Antall as the most important achievement of his life and the core of his entire value system.

The second key dimension, closely connected to the first one, of the values most relevant has to do with the social and economic order that Antall strove for under the term of a "Hungarian version of the social market economy". This includes social progress and solidarity as well as international economic integration.

The third relevant aspect has to do with moral and ethical values: religious freedom, respect for all religions and separation of religion and state, political and human rights, condemnation of racism, anti-Semitism and moral intolerance.

A fourth category of essential values belongs to the class of political order and external relations: constitutional parliamentary order, law and order, international law, peace and collective security, the scope of sovereignty, and solidarity in the framework of the liberal international order, the role of international organizations and of non-governmental organizations.

Last but not least, Hungarians must remember two important points. (1) The late Prime Minister never ceased to confirm that he belonged neither to the traditional "left" nor to the traditional "right". His temperament and political values were those of the moderate center. (2) Today "Hungarian identity", like other "national identities", is not an exclusive one. It is fully compatible with double or multiple citizenship. Those

who claim Hungarian identity outside the country, may live near or far away from its borders e.g. in Australia, Canada or the United States.

Legacy for Europeans

Europeans at the national level and in the European Union and in its various organs should be reminded in particular of the following values among those cherished by József Antall: (1) respect for the positive elements of European history and European traditions, without forgetting the negative elements, including the crimes that had been committed in the past in the name of Europe; (2) the belief that “new Europe” means peace among its members and the upholding of the rights of small and large countries alike; (3) the objective of European integration is not to build an oppressive “mega state”, but the fundamental rights and principles of this “new Europe” have to be respected by all those who want to enjoy the benefits it offers. Considering a small democratic non-member country like Switzerland as a “second-class European” is a distortion of the fundamental objectives of European unity.

Legacy for Americans

American democracy has been an essential factor in assuring the freedom, security and prosperity of the American nation. But the United States has also played a unique role in promoting the diffusion of democracy and freedom beyond its own borders. American democracy cannot survive in isolation. It needs constant interaction with other democracies in the world. Throughout the country’s history, the leaders and people of the American nation never ceased to learn from the history and people of other countries that were striving to gain their own freedom, such as Hungary in the middle of the 19th century and in 1956. How should American (and Hungarian) leaders react if history books would call the 1956 Hungarian uprising “an attempted fascist coup” as was the case recently in Putin’s Russia?

CONCLUSIONS

My conclusions are briefly presented under two headings: (1) the role of policy-making and ideas in economic and societal regime change and (2) the lasting impact of the regime change achieved by the Antall administration.

1. The role of policy-making and ideas in economic and societal regime change

There are two widely held but contrasting fallacies about regime change. One is that regime change as a rule is the result of chance or hazard, i.e. regime change just happens. The other is the belief that regime change always comes about through the conspiracy of a few people.

While recognizing that both chance and conspiracy may play a role, Antall knew that these two factors are far from the whole story. Accepting them blindly can lead to misunderstanding between the new leaders in charge and the population directly affected. In fact, the quality of policy-making – in the old and in the new regime – as well as of the ideas about what is important and what is irrelevant in economic and societal systems, what should be kept and what should be discarded, have a decisive impact on the outcome of the transformation of an entire political system.

The great strength of Antall, both as a thinker and as the head of government at an extremely challenging time, came to a large extent from the fact that for him policy-making was not a mechanical exercise that can be carried out with only book learning, as a bridge cannot be built only with the help of a degree in architecture. Also, without being a rigid ideologue, Antall was also convinced that political leadership and the governing of a country required the ability to fit specific measures and policy objectives into a broader framework of values and ideas. This was a more important condition for being able to work for the common good than striving for power or clinging to power once in office.

Ideas have consequences

In 1948, three years after the end of the Second World War, Richard M. Weaver, an American philosopher and professor at the University of Chicago, published a slim volume called *Ideas Have Consequences*, which made him instantly famous.

The title of this book has stayed with me ever since I first read it as a young professor of Economics at the University of Dallas in 1964. In the preface to the paperback edition Weaver wrote: “This book was written in the period immediately following the Second World War and it was in a way a reaction to that war – to its immense destructiveness, to the strain it placed on ethical principles and on the tensions it left in place of the peace and order that were profoundly sought.... It is a work of philosophy to the extent that it tries to analyse many features of modern disintegration by referring them to a first cause... I believe that something like this is necessary if one believes in the primacy of ideas. I was attempting a rigorous cause-and-effect analysis of the decline of belief in standards and values... I have come to feel increasingly, however, that it is not a work of philosophy; it is rather an intuition of a situation, the intuition of a world that has lost its center, which desires to believe again in value and obligation.... This book was intended as a challenge to forces that threaten the foundations of civilization....”¹²⁰

My purpose is not to discuss in detail Weaver’s book or his place among mid-twentieth century American political philosophers. The reason for mentioning him is two-fold. I strongly believe that the very title of Weaver’s book is highly relevant for what we can learn from Antall’s approach to policy-making and to the complex task of economic and social regime change. In fact, the concept that *Ideas Have Consequences* can be applied to the story I attempt to tell of “Antall and the Hungarian regime change” in this book. The second reason is also a significant coincidence. Weaver in the brief excerpt from his book defined the destructions brought about by the Second World War as the main impulse for undertaking his analysis, while the main conclusion of his analysis – a non-philosophical conclusion (i.e. one does not have to be a professional philosopher to grasp its essence) – was that in order to counter the threats against civilization the role of values and of individual responsibility have to be restored. For Antall, as we have seen, the main source of the crises and difficulties incurred in the process of regime change were the result of the nature of the Communist economic and social system that had been imposed by force on the Hungarian people. The solution could only be a value-based new political and social order.

¹²⁰ Weaver, Richard M. (1948): *Ideas Have Consequences*, University of Chicago Press, Chicago, pp v–vi.

2. The lasting impact of the regime change achieved by the Antall Administration

Stability and change

The coalition government that was sworn in May 1990 lasted four years. Had it not been for Antall's death a few months before new elections were due, he would have entered the history books as having held the position of Prime Minister for the full electoral cycle. This was a remarkable sign of stability. During those years he oversaw and initiated change of an unprecedented magnitude. As he had hoped or even predicted at the start in 1990, by the spring of 1994 the most important tasks related to the regime change were accomplished.

Today, 30 years later, we have come to see this combination of stability and change as one of the most important features and accomplishments of the Antall government. Also, it is only from this perspective that we can understand the lasting impact that the bulk of his policies had.

Domestic and external developments

The principal achievements of the Antall administration with respect to regime change fell into three general categories: the domestic political system, the economic and social order and Hungary's external security, and its place in Europe and in the world.

The Antall years saw the development and consolidation of a dynamic parliamentary democracy in Hungary. Subsequent parliamentary cycles brought changes in electoral majorities and new governing coalitions. Since the elections of 2010, Prime Minister Orbán and his party (FIDESZ) have succeeded in winning the parliamentary elections and to stay in power without interruption. During the last 30 years Hungarian political life has been quite turbulent, and Victor Orbán and his policies have been the subject of recurring criticism at home and abroad.

During this same time, many of the other Western democracies have also undergone periods of turbulence and the disintegration and re-composition of political parties and governing majorities and governments. This was the case in Austria, Italy, France, Spain, Germany and the Netherlands, as well as in Britain, the United States and Japan. One may say that democracy – both “new” and “old” democracy – has been under pressure, but so far democracy has resisted well.

In the economic and social area, the Antall government was committed to creating the conditions for a modern market economy based on private initiative and a just

social safety net. It was opposed to an extreme libertarian and monetarist version of the market economy. Over the years the reckless approach to market competition and short-term speculation brought about extensive economic fluctuations and insecurity in the world economy. Also, growing economic and social inequality has created new forms of marginalization and poverty. Hungary could not fully escape these worldwide developments. However, the fact that the Hungarian economy is embedded in the European Union and in the Western economic system has provided the country with a secure framework and with actual or potential resource transfers from the richer member countries.

By far the most important long-term impact of Antall's policies was in the third category mentioned above: the place of Hungary in Europe and the world. The majority of Hungarians feel at ease with Hungary being a member of the European Union and of the Western Community.

EPILOGUE

I end this volume with a question about the future: should we be pessimistic or optimistic about the future of liberal democracy in Hungary and the world in the light of the lessons that can be drawn from this book and from the changing environment in the world?

How to think about the future?

Both as the author and as someone who has worked for many years as a “professional forecaster”, I believe that the events and developments described and analysed in this book can help us to think about the future. One of the main aims of writing and reading books on the distant or more recent past is to allow us to think in a systematic manner about the future.

The near or far future are not predetermined. Even if a given future is considered to be highly likely in a certain part of the world, changes in trends, unexpected events or simply human errors or insufficient understanding of the complexities involved, may result in a very different outcome than the one we had predicted.

Thus it would be wrong to assert that we can know precisely what will happen in the future, however sophisticated our forecasting tools are. To quote an old popular song: “the future is not ours to see.” Nevertheless, ever since the Second World War forecasting has become a significant component of political and economic analysis and decision making. It is in this spirit of caution that I try to answer the ambitious question raised in this Epilogue: should we be optimistic or pessimistic about the future of democracy in Hungary and the world?

The defeat of totalitarianism and the victory of democracy and of human rights

The 20th century totalitarian systems – Communism, Fascism and National Socialism – were among the worst enemies known in history not only of democracy but also of human rights. Fascism and National Socialism were defeated in 1945 but Soviet

Communism expanded. The spreading and consolidation of democracy and of human rights was the principal objective of the emerging Western Community. The end of the Cold War signalled the victory of democracy and of human rights. It also brought the liberation of Hungary both from foreign occupation and from dictatorship. This was the sense of the regime change.

European integration aimed to achieve peace and freedom among European democracies. The upholding of common values, including the respect for human rights became both an objective and obligation of the members of the European Community. Whereas European ideologies and movements and governments had been responsible for the worst crimes against humanity, it was in Europe that the most extensive protection of human rights was established, beginning with the Council of Europe, the European Convention of Human Rights and the European Court of Human Rights. The range of protection against arbitrary government action and against political and human rights has been broadened through the definition of European values and rights and their inclusion in the European Union Treaties.¹²¹

Is it worth respecting the rules?

Within the European Union there is also an elaborate system for controlling whether the member states respect their obligations concerning European values, human and political rights, and the national and European constitutional order.¹²² Countries that violate these rules may be subjected to material or political and administrative sanctions but only after a lengthy and complex procedure.

The European Union is by far the most elaborate *quasi*-federalist community of democracies in the world. The question of how much legal and political power should be transferred to the common institutions and how much sovereign autonomy is or should be retained by the member states is an issue that has been debated for many years on various occasions. Revisions of the treaties that regulate the functioning of the community – from the original 1957 Rome Treaty through the current version of the Lisbon Treaty – have been recurring exercises since the beginning, and it is unlikely that they will cease in the future. With the exception of the United Kingdom, no country has chosen to leave the Union and no country has been excluded so far.

¹²¹ European Parliament (April 2023): “Fact Sheets: The Protection of Article 2 TEU Values in the EU” (Marzocchi, Ottavio).

¹²² See Lenoerts, Koen and Van Nuffel, Piet (2011): *European Union Law*, Sweet & Maxwell, London.

Thus, there can be no doubt that respecting the rules is a much better alternative than quitting, especially because the rules can be modified if there are enough members who believe that they should be changed. Today it is widely held inside the United Kingdom and outside that the outcome of the vote on Brexit was the result of explicit lies by the advocates of “leave”, and that both politically and economically Britain has been weakened by Brexit, and its international position is less favorable than it had been before that fateful vote.

The virtual community that encompasses all the Western democracies is less structured than the European Union but it also has shared common values and rules, even if some of these rules remain unwritten. While there have been attacks from the right and from the left against the “West”, and in particular against the United States, being a member of the Western Community has proven to be an important advantage over the years.

There is thus only one valid answer to the question raised above: “yes, it is worth respecting the rules”. Both individually and as a group, the members of the European Union and of the Western Community would be much worse off if either one or both communities would be seriously weakened in the years to come, and especially if they were to be destroyed by forces from the inside or from the outside.

The inferiority of unfree political systems

Authoritarian rulers like to boast that dictatorships are “more efficient” than democracies. It is with this false claim that they usually justify depriving citizens of their freedom, and especially of their freedom to choose their leaders and the regime under which they want to live.

Oppressive, unfree political systems are inferior to free regimes in terms of economic, political, cultural and technological performance. If this were not the case, dictators would not have to maintain their regimes through terror, through the threat or the use of force. Freedom, free choice stimulates people to seek and find a better life, not only for themselves but also for their community. Fear and oppression have an opposite effect.

This was proven to be true in the case of both large and small countries. A comparison of the United States and of the former Soviet Union, or of small countries like Austria and Czechoslovakia between 1950 and 1990, serve as ample illustrations for the inefficiency of dictatorships in all-important respects.

The explanation is quite simple: there is no valid alternative political and societal model to the one that is based on freedom, security, peace and solidarity.¹²³ This is what I believe. People do not want to live under violence, in intellectual and material confusion and disorder. This is true for Europe and for the Western Community, and it is also true for Hungary.

This realistic optimism is part of the legacy of József Antall.

Geneva, October 4, 2023

¹²³ Ikenberry, G. John (2020): *A World Safe for Democracy, Liberal Internationalism and the Crises of Global Order*, Yale University Press, New Haven.

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