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Economic transition and macroeconomic performance in the Czech Republic, Hungary and Poland: and prospects for membership of the European Union

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ABSTRACT

On 1 January 1993 the European Union (EU) formed the world’s largest single unified market consisting of some 350 million consumers. Since this time additional Western European countries have become members of the EU, with the prospects of expanded membership to include other wealthy Western European nations. However, this paper attempts to analyse the prospects of expanded EU membership from the ranks of the former Eastern bloc states, which have, since the late 1980s and early 1990s, been attempting to transform their economies from the communist era of central planning to that of market economies.

The likelihood of such membership from the former Comecon group of nations in the foreseeable future, is most realistically limited to those from Central Europe—Czech Republic, Hungary, Poland, Slovakia and Slovenia. All of these have already applied for such membership. In the process of striving for EU membership, which is regarded by each nation as being both economically and politically desirable, instead of having adopted a group, or cooperative, approach, each have adopted an individualistic approach involving a reorientation of their trade away from each other to the EU and active competition for hard currency exports and for foreign direct investment.

The paper is primarily concerned with identifying the recent macroeconomic performance of three of these Central European economies—Czech Republic, Hungary and Poland identifying some of the major reform measures which have been implemented as well as some of the major difficulties which each of them is currently experiencing. The major issues and stumbling blocks which exist to their membership of the EU are also discussed.
INTRODUCTION

In a recent best seller written by Lester Thurow,¹ he predicted that the economic battle of the twenty first century between the three economic superpowers — Japan, USA and Europe — would be won by Europe with Germany at its hub. However, such a prediction was based upon the premise that Europe — both West, Central and East would be able to unite to form a single unified market, incorporating Russia, consisting of some 800 million consumers. On 1 January, within the confines of Western Europe, the European Union took a major step in this direction by forming the world’s largest single unified market consisting of some 350 million consumers. Since this time additional countries have become members of the EU (as of 1 January 1995 — Austria, Finland and Sweden), with the prospects of expanded membership to include Switzerland and perhaps Norway in the reasonably near future and Turkey somewhat further down the track. However, of some interest is the prospect that EU membership will be expanded from the ranks of the former Eastern bloc states, which, since the late 1980s and early 1990s, are transforming their economies from being centrally planned to market driven.

The likelihood of such membership in the foreseeable future from the former Comecon² group of nations, is most realistically limited to five of these from Central Europe — Czech Republic, Hungary, Poland, Slovakia and Slovenia. The remaining nations of Central and Eastern Europe are experiencing major economic dislocations in their transition processes, or from the ravages of

¹ L. Thurow (1992), Head to Head, Allen & Unwin.
² Of course the reunification of West and East Germany in 1990 resulted in the former Comecon country of East Germany now having become incorporated in the EU.
war, and are in much too weak an economic position to be realistically considered for membership in the foreseeable future. In 1991 four of these Central European economies met in Visegrad, Hungary, after the demise of the Council for Mutual Economic Assistance (CMEA) in January of that year, to identify what their options were for the future. However the "Visegrad group" as they became known, and the resulting Central European Free Trade Agreement (CEFTA), has become largely irrelevant, with members instead reorientating their trade away from each other and actively competing\(^3\) for hard currency exports to the EU and for foreign direct investment. Such an individualistic, rather than cooperative, approach by these nations may also be a reflection of their belief that in doing so their individual prospects for joining the EU is likely to be enhanced.

All of these Central European nations have applied for membership of the EU, and an important issue arises as to the timing of such membership. Their are diverging viewpoints over this. The Hungarian position is that membership of the EU should be based on merit and should not be on a group basis, whilst the Poles take the position that the group should take a more cooperative stance and join the EU at the same time. Although in the latter case the reality is very different.

The remainder of this paper considers some of the major reform measures which have been conducted in the Central European economies of the Czech Republic, Hungary and Poland in particular, as well as some of the major difficulties which each of them is currently experiencing in their transition process. Their recent macroeconomic performance during this transition to a market economy is also considered. In addition, some of the

\(^3\) Or in the case of the former countries of the Czech and Slovak Republic (CSFR), the Czech Republic and Slovakia, actively squabbling with each other after their agreed separation on 1 January 1993.
major issues and stumbling blocks which exist to their membership of the EU are also discussed. Finally a summary of the major conclusions from this paper is presented.

ECONOMIC REFORMS IN THE THREE ECONOMIES

This section focuses upon the major reform measures which have been implemented in the three countries under review, in the process of transforming from centrally planned to market economies during the 1990s. The situation for each country is now discussed in turn.

Czech Republic

During its transition process to date, there have been two major areas towards which economic reform has been directed:

i. Monetary policy and financial sector reform
ii. Fiscal policy and reforms

i. Monetary policy and financial sector reform

Since the introduction of reforms in early 1991, monetary policy has played a key role in the financial stabilisation of the economy. Its successful implementation is reflected in the reduction of inflation, the stability of the nominal exchange rate and the strengthening of the external reserves position. However its implementation has been difficult due to the short period of time since the introduction of the reforms, and the change in underlying behavioural relationships which have made the formulation of an appropriate policy stance even more difficult. The economy's fixed exchange rate regime, strong capital inflows, which have been the sole source of increase in reserve money since mid 1993,
have additionally exerted pressure on the central bank in the conduct of monetary policy.

However Czech policy makers have made considerable progress in developing indirect instruments of monetary control. With the removal of direct ceilings on commercial bank credits by October 1992, the primary focus of monetary control shifted to auctions of refinance credit and adjustments in minimum reserve requirements. Since mid 1993, the use of refinance credit auctions has been minimal and, with growing capital inflows, open market operations have become increasingly important. From 1994 the system of monetary management has been based on open market operations, changes in reserve requirements and adjustments of the discount rate.

The establishment of a sound commercial banking sector was emphasised in the transition program of the former Czech and Slovak Federal Republic (CSFR) during 1991-92, and later in the newly formed Czech Republic. Such efforts have included the introduction of a more effective banking regulation and supervisory regime, the establishment of an efficient payments system and strengthening the balance sheets of the commercial banks through a combination of both centralised and decentralised approaches. The centralised operations were aimed at non performing loans inherited from the days of central planning or incurred on behalf of the state. The measures have included transfers of debt out of individual banks, exchanging poor quality debt for official assets and providing capital infusion. The decentralised approach requires banks to bear major responsibility in accumulating loan-loss provisions and building up their capital base. To facilitate this task the government has given limited tax incentives for loan-loss provisions and issued risk classification guidelines and regulations covering credit exposures and capital adequacy. To minimise the moral hazard issues associated with the balance sheet restructuring operations
and to strengthen corporate governance of banks, all the large formerly state owned banks, with the exception of the foreign trade banks, were privatised in the first wave of voucher privatisation.

To foster competition, a liberal approach was taken to the entry of new private banks. Forty seven new banks have emerged since the beginning of the reform process, about one-half with partial or full participation.

**ii. Fiscal policy and reforms**

The objective of fiscal policy has been twofold: to reduce the role of the state in the economy, and secondly to assist in the stabilisation of the economy. With the first objective in mind, the government has implemented the following measures:

- cut subsidies in 1991 and kept the level unchanged in nominal terms thereafter,
- reformed corporate income taxation. In 1991, the rates of tax on profits were reduced by 10-20 percentage points and the rate structure was simplified. In 1993 a single 45% profits tax replaced three earlier business taxes. The rate was lowered to 42% in 1994,
- introduced further tax reform in 1993, including the introduction of a Value Added Tax (VAT) (at rates of zero, 5 and 23 %) and reform of the income tax (both personal and corporate) and social security systems. A personal income tax on a progressive scale was introduced to replace the previous patchwork of taxes on the wages of large enterprises and various other forms of income. For social security, the old payroll tax of differential rates was replaced by a system where both the employer and the employee contributed. The
effect of the tax reforms of 1993 was to shift the tax burden from corporate incomes onto wage incomes.

On the expenditure side, a number of social safety net programs were introduced in 1990. These included unemployment insurance, support for families in poverty and the long term unemployed, and cash payments to households as compensation for price liberalisation. In 1994 aid programs for low income tenants and matching subsidies of voluntary, supplemental pension contributions in private plans were introduced. Outwith these changes the entitlement system, especially pensions and family allowances, continued to be as before under central planning.

From 1994 the government formulated its budget within the framework of a medium term strategy to achieve the following objectives: reduce the expenditure to GDP ratio gradually to 40-42% by the year 2000, reduce the tax burden to levels prevailing in industrial countries, and stabilise the nominal level of public debt. To achieve the latter, a balanced budget every year was the objective.

The Czech transformation has now entered a new stage. The major tasks in this new stage are to consolidate the gains of stabilisation, and to focus upon the restructuring of enterprises. The recent recovery of output and strong export performance (as discussed in the following section) as well as strong capital inflows in the form of enterprise borrowing abroad, suggest that some parts of the industrial sector are making the necessary structural adjustments. However increasing non performing loans in the portfolio of domestic banks suggests that others are continuing to struggle through the transformation process.

It is unlikely that the desired transformation of the economy can be achieved without substantial enterprise closures. Rigidities and distortions that are still built into the economy will also need
to be eliminated. Unless measures are urgently taken to improve labour mobility from areas of surplus labour to places where new jobs are being created, not only is it likely that regional unemployment from firm closures will be high but economic growth will be stifled. A chronic shortage of housing currently constrains such labour mobility.

Hungary

With the end of the socialist era in 1990, Hungary faced many economic and social challenges. Beginning with the New Economic Mechanism in 1968, efforts had been made to adapt the system of central planning to increase its responsiveness to the needs of producers and consumers. However major changes were still required in order to enable the economy to operate in such a way as to be consistent with that of a market economy by 1990, including changes in enterprise structure and governance and in labour and capital markets. Although there had been previous reforms in the areas of trade and price liberalisation, and those relating to the budget, tax policy, and the banking system, they needed to be further extended and refined.

The newly elected incoming government devised a broad based four year plan for structural and macroeconomic reforms during its first year in office. The so called Kupa program, named after the Minister of Finance, spelled out a detailed plan specifying the problems to be addressed, the intended goals, the necessary tasks of the government, the forms of remedy (laws, regulations, creation of new institutions), their scheduled dates of enactment or creation and the relevant government institutions responsible.

Success with structural reforms has been uneven however. Whilst considerable progress with respect to price and trade liberalisation has been achieved, enabling the Hungarian economy to achieve a relatively liberal system, progress has proven more
difficult in many areas of fiscal reform, as well as enterprise and banking restructuring. The state still plays a major role within the economy, including its redistributive function which has contributed to high marginal tax rates. This has hampered economic activity, and contributed to adverse macroeconomic developments in the budget deficit, current account deficit and the uncomfortably high foreign debt.

The major areas of economic reform have been as follows:

Price liberalisation

The price system had been liberalised in stages since the introduction of reforms under the New Economic Mechanism. By 1989, only 17% of consumer prices remained officially determined with the remainder freely determined. The share of free consumer prices was increased to 89% in 1991, 92% in 1992 and 94% in 1993. Government determined prices remained only for electric energy, public transport and pharmaceuticals. In 1991, the Price Office, which was responsible for controlling prices, was eliminated.

Trade liberalisation

The new government was the leading international advocate of dismantling the CMEA trading system. This dismantling occurred in 1991, and thereafter almost all transactions were conducted at world prices and in convertible currencies. The objective of the new government was instead to focus the country’s trade policy with that of EU members, and in early 1992 an Association Agreement was adopted with the EU outlining a timetable for the dismantling of trade barriers. In addition the Central European Free Trade Agreement (CEFTA) comprising Hungary itself, Poland, the Czech and Slovak Republics and subsequently
Slovenia, was adopted, including a timetable for a free trade area among the partner countries. At the beginning of 1995, further trade liberalisation was implemented under agreements with the EU, CEFTA and the European Free Trade Association (EFTA) as well as under the Uruquay Round. By as early as 1990, about 90% of total imports were already free of quantitative or value limitations

Fiscal reforms

The fiscal reform program included an ambitious strategy to modify the budgetary sector to make it consistent with a market economy. This included further reforming the tax system, reducing the scope and scale of fiscal activities and increasing the efficiency of remaining activities. While partial, but significant, progress was made in regard to achieving the first objective, the other two objectives were essentially not achieved.

In regard to tax reforms the government’s intention was to broaden the direct tax bases by reducing and eliminating large numbers of tax reliefs and exemptions granted under enterprise profit and personal income taxation. In addition, it intended to introduce realistic depreciation rates and to eliminate the zero bracket in the value added tax (VAT). However measures to broaden personal income tax and social security contributions were not adopted. In addition VAT reforms were delayed until fiscal pressures dominated in January 1993.

As to the intended goal of reducing the scope and scale of government activities, the authorities were even less ambitious and successful in comparison with their stated objectives. The share of general government expenditure was estimated at around 60% of GDP in 1993/94, a higher share than at the beginning of the reform process in 1990 and also considerably higher than in most of the other transition economies in Central Europe.
Monetary policy and banking reforms

Steady progress was made by the National Bank of Hungary (NBH) in introducing, and increasingly relying on, indirect instruments to effect monetary policy, and the practice of providing automatic refinancing credits was gradually replaced with a system of auctions. In addition the cost of such credits was progressively increased, to induce banks to compete for deposits. Ceilings on household deposit rates were eliminated in 1992. An interbank market, created in 1990, played an increasing role in supplying banks with marginal short term funding. The NBH also streamlined, reduced, and began paying interest on banks’ mandatory reserves.

Parliament passed in December 1991 laws relating to both central and commercial banking, with one of the more important features of the first being an explicit statement concerning the NBH’s legal independence; its primary responsibility for ensuring the value of the currency; and a stricter limit on the amount of direct financing of the state budget deficit to be phased in over a number of years.

It was also recognised by the government that higher priority needed to be given to improving both the financial integrity of the banking system, and to altering incentives such that banks would be willing to reduce operating spreads and resume lending to creditworthy customers.

In regard to capital market reforms the Budapest Stock Market was reopened after 40 years in 1990, making Hungary the first European transition economy to take such a step. A large number of supportive acts (such as the Act on Compensation, Accounting, Investment Funds and Employee Stock Ownership Plans) were implemented for the development of private capital markets. An interbank market for foreign exchange was created in 1992, and a futures market for these assets was created the following year. Also an act in 1993 established a bank financed
deposit insurance fund, and the adoption in 1994 of a law allowing for the creation of private pension schemes further strengthened and began to broaden capital markets in Hungary.

_Enterprise governance and structure_

The government, determined to accelerate the transformation of state enterprise behaviour so as to be consistent with that of a market economy, hardened budget constraints, instituted a broad based privatisation plan, and further increased the autonomy granted to enterprise decision making from earlier periods. The government's privatisation plan combined a quick privatisation of some 10,000 small service establishments and, following the negative reaction to "spontaneous" privatisation, a case by case decision process concerning larger enterprises. In 1990 the government created the State Property Agency to privatise enterprises within its portfolio. The State Asset Management Company was formed in 1992, and was given control over 150 enterprises in which the government intended to retain a 100 per cent, a majority or a significant minority interest.

Despite the growth of the private sector, which soon accounted for the majority of activity, problems still existed with a number of significant large loss making state owned enterprises. The tightening of budget constraints, combined with the sharp fall in external demand and change in production and trade patterns, exposed a large number of state owned enterprises as being fundamentally unsound. While most small and medium sized enterprises were forced to confront their situation through downsizing, bankruptcy or liquidation proceedings, a number of large enterprises, employing significant shares of the labour force, were able to continue operating while accumulating large losses.
Labour market reforms

A number of significant reforms have taken place regarding labour issues in recent years. A system of centralised bargaining has been created, and institutions facilitating labour market mobility have emerged. However the labour market remains extremely inflexible, with little mobility between employment and unemployment, and within employment. In addition real wages have remained fairly rigid, especially when non wage compensation is taken into account.

To promote labour mobility and provide a social safety net, a number of institutions were created in the early 1990s. For example the Solidarity Fund was created in 1991 to provide unemployment compensation, and in 1992 a social assistance law was adopted which provided cash benefits and specific services to those who had either exhausted or were not eligible for unemployment compensation.

Poland

The economic situation in Poland deteriorated in the late 1980s, becoming particularly acute in 1989 with the emergence of hyperinflation and a large fiscal deficit. In the preceding years there had been several attempts to reform the economic system, to redress the inadequacies of Poland’s centrally planned regime. However their limited nature appears, if anything, to have exacerbated the difficulties that were being experienced. It became increasingly clear that a more fundamental break in the economic regime was required, and in 1990 Poland embarked on a program of reform with a view to stabilising the economy and putting it on a transition path to a market economy. The Polish reform approach provides an excellent example of a shock therapy or "big bang" approach, indicative of an immediate change from a centralised to a market economy. In successive steps the new
Polish government conducted the following reform measures from January 1990:

i. freed most prices from central control and eliminated most subsidies. Prices were allowed to increase with the objective of increasing supply, by providing an incentive for farmers and factories to produce more,

ii. the central government set itself the objective of balancing its budget to eliminate deficit spending, which had been a major contributor to the rapid increase in inflation in the economy in 1988 and 1989,

iii. in January 1990 the official and black market exchange rates were unified, and the exchange rate was devalued by some 31.6% and fixed against the US dollar (9,500 zloty per US dollar). The devaluation, it was hoped, would encourage foreign investment and make domestic products competitive in world markets. In May 1991 the currency was further devalued (by 16.8% against the dollar and 14.4% against a basket of currencies) and the exchange rate was now pegged to a basket of currencies and not just the dollar. This reflected the increasing importance of Western European markets for domestically produced products. From October 1991 the zloty was allowed to devalue on the basis of a preannounced crawl, and has steadily fallen in value ever since; and

iv. state enterprises were privatised. The Ministry of Ownership Change was created to oversee the process, and specialised institutions were set up to facilitate it. The State Enterprise Privatisation Law was adopted in July 1990, permitting four separate approaches to the privatisation of state properties:

- sales of entire firms to Polish or foreign investors,
- liquidation of firm assets and their sales to private investors,
- free distribution of shares to investors,
- establishment of holding companies.

A number of problems regarding privatisation have become apparent, not the least of which has been in regard to the sale of large scale and obsolete state industrial enterprises. There was no idea as to the real value of such factories, hence there was no way of determining their fair market value. Additional problems lay in poor infrastructure such as for financial institutions, with the country only in the very elementary process of creating a commercial banking system and in the setting up of a stock exchange in Warsaw. The problem of unemployment necessitated, in practice, increased government support for large employers, such as the steel industry. In addition, state managers through corruption, ineptitude, or both, either sold or absconded with enterprise assets.

Privatisation, however, has had successes. Small scale retail and wholesale outlets were quickly privatised, and more than 1.2 million new private companies were created in the 16 months after privatisation occurred. Privatisation has worked particularly well in the service sector, with banks and most department stores having been privatised. However the industrial base of the economy remains weak, and prospects for its recovery remain poor because of the difficulty of making such Polish industries as steel and shipbuilding competitive in world markets. However the slow progress in the privatisation of medium and large scale industrial enterprises has led to the adoption of an alternative approach. The government intends privatising such enterprises through a Mass Privatisation Program (MPP). The MPP is to be a voucher based privatisation scheme, in which as many as 600 state owned enterprises can choose to participate. The vouchers to be distributed could be used to purchase shares
in investment funds, which would be freely traded on the Warsaw Stock Exchange. The MPP was implemented in 1995.

MACROECONOMIC PERFORMANCE DURING THE TRANSITION PROCESS

This section identifies macroeconomic developments since 1989 in the three transition economies focused upon in this paper. A brief review of these for each economy in turn is now conducted.

The Czech Republic

Among the transition economies of Central and Eastern Europe, it is generally regarded that the Czech Republic has been the most successful, to the present, in moving to a market oriented economy. Macroeconomic developments strongly support this, and particularly in regard to the attainment of financial stability. Inflation has been significantly reduced (Table 3) and the balance of payments surpluses have made it possible for the country to accumulate substantial foreign exchange reserves (Table 9). This has reduced its reliance on balance of payments assistance and enabled it to repay early its entire debt to the International Monetary Fund.

The Czech Republic stands out from the other transition economies in a number of respects. Firstly, its unemployment rate has remained low and indeed below that of most countries in the EU (Table 4). Secondly fiscal difficulties arising from the transition process have been contained, with the government achieving a budget surplus in both 1993 and 1994 (Table 6). Thirdly, with the completion of the second wave of privatisation, some 80% of the assets in the economy are in private hands. Fourthly the credit rating of the country in international capital markets has continually improved, and is much higher than that
of any other transition economy. Finally, and by no means least, the authorities have been very successful in maintaining support for the reforms from the population, primarily due to the popularity of the President Vaclav Havel and respect for the Prime Minister Vaclav Klaus.

These achievements are even more noteworthy due to the particular difficulties faced by the country both at the outset and during the transition process. At the outset the country, whilst it was part of the Czech and Slovak Federal Republic (CSFR), was in a much weaker position than the other former centrally planned economies. Firstly the state dominated production, the market mechanism was virtually absent and trade was heavily oriented towards members of the former Council for Mutual Economic Assistance (CMEA) (Table 1). In addition as the reform program was being launched the external environment deteriorated sharply, as trade with CMEA members shifted to world prices and convertible currencies, and economic adjustments or crises in other CMEA countries significantly reduced the CSFR’s traditional export markets.

The former CSFR achieved early success in overcoming the cumulative effects of large scale liberalisation and a severe terms of trade shock associated with the dismantling of the CMEA trade and payments arrangements. However the CSFR did start with favourable macroeconomic conditions — low inflation, limited monetary overhang and a small external debt burden (as a per cent of GDP)(see Table 8 specifically for the case of the Czech Republic) — all of which contributed to this early success. But more importantly was the vigorous pursuit of stabilisation policies comprising a pegged exchange rate and restrictive fiscal, monetary and incomes policies.

The reform program itself was of the "big bang" type and included a number of structural measures, including: the liberalisation of prices and the exchange rate and trade systems;
preparation for a rapid privatisation program; and a mutually reinforcing package of financial reforms. In the months preceding the introduction of the reform measures the external value of the koruna had been cut by nearly one half through several rounds of devaluation. Czech officials believed that for the sake of macroeconomic stability, and to limit the costs of the transformation, it was desirable to create two initial conditions — a depreciated exchange rate and a cut in real wages, both with the objective of maintaining international competitiveness.

The early progress in domestic and external stabilisation was threatened in the second half of 1992 and early 1993, due to uncertainties arising from the dissolution of the CSFR on 1 January 1993 and the early termination of the Czech and Slovak monetary union in February 1993. However such difficulties were overcome by the new Czech Republic government’s commitment to strong stabilisation policies.

Major success has been achieved by the Czech Republic in four key areas:

i. unemployment and output recovery,
ii. rebuilding the external sector,
iii. inflation reduction,
iv. privatisation and restructuring.

Unemployment and output recovery

A combination of reforms and external shocks contributed to a sharp decline in economic activity in the CSFR (see Table 2 specifically for the Czech Republic), mainly focused in 1991 but also occurring in 1992. Economic recovery occurred in the second half of 1992, but was undermined by uncertainties relating to the dissolution of the Czech and Slovak Republic and a considerable deterioration in Czech-Slovak trade. After suffering a cumulative
decline of about 20 per cent during 1991-93, real GDP increased by 2.6% in 1994. The Czech Republic's decline in activity was marginally higher than that of Poland's, to some extent reflecting its previously higher dependency on CMEA markets (Table 1) and the extra year it took to recover due to the dissolution of the Czech and Slovak federation. Developments in the output trend is largely dominated by industry, which accounts for some 35% of GDP. All branches of industry experienced a sizeable decline in 1991 arising from economy wide factors, but during 1992-93 the impact was variable across sectors indicative of specific sector factors. In late 1993 the decline in output in industry bottomed out, recovering slowly in 1994 (Table 5).

Whilst the initial decline in output was very pronounced the decline in employment was much less so. During the period 1991-93, the cumulative fall in employment was only 9%. The development of small scale activity in industry and construction and rapid growth in trade and services (particularly tourism), provided a safety cushion against employment losses. Large industrial enterprises (i.e. those employing 25 or more workers) held back on labour retrenchment, and were more inclined to cut work hours than the work force in the first year of the reform. Given the uncertainties surrounding the reform process, enterprises may have perceived that the output decline was temporary. Additionally, the pressure for downsizing was small, as the incomes policy contributed to a sharp decline in product unit labour costs. There was no catch up in labour shedding in 1992-93, with output and employment declining in parallel.

Despite the decline in employment during the Czech transformation, it has not been matched by rising unemployment. After peaking at 4.4% in early 1992, the unemployment rate declined in the following 12 months and fluctuated between 2.5 and 3.5% during 1993-94. Three factors have contributed to the low unemployment rate. Firstly many of those who lost jobs took
up employment in the significantly underrecorded services sector, especially in rapidly expanding tourist related activities. Secondly, job opportunities have been available in neighbouring Germany and Austria. The German authorities, for example, have estimated that some 50,000 Czechs are legally employed in Germany, most of whom commute daily across the border into Bavaria under a special arrangement. But the most important factor that has kept unemployment down has been the withdrawal of a large number of workers of pensionable age from the labour force.

The government has also engaged in specific employment policies with the objective of keeping unemployment down, especially since 1992. The most important of which provide grants and subsidies for long term jobs, short term public works type jobs, retraining schemes and employment subsidies for high school and college graduates. In 1992, the number of people involved in such policy schemes exceeded 125,000.

Rebuilding the external sector

The progressive improvement in the external reserves position (Table 9), especially since the termination of the monetary union with Slovakia, has been impressive, and is indicative of strong export performance, growing receipts from tourism and large inflows of foreign capital.

The demise of the CMEA led to a major decline in exports to its former members, requiring a reorientation of Czech exports to the markets of Western Europe. This met with considerable success, with the share of Czech exports to the EU jumping from 31% in 1990 to about 47% in 1994 (Table 10). Exports to Germany alone amounted to 31% of total exports. Greater access to EU markets in March 1992 arising from an Association Agreement and a further trade agreement with the European Free
Trade Association (EFTA), were both influential in helping to direct exports away from the former CMEA countries toward the industrial economies of Western Europe. Exports to Western markets continued their strong growth in 1993 and 1994. However the Czech Republic has also been making inroads into new markets for products adversely affected by EU restrictions, such as iron and steel products (for example to China in 1993 which absorbed 10% of the increase in exports). These overall gains have more than offset the steep decline in exports to Slovakia.

An important factor behind this successful reorientation of trade was the initial depreciation of the exchange rate at the beginning of the reform program, which created a substantial gain in competitiveness for Czech enterprises. Since this time competitiveness has been steadily eroded, but relative to its pre transition period it has still improved.

The scope for trade reorientation is much greater for the Czech Republic in comparison to its transition neighbours, due to its larger initial dependence on CMEA markets (Table 1). In addition, the structure of its commodity exports is more suited to taking advantage of its increased access to EU markets. Compared with Hungary and Poland, the share of agricultural products and mineral fuels (mainly coal) in Czech exports is small. With the exception of steel and some chemical products its access to EU markets for industrial products is largely unrestricted, while markets for agricultural products and coal are struggling with over capacity and strict regulations. The Czech Republic has also benefited from new marketing links associated with direct foreign investment, which has led to the diversification of its exports. Initially the rapid increase in Czech exports was concentrated on intermediate manufactured goods, but since 1993 machinery and transport equipment, which were the main
recipients of foreign direct investment, and miscellaneous manufactured goods have led the growth in exports.

Except for a brief period in late 1992 and early 1993, foreign medium and long term capital inflows have grown steadily. Net capital inflows amounted to an equivalent of about 12% of GDP in 1994, compared with 5% of GDP in the former CSFR in 1991. The nature of these inflows has changed significantly over the past four years. In 1991, the first year of financial stabilisation, capital inflows were largely in the form of official balance of payments support from multilateral organisations and foreign bond issues by the central bank. By 1992 as the success of stabilisation efforts became apparent, and the start of the privatisation process began, foreign private sector confidence in the Czech Republic was substantial, and was reflected in a major increase in foreign direct investment. From 1991 to 1992 net foreign direct investment almost doubled to $1 billion. However direct foreign investment slowed as the focus of the privatisation program shifted from direct sales to the distribution of vouchers, and also from weaker economic activity in Western Europe. The slowdown has, however, been more than offset by rapidly rising external borrowing by Czech enterprises. External borrowing by enterprises accounted for nearly 40% of net capital inflows in 1994, while foreign direct investment and portfolio investment each accounted for about one-fourth of the total. Since mid 1994 local governments and domestic commercial banks have also turned to raising money in international capital markets.

Inflation reduction

After an unexpectedly large jump of about 40% in the first quarter of 1991, inflation declined rapidly to less than 1% a month by July and remained stable until August 1992. Price increases accelerated in the last four months of 1992 and culminated in a
jump of the monthly rate of inflation to 8.5% in January 1993, following the introduction of a value added tax (VAT). After this, inflation came down rapidly and was contained at 20.80% for the 12 month period ended December 1993 (Table 3).

The reduction of inflation was seen as being essential to the containment of inflationary expectations, and was to be achieved through tight financial policies. Inflation has tended to remain fairly sticky, however, arising from a substantial number of relative price changes that are still taking place as part of the transformation process. Price rigidities still persist in the case of house rents and charges by the public utilities. Full liberalisation of energy prices is likely to involve increases of 45-50 per cent for natural gas, 80-85 per cent for electricity and 15-100% for central heating depending upon the sort of fuel being used.

**Privatisation and restructuring**

The government has adopted a strategy of rapid privatisation, leaving the task of enterprise restructuring to their new private owners. Enterprise restructuring has been relatively slow, however, since the tasks involved for their new owners is massive both in scale and coverage, with existing managers postponing investment decisions and organisational changes. The legal framework for enforcing financial discipline and encouraging enterprise restructuring, was only put in place in April 1993. The delay in introducing the bankruptcy law was prompted by the government's desire to prevent bankruptcies from interfering with the privatisation process itself.

Privatisation of small enterprises was completed in 1992, whilst privatisation of large enterprises has been implemented in two waves involving both conventional sales to domestic and foreign investors as well as transfers of shares in enterprises to citizens through a voucher scheme. In both waves, the voucher
scheme accounted for about one-third of the book value of total assets privatised. The first wave was concluded in May 1993, and the second wave effectively came to an end at mid November 1994 with the completion of the last round of bidding in the voucher scheme. The shares were distributed to voucher holders in February 1995. With this an estimated 80% of assets in the economy are now in private hands. The new owners of the privatised enterprises as already indicated are expected to play the main role in restructuring and in the strengthening of corporate governance.

Hungary

Hungary entered the post-communist era in many respects in a relatively favourable position compared with its former CMEA partner countries in Central and Eastern Europe. Its more favourable conditions included a less distortionary price system, a more stable internal macroeconomic position at the outset of the transition process, a smaller share of trade that was conducted within the CMEA trading bloc (Table 1), a skilled workforce and close proximity to Western markets. On the other hand, the country was burdened by a very high level of external debt (Table 8).

During the period of transition developments in the country’s external accounts (Table 7) have provided the focal point for macroeconomic developments. The past five years or so can be divided into two broad periods. Firstly the period of external stabilisation during 1990-92 when the current account recorded small surpluses, access to external capital markets was re-established, and inflation rates initially declined before increasing again. A second macroeconomic phase beginning in late 1992, but more apparent in 1993-94, saw a deterioration in the private savings-investment balance accompanied by high public sector
dissaving, resulting in a marked deterioration in the current account. In addition progress towards a major reduction in inflation faltered (Table 3), employment fell sharply and officially reported output contracted further in 1993 before recovering somewhat in 1994 (Table 2). Recent developments in Hungary's performance in terms of output and employment, inflation and external balances and debt are now discussed.

Output and employment performance

During the initial adjustment period the cumulative fall in official GDP, over the period 1990-93, was about 20%, which was broadly similar to that of the Czech Republic and Poland. For Hungary the sharp decline followed a decade of slow growth (an annual average growth rate of about 1.5%) despite a high investment to GDP ratio, which had been partly financed by external borrowing. The first strong growth in GDP occurred after seven years in 1994 at some 2.6% (Table 2). The earlier output decline was accompanied by a broadly similar lagged proportional decline in employment. Official unemployment rates increased rapidly to over 10% (Table 4), despite a sizeable part of the reduction in employment being followed by a reduction in the active labour force.

For the period 1990-93, the decline in output affected most sectors and all major demand categories. At the beginning it was particularly pronounced in industry (Table 5) and construction, while agricultural output fell sharply in 1992-93 as a result of severe droughts the effects of which were further aggravated by uncertainties and initial inefficiencies related to the transfer of property claims in this sector. Smaller declines were recorded in the services sector. Gross investment declined from some 26% of GDP in 1989 to around 15% in 1992, and the external sector
began to show a sharp deterioration in 1993. At this time a recovery in domestic demand contributed to a strong acceleration in imports while exports fell by some 12% in real terms, resulting in a noticeable widening of the external gap (Table 7). In 1994 the external balance remained largely unchanged and the recovery of GDP growth reflected a strong expansion of domestic demand, in particular form investment and private consumption, as household’s disposable real income increased by over 3%.

The loss of trade with other CMEA countries presented a major disruption to the Hungarian economy, which eliminated existing productive structures and interrupted long standing business links that could only be replaced to a limited extent by trade with other markets in the short run. Even though the importance of CMEA trade disruptions may have been less in Hungary than in several other countries, with rouble trade accounting for about 42% of exports in 1988 (an additional 10% was conducted in convertible currencies with the then socialist countries), these disruptions did represent a major shock to the domestic economy. However if this had been the only major shock, external trade would have also recorded the sharpest contraction in its aftermath. Yet this did not happen and the share of exports in GDP remained fairly stable during the years 1991-92.

The Hungarian government has been slow to reduce its dominant influence over the economy. The share of general government expenditure in GDP increased by almost 10 percentage points in 1991-93 to over 60%. The large role of the state contributed to a heavy tax burden with disincentives for work and investment, and negative effects on overall production in the economy. The increased government expenditure was partly a result of increased, and inadequate targeting of, social expenditures related to declining economic activity. In addition to the level of state involvement, the widening borrowing requirement
of the public sector (Table 6) is likely to have resulted in some crowding out of private credit with negative effects on investment.

The effect of uncertainty on investment may have slowed the transformation process initially as enterprises postponed investment activities until at least some of the uncertainties were resolved. However in view of its political stability and sizeable inflow of foreign direct investment (Table 13), this argument is probably less persuasive in Hungary for the years 1990-93 than in most other countries of Central and Eastern Europe.

Other factors contributing to developments in GDP at this time included a redistribution of income towards labour and a resulting deterioration in enterprise profits, which had negative repercussions on investment and on the short term growth capacity of the economy. A sizeable rise in household saving rates at the beginning of the transformation process in 1991-92, may have weakened demand and output in this period. The situation changed dramatically in 1993 when the share of household saving in GDP fell by about 6 percentage points. There was a slow growth of credit to enterprises during this period, a reflection of risk assessment, which contributed to pricing many enterprises out of the credit market. On the credit supply side the financial weakness of the banking sector contributed to the slower credit expansion, with most of this being absorbed by the public sector. The recession in Western Europe, depression in other transforming countries, a prolonged drought with large output losses in the agricultural sector, UN sanctions against the neighbouring Federal Republic of Yugoslavia (Serbia/Montenegro) also contributed to GDP developments at this time.
Inflation

Inflation rates accelerated in 1990-91, peaking in mid 1991 at around 40%. Whilst it has declined since it has shown considerable inertia, remaining at around 20% since early 1992. This inflation inertia to some extent reflects the gradual removal of subsidies which is being implemented over a number of years and is still continuing. While this policy of gradually eliminating subsidies may have limited the size of price increases in the short term, it is likely that the cost of this policy is the entrenchment of inflationary expectations over a longer period of time.

Increases in labour incomes provided a persistent cost push factor during this period. For example during 1990-93 real wages fell by only about 2%, and the decrease was more than recovered by the 3.5% rise in real wages in 1994.

The conduct of monetary policy also contributed to persistent inflation. Without well explained and well understood monetary targets, including that for the exchange rate, the economy lacked a clearly visible nominal anchor. Exchange rates were adjusted intermittently in an ad hoc fashion against a basket of currencies, with considerable uncertainty surrounding each devaluation and the exchange rate path. Domestic monetary conditions also lacked at times the necessary firmness and stability for reducing inflation. This was particularly apparent in 1992 and early 1993, when an easing of monetary conditions was accompanied by a sizeable sharp decline in market rates of interest.

The inability of monetary policy to address the inflation problem more decisively reflected to some extent insufficient support from other policy instruments, most notably that of fiscal policy. Public sector dissaving also contributed to the large external current account gap that increasingly required the attention of monetary policy instruments, at times at the expense of a lower inflation rate. The effectiveness of monetary policy was further hindered by the ease of availability of government funds.
guaranteed and subsidised credits. This effectively protected a considerable segment of the market from the transmission mechanism of indirect monetary policy instruments through interest rates. These forms of credit amounted to about two thirds of the increase in credit to enterprises in 1994.

The external balance and foreign debt

Early on in the transition process the external accounts performed much better than anticipated. In terms of the saving-investment balance, this reflected a strong improvement in household saving in 1991-92 and weak investment demand. Hungary was also initially successful at containing imports even as trade was liberalised. Exports were directed towards the West, and the share of industrial countries in total exports increased from 40% in 1989 to almost 70% in 1992. By 1994 about 52% of total exports went to the EU with Germany accounting for 28% of total exports (Table 10).

The current account was in surplus over the period 1990-92 and the net debt level decreased by $800 million to about 43% of GDP. Interestingly, Hungary attracted larger inflows of foreign direct investment than any other country in Central and Eastern Europe, averaging over $1 billion in this period (Table 13). In addition, the renewed access to international capital markets after 1990 enabled the central bank to borrow from abroad and increase its foreign exchange reserves (Table 9).

In 1993 and 1994, however, the current account deteriorated noticeably, being $3.5 and $3.9 billion respectively (each close to 10% of GDP), with a sharp decline in exports but continued strong growth in imports. This development was due to a number of developments including a loss of cost competitiveness arising from comparatively large increases in labour costs during 1990-92, which left labour costs considerably above those in other
transition economies. There was also a strong growth in domestic demand which stimulated imports but a recession in Western Europe which depressed exports. In addition the large dissavings of the state, with a fiscal deficit of 6.7% and 6% of GDP respectively in 1993 and 1994 (Table 6), weakened the macroeconomic saving-investment balance. On the supply side a drought related reduction in agricultural exports, repercussions from the 1992 bankruptcy law and the effects of UN sanctions on a neighbouring country also played a role in widening the external deficits.

The deterioration of the current account in 1993 and 1994 was offset by non debt and debt creating capital inflows. Foreign direct investment was particularly strong in 1993, exceeding $2 billion, assisted by the partial privatisation of the telecommunication sector. In international capital markets enterprise and, especially, official borrowing increased strongly during this period, with the latter concentrated in the bond market. This was in part used to increase the foreign exchange reserves of the central bank, which increased to $6.8 billion at the end of 1993, with a further small increase to $6.9 billion in 1994.

The deterioration of the current account resulted in a further increase in foreign debt. Gross external debt increased to $27.7 billion (69.5% of GDP) (Table 8) and the debt service ratio$^4$ increased precariously to 60.8% in 1994. Such developments indicated an urgent need to reduce the size of the current account deficit, and to bring about changes which would reduce the country’s external indebtedness. Policy makers in Hungary have recently initiated measures to tackle this important issue.

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$^4$ Debt service payments as a per cent of exports of goods and non factor services.
Poland

Poland has received significant attention because of the recovery of growth of the economy since 1992, the first of the Central and Eastern European transition economies to achieve such an outcome. This followed a period in 1990 and 1991 which saw a collapse of economic activity (Table 2), after the introduction of a comprehensive program for economic transformation. Since Poland embarked on this program earlier than the other countries of Central and Eastern Europe, the recovery of output and Poland's experiences contain valuable lessons for other countries pursuing the road to a market economy.

Economic performance in 1990, the year in which the reform program was introduced, was mixed. Inflation reached the hyperinflationary level of 585% (Table 3), reflecting in part the initial choice of a fixed exchange rate at 9,500 zlotys to the US dollar. The general government fiscal balance recorded a surplus equivalent to 3.2% of GDP (Table 6) which was in part due to a one off increase in revenues arising from the taxation on nominal inventory valuation adjustments, taxation that contributed to the decapitalisation of the state enterprise sector. An incomes policy was set in place with a projected level of inflation that in the event turned out to be an underestimate, resulting in real wages falling sharply. This and the fiscal outcome resulted in a decline in domestic demand in 1990, which contributed to the sizeable surplus on current account (Table 7). These activity dampening developments contributed to the sharp decline in GDP growth in this year by some 11.6%.

It was anticipated that economic activity in 1991 would recover, but once again GDP declined by a further 7%. The most important factor contributing to this further decline was the collapse in trade amongst the CMEA partner countries, and the resulting deterioration in the terms of trade. There was also evidence of slow adjustment to the new economic realities with
real wages increasing by 3%, reflecting in part the persistence of inappropriate incentive structures in the state enterprise sector. In addition a combination of reluctance on the part of enterprises to shed labour in the face of real wage increases and declining demand, contributed to a steep decline in enterprise profits. This in turn contributed to a decline in revenue to the government at a time when there was intense pressure to expand the social expenditure program. This was further compounded by the postponement of a value added tax to replace the turnover tax in this year, and the poor targeting of social expenditure programs.

Overall consumption gained at the expense of investment in 1991, with an associated deterioration in Poland’s current account balance, foreign exchange reserves (Table 9) and noticeable appreciation of the real exchange rate. These developments did not result in an acceleration of inflation. Although it still remained high, at 70%, this was significantly less than its rate in 1990.

The outlook as Poland entered 1992 was for a prolonged period of pronounced adjustment, and it was hoped that output in that year would fall no further. However the economy experienced a sharp turnaround in the early part of the year, with industrial production, in particular, showing a major recovery rising by 4.2% in 1992 (Table 5) after a cumulative decline of 42% during 1989-91. The recovery was broad based reflecting mainly favourable domestic supply factors, assisted, in part, by increased access to EU markets and gains in competitiveness from a further currency devaluation in February. The private sector played a key role in the recovery, with industrial production in the private sector increasing by 32% while in the state sector it declined by 5%. As a result the share of industrial output in private hands increased from a fourth in 1991 to almost a third in 1992. Industrial productivity was also considerably enhanced by the substantial shedding of employment. In addition
within the state sector there was increasing evidence that enterprises were adjusting to the realities of hard budget constraints, implying a general strengthening of corporate governance. GDP increased by some 2.6% in this year.

Despite attempts to reduce it, and the buoyancy of the economy, the fiscal balance deteriorated further in 1992, largely reflecting the persistence of underlying structural problems in the budget and difficulties in the implementing structural reforms on both the revenue and expenditure side. The introduction of a comprehensive tax on personal incomes in January 1992 was a notable exception. The fiscal deficit for the year was equivalent to 6.7% of GDP.

Whilst the trade balance improved, primarily due to a larger decline in merchandise imports relative to exports, the current account deteriorated further (to 3.7% of GDP), largely due to a sizeable increase in the deficit on net income flows.

Official projections for 1993 included a rise of 2% in real GDP. However the actual recovery in economic activity was much stronger, especially in the first half of the year. For example industrial production in mid 1993 was 8.5% higher in comparison to the equivalent period in the previous year, with employment in this sector stabilising. However the increase in demand in 1993 outstripped that of supply, and the savings-investment balance deteriorated by some 4 percentage points of GDP. Progress in terms of consumer price inflation continued with inflation falling to 35% for the year.

The fiscal deficit for the year was equivalent to 2.9% of GDP, significantly less than the anticipated deficit of 5% of GDP. The improved result reflected buoyant revenues from the stronger than expected recovery of economic activity, and the successful introduction of a VAT to replace the system of turnover taxes. However the sizeable deterioration of the trade balance and the current account was of considerable concern, largely arising from
a significant increase in imports with the further recovery of economic activity. Concerns about the deteriorating trade performance and Poland’s international competitiveness, influenced the decision to devalue the zloty by a further 7.4% against a basket of currencies in August 1993. At the same time it was announced that the rate of crawl would be reduced from 1.8% per month to 1.6% per month. Developments towards the end of 1993 and early 1994 indicated a reversal of the deterioration of the trade balance and a strengthened international reserve position, suggesting that the strong domestic excess demand pressures had significantly been reduced. Inflation, however, was still proving to be stubbornly high.

The 1990 transformation was introduced against a background of large and growing macroeconomic imbalances. Since this time the Polish economy has made substantial overall progress on its transition path to a market economy. Major success has been achieved in reducing inflation from the hyperinflationary levels in 1989 and 1990, to 32% a year by 1994 and this is projected to fall further in the near future. Reflecting this development, confidence in the zloty is being restored and the country has begun to remonetise. The impact of comprehensive liberalisation has been to reduce queues apparent during the 1980s, and the range and quality of goods available has dramatically improved. The economy has also acquired a growing and dynamic private sector, accounting for some 50% of total output. In addition the financial performance of many state enterprises has greatly improved in advance of their privatisation. The liberalisation of Poland’s trade regime has also resulted in an outward oriented economy that is looking to exports for growth. Finally, economic activity has been expanding in Poland over the past 4 years, making it the most rapidly growing transition economy in Central and Eastern Europe.
PROSPECTS FOR MEMBERSHIP OF THE EU

Membership of the EU by the three economies under study, as well as that of Slovakia and Slovenia\(^5\), will be essentially a political rather than economic decision. Certainly few economic commentators in Western Europe would be serious enough to extend EU membership to these Central Europe countries at present on purely economic grounds. EU membership requires the fulfilment of three conditions:

i. applicants must be European,

ii. applicants must be market oriented, and

iii. applicants must be democratic.

All of these conditions have now largely been satisfied by the three economies under review. From the perspective of these countries priority must be given over the next few years to obtaining full membership of the EU, with any watering down of this likely to be unacceptable. Integration with Western Europe offers the prospect to them of a better way of life and a higher standard of living. Membership of the EU would provide them with the basis to achieve the kind of society which they wish to become. From the EU's perspective the costs and benefits of such membership, both economic and political, need careful scrutiny. Some of the key issues relating to this are now discussed.

A number of problems are likely to arise from the possible membership of the Central European economies, and these include:

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\(^5\) These fellow Central European economies have also applied to join the EU. Although much smaller size than the three economies reviewed in this paper, populations of 5.4 and 2.0 million respectively, they have a similar GDP per capita, and were projected by the IMF to achieve real growth rates of GDP between 4-5% over the period 1994 to 1996.
The economic imbalance between the EU and the Central European economies

The countries of Central Europe constitute a market of some 70 million people. The demand for high quality produce from the west is very strong and would appear, therefore, to be an inviting new market for the west. However, Central Europe in comparison with Western Europe is still poor (Table 11), with living standards being approximately one-third of that of the EU average⁶. Central Europe itself admits that EU membership will have adverse consequences for some of its own industries, unable to compete with the west, but sees an expanded market as offsetting these adverse effects bringing benefits to domestic producers.

Common Agricultural Policy

One major problem standing in the way of Central European membership is the EU’s Common Agricultural Policy (CAP). This presently accounts for about half of the EU’s budget. Unless this is radically overhauled and farmers exposed to world prices and markets, the cost of integrating Central Europe will be equivalent to one-third of existing farm spending according to calculations done by the EU in Brussels. Alternatively the larger farming states of Central Europe, particularly Poland, might have to be content with some watered down form of membership that keeps them out of the CAP. This is of concern to the Central Europeans who may find such “second class” membership unacceptable.

The contribution of agriculture in the EU and Central Europe is very lopsided. The exception to this is the Czech Republic which

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⁶ The poorest country to join the EU to date has been that of Portugal, which had a standard of living approximately half of the then average of EU members.
is much closer to EU averages (Table 12). In the EU only one person in 20 makes a living from the land, whilst in Poland (accounting for almost 60% of the population of Central Europe) one person in three lives in the countryside and mostly lives off it too. In Hungary nearly a third of the population live in the countryside, although only a tenth are formally employed in agriculture. Central Europe is very rural, with some 58% of its land area given over to farming compared with 43% in the EU. The sector accounts for 5.5% of Central Europe’s regional GDP which is over twice its average share in the EU. Farming is particularly important in Poland where, unlike say Hungarian farmers who were collectivised, Polish peasants continue to cultivate small plots in the way that they always have. Polish farms are very small with an average size of 7 hectares, whilst the EU average is 16.

Like Hungary, Poland is a large exporter of food. But, unlike Hungary, it has become a net food importer since its transition to a market economy. One reason for this is that its food industry does not provide the quality Poles now expect. The small farms in Poland therefore cannot compete, and could only survive in the EU with an unacceptably high level of financial support. Major restructuring of the Polish economy would therefore be required. The problem for Poland would be compounded by the fact that its cities already have high levels of unemployment, higher than in most of Central Europe, and could not easily absorb a massive influx of people from the land. The EU in a recent review of the former eastern bloc’s farm prospects, concluded that any future financial support should go into rural infrastructure, modernisation and putting together smallholdings to make viable farms. Certainly not into maintaining prices and incomes.
Disharmony and instability

Instead of co-operating with each other, the countries of Central Europe compete and squabble amongst themselves. In addition there is always the question of political and economic instability. Foreign direct investment (FDI) is a key measure of the perceived stability of an economy. The three Central European economies focused upon in this paper are short of cash and hence the role of FDI will be crucial to their development. However since 1990 the picture is quite variable (Table 13). Poland and the Czech Republic, for example, have proved to be very disappointing in this regard. The stable and market minded Czech Republic might have been expected to have been very attractive to foreign investors. Yet total foreign investment since 1990, at under $4 billion, has been disappointing. This could be due to the fact that the government still controls much of basic industry. The low unemployment rate of below 5% suggests also that it has failed so far to undertake essential industrial restructuring. Poland similarly has performed disappointingly in this regard, and one reason suggested by German investors, the major single source of FDI to these countries, is the instability caused by the numerous changes of government. Since 1990 they have had a different government every year. Hungary shifted relatively easily to western ways in the 1990s, and has attracted nearly half the $18 billion of FDI in Central Europe since 1989, although the pace of this is slowing down. However Hungary’s recent intense financial plight (high budget deficits and perilously high foreign debt) has resulted in the imposition of a tight austerity program, which threatens economic growth and FDI. Membership of the EU could ease such concerns about instability which appear to exist, thereby encouraging further FDI for these three countries.

After the deliberations of the present 15 EU members as to their own future in Spring 1996, it would then be possible for serious negotiations to take place over the membership of the
Central European economies. A number of encouraging developments have recently taken place which would improve their prospects.

- The economic performance of the three economies under review has been improving, with obvious problems still apparent. Poland's economy is the fastest growing in Europe, with 5% real growth of GDP anticipated for 1995 and 1996. Well above that in the EU itself. Already around 60% of GNP comes from the private sector. Poland has recently been compared with the Asian tiger countries by the German Deutsche Bank. Inflation is coming down but still remains too high, whilst unemployment at around 12% is the same as in France and much lower than in Spain. Problems with agriculture, in particular, keeps the country's standard of living down. The Czech Republic is now also experiencing steady growth of real GDP comparable with that in the EU, inflation is still well above the average in the EU but is still better than some members such as Greece, but unemployment is much below that of the EU. Hungary has been slow to recover from the initial sharp drop in output arising from the economic reforms, and inflation has remained stubbornly high as with unemployment. Its major difficulties remain in terms of the fiscal deficit, the current account deficit and its very high, per capita, foreign debt.

- The three countries have reoriented their trade towards the EU very successfully (Table 10) and would wish to expand this further, as well as attracting further FDI from EU members. Germany, in particular, has become a very important market for their exports, and is a major source of capital imports in particular. In the space of five years, well over half the region's trade is now conducted with Western Europe with invariably Germany as the leading partner. Germany is also the major source of FDI for the Central
European economies after the US and Italy, and, under the leadership of Chancellor Kohl, is also a major sponsor of Central European membership of the EU.

- The countries of Central Europe have a number of advantages including a cheap and well educated labour force, and a dynamism which has enabled them to redirect their trade so effectively to the west.
- So far in Central Europe this labour force has remained where it is, however further instability could create a wave of migration which would be difficult to control and Germany, in particular, would face the brunt of it. Hence a major, and influential, sponsor of Central European membership of the EU has been Germany. The desire to see stability and rising living standards in the countries on its eastern borders, is seen as being very important to them. Chancellor Kohl has made little secret of his desire to see membership of the EU by the Central European countries by the end of the decade. This time period, at the very least, will be required to enable these countries to achieve a level of development compatible with membership of the EU.

SUMMARY/CONCLUSIONS

This paper has conducted a review of the recent economic reforms and post reform macroeconomic performance of three Central European economies — Czech Republic, Hungary and Poland. The reforms implemented clearly had a traumatic initial impact upon these countries, however there are positive indications that these economies are now in the recovery phase. The extent of this varies across the three countries. Poland’s recent economic growth has been very strong and their is the anticipation that the Czech Republic is about to achieve the same, although Hungary’s performance is still very weak. Major restructuring will still be
required, particularly in the Czech Republic and Hungary, although significant progress in a number of areas has already been achieved. The remarkable reorientation of their trade towards the EU since the reforms and the continuing need for FDI to facilitate the restructuring process, suggests that these countries must look west. The development of their market oriented economies, desire for a higher standard of living and quality western goods by the populace, as well as desire for security and political independence, all indicate that their future lies with Western Europe and membership of the EU in particular.

These countries have a major sponsor for EU membership in the very influential form of Germany, by the year 2000 according to Chancellor Kohl, which would see the membership of these countries as achieving a number of their political and security goals. However it seems apparent that the EU which these countries wish to join is not necessarily that envisaged by the German authorities. The latter envisages a united economic and political Europe, including that of a European parliament, central bank and single currency, however the Central Europeans have a vision which is closer to that of the UK’s, where Europe would be made up of independent nation states united mainly for economic rather than political ends. This would add another interesting dimension to the future evolution of the EU, should these countries achieve membership by the end of the century.
<table>
<thead>
<tr>
<th>Share of Exports in GNP</th>
<th>Eastern Europe(^2)</th>
<th>USSR</th>
<th>Industrial Market Economies</th>
<th>Developing Countries</th>
<th>Others(^3)</th>
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<td>48.8</td>
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1 Figures for Hungary, the CSSR and Poland are based on IMF: *International Financial Statistics*; Soviet figures according to IMF et al.: *PLANECON*, 1990; figures for Bulgaria and the CSR are estimates; figures for the GDR refer only to industry and are from DIW Wochenbericht 12/91.

2 CMEA-6 (incl. GDR).

3 Includes PR China.

Table 2 Real GDP Growth (%)

<table>
<thead>
<tr>
<th>Year</th>
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<th>Hungary</th>
<th>Poland</th>
<th>EU</th>
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<td>-11.90</td>
<td>-7.00</td>
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<tr>
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<td>1.00</td>
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<tr>
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<tr>
<td>1994*</td>
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<tr>
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<td>1996**</td>
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<td>5.00</td>
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</table>

* Estimates  
** Projected  
*** Until 1992 The Czech and Slovak Federal Republic (SCFR)  

Table 3 Consumer Price Inflation (%)

<table>
<thead>
<tr>
<th>Year</th>
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* Until 1992 The Czech and Slovak Federal Republic (CSFR)  
### Table 4 Unemployment (% of Labour Force)

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Source: IMF and EIU

### Table 5 Industrial Production (1990=100)

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* Preliminary
** Figure for the forth quarter
*** Figure for the third quarter

Source: IMF and Author's Calculations
### Table 6 Fiscal Balances (% of GDP)

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<th>EU***</th>
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<td>-0.10</td>
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<td>-3.30</td>
<td>-4.80</td>
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</table>

* Estimates  
** Forecasts  
*** General Government Fiscal Balance  
Source: IMF

### Table 7 Current Account ($ Billion, % of GDP)

<table>
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<tr>
<th>Year</th>
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<th>EU</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>$ Billion, US</td>
<td>% of GDP</td>
<td>$ Billion, US</td>
<td>% of GDP</td>
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<td>—</td>
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<td>-1.90</td>
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* Estimate  
Source: IMF
### Table 8  Gross External Debt ($ Billion, % of GDP)

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Source: IMF

### Table 9  Gross Reserves ($US Billion)

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* 1989-92 The Czech and Slovak Federal Republic
** Third quarter figure only

Source: IMF, International Financial Statistics (Various)
Table 10: Trade with the West. Trade figures as % of total, 1994

Source: IMF
Table 11 Living Standards

<table>
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<th>Car Ownership 1995, % of households</th>
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* At PPP exchange rates † 1993
Sources: World Bank; ANR: German Federal Statistics Office
Table 12 Agricultural Production/Employment

Agricultural Production
as % of total GDP, 1993

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Agricultural Employment
as % of total employment, 1993

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Source: European Commission
Table 13  Foreign Direct Investment, $bn, 1990-1995*

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* To October
Source: National Statistics
REFERENCES


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<td>C. Nyland</td>
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