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Communism to Capitalism in Hungary and the Czech Republic:

The Transition to a Market Economy

In the twentieth century, Communism was an ever present, dominating regime that controlled society and all economic activity all over Europe in the 20th century. The state dominated all enterprises, controlling every aspect of it including labor. Under this regime, every person living in the country was assured a job. This also meant fixed income. Prices were adjusted to accommodate the incomes of the working class, thus the way of life in the pre-1989 era was stable, yet poor and unchangeable. In Hungary and Czechoslovakia, Communism was a way of life. "Though Communism had always been historically weak,"[1] it brought food to the table and job security for the locals. The economies of both countries were running in this continuous circle, and not much from the outside was allowed in the state. After the breakup of Communism in 1989, the main problem came with, "the disastrous conditions in which the great majority of working people have been forced to live."[2] The Hungarians and Czechs are worse off now than they were in the 1980's, but their mentality is said to be apathetic. For example, in Communism, everyone was forced to be a member of some sort of Communist controlled organization, such as trade unions. Now that democracy is present, people are not forced to do anything, but they have lost that sense of security they once had. One must not overlook the fact that the Communist regime in Hungary "was the least repressive among

[1] Peter Gowan, "Communists and workers in ex-Communist Europe," *Monthly Review* 1 May 1998, 44.
[2] Ibid. 46.

Communist states: It tolerated the greatest degree of contact with the West."[3] Hungarians today have "the freedom of speech and travel, but in material terms, they are worse off."[4] In Czechoslovakia, "almost half the population was dissatisfied and nonsupportive of economic reform."[5] During the Cold War, "Czechoslovakia had one of Communism's highest living standards."[6] "Before the end of the world war, Czechoslovakia was one of the world's most developed economies."[7] In the 1970's, Communist countries began to see some growth. Hungary was enjoying a 3% growth rate and Czechoslovakia was seeing a rate of 5%. In summary, these countries were doing relatively well in their standards during Communism compared to the situation of their economies immediately after 1989. The question that now prevails is this: Were both countries ready for the transition to democracy? Were the state-owned enterprises ready to become privatized? These countries began to face serious economic reforms as result of this transition, and the labor and industrial sectors were not prepared for this drastic change.

First, we must understand some of the history that brought these two countries to where they stand right now.

HUNGARY:

On August 20, 1000 AD, Stephen the Saint commemorated the founding of the first Hungarian state. After many years, there was a revolution on March 15, 1848 between Hungary and the Hapsburgs. At this time, the Hungarian community revolved around agriculture, and they were trying to preserve their local government. The non-violent velvet revolution was promising for the Hungarians in that it signified the

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[3] Peter Kenez, "Letter from Budapest, the mood in Hungary," *The New Leader* 1 July 2001, 12.
[4] Kenez, "Letter from Budapest, the mood in Hungary," 13.
[5] George J. Church, "The Shock of Reform Creating a Market Economy," *Time* 17 February 1992, 38.
[6] "The New Bohemians: the Czech Republic," *The Economist* 22 October 1994, 23.
[7] Ibid. 23.

independence of the country. 50 years later, the 1956 uprising came, which was the largest uprising against the Soviets. The uprising was a peaceful attempt at sovereignty and independence from Soviet rule. Then on June 16, 1989, many people gathered at Heroes Square for the reburial of the 1956 revolution leader, Imre Nagy. This led to the peaceful transition from Communism to democracy.

CZECHOSLOVAKIA

Czechoslovakia was created on October 28, 1918, after the fall of the Austro-Hungarian monarchy. In Czechoslovakia, democracy fell around February 1948 and Communism took over. In Prague on November 17, 1989, university students pay tribute to the memory of Jan Opletal, a Czech student who died of injuries suffered during anti-Nazi demonstrations in the autumn of 1939. The act develops into a demonstration in which political changes are demanded. The student demonstrations were gradually joined by all of the state population calling for political reforms and acceleration of the process of democratization. On November 28 of that same year, Communism in Czechoslovakia was abolished, and Václav Havel was elected President of the new republic.

Privatizing Hungary and Czechoslovakia would be a hard task for both countries. We first have to look back at privatization in a historical perspective to understand what path both countries should pursue. "In the late 19th century, the Czech lands produced 70% of the Austro-Hungarian empires industrial output." [8] Both countries, before 1945, "were more strongly dominated by foreign owners."[9] The role of foreign capital in the 1930's was 30% in Czechoslovakia and 24% in Hungary, all coming mainly from heavy industry. Germany played the biggest role, penetrating capital in Hungary through heavy

[8] "The new Bohemians: The Czech Republic," 23.
[9] Zoltan Bara, "Privatization in Hungary and Central Europe," 2.

metal, chemicals, and heavy industries. In Hungary, "former boss Janos Kader's 'goulash communism' allowed some privatization of industry (15% by 1989) and considerable management by state-owned enterprises."[10] Goulash socialism meant that the state control of the economy was not absolute. Looking back even earlier, only 25 joint stock companies owned a share of foreign ownership in a registered equity in Hungary around 1937, 29 companies in Czechoslovakia. By the end of 1986, Hungary's number of joint ventures in Eastern Europe was 86, Czechoslovakia's was only 1. Two of these companies originating in Hungary are MOL (national oil and gas company), and Dunaferr (steel work), both major exporters from pre-1989, and still remain among the top as of 1998. Czechoslovakia was enjoying a highly developed infrastructure, "including the core of Central Europe's railway network."[11] Before 1989, textile and steel industries were the major sectors in Czechoslovakia and Hungary. After the transition, these sectors "suffered deep drops in production and endured the heaviest layoffs."[12] Czechoslovakia suffered a steeper drop in government spending than Hungary did. "Between 1989 and 1992, government spending as a share of GDP fell by 14 percentage points."[13] "There was no well-developed banking system capable of siphoning capital and credit to entrepreneurs. No country had been able to figure out a way to convert state businesses to private ownership."[14] This problem would plague Czechoslovakia for the first years after 1989. The transition that lay ahead was going to facing some turbulent times, and the local people were beginning to have difficulties with the situation they had just been handed.

[10] Church, "Shock of Reform Creating a Market Economy," 40.
[11] "The new Bohemians," 23.
[12] Ibid. 40.
[13] Ibid. 24
[14] Ibid. 38

The new emerging question becomes this: Why privatize? The economies of these two countries seemed promising under the states control. What will privatization bring to Hungary and Czechoslovakia? Privatizing former state-owned enterprises meant that more foreign investment was needed. By bringing in more FDI, the technology gap between the West and once isolated East can be bridged. Entrepreneurship was also lacking, thus there was a need to replace "bureaucratic incentives with profit-oriented ones at the company level."[15] Strengths to this new process are that the government will have little interference, competition and efficiency can be promoted, and both countries can see a rise in "globalization through cross-border mergers and/or acquisitions."[16] Problems will also arise, posing some weaknesses to the privatization process: "Resistance from existing management, labor unions, local interest groups, and from the political class."[17] The bottom line is this: Hungary and Czechoslovakia are now able to privatize the former state-owned businesses but need to attract investors while not forgetting about the workers themselves. The fall of Communism meant democracy, and this leads to a new market economy. "Democracy requires more than free elections and free press."[18] What both countries desperately needed was the right leadership to give the economy a sense of direction.

Each country had several different parties that at the post-1989 time, needed to immediately introduce a plan to help their country survive and prosper. There was a need to help the underdeveloped economic stagnation, introduce various aspects of Western life, and most importantly help preserve their independence in a Central European

[15]Bara, "Privatization in Hungary and Central Europe," 2.
[16]Ibid. 3.
[17]Ibid. 4.
[18] Stephen Budiansky, "Democracy's Detours," *US News and World Report*, 27 January 1992, 47.

location. Major confrontations of society also reflected on the parties: Urban versus rural and capitalists versus the labor class. We will first look at Hungary:

HUNGARY

In the 1990 elections, the Hungarian Democratic Forum (MDF) won 24% of the votes, the most that year. At the time, Jozsef Antall was the leader, and he molded the party into a, "Christian-conservative-national liberal image."[19] After the death on Antall, the party took a downward spin in February 1996 that led to the branching out of the short lived Hungarian Democratic Peoples Party (MDNP). However, the most significant party is the Hungarian Socialist Party (MSZP). In 1990, they received only 10% of the votes, but now in 2002 control the Parliament by winning 42% of the total votes (178 seats). The MSZP represent left-wing universalists and cosmopolitans. This party is more prevalent in urban areas and more tolerant with relationships amongst their neighboring countries. The third major party is the Young Democrats, or FIDESZ for short. This party emerged in 1988 out of the liberal camp and has transformed from a, "centre-right moderate-pragmatist party,"[20] to an economically and cultural right wing party. The most prominent leader of this group is Viktor Orban, a man who, "Wants Hungary to build up its economic muscle through small and medium-sized family-owned companies and wants to help half a dozen or so Hungarian-owned heavyweights to emerge on the global stage."[21] "FIDESZ has managed to undermine the smaller parties that have been in alliance with it and to attract their voters."[22] Orban was pointing Hungary in the right

[19] Mary Kaldor, *Democratization in Central and Eastern Europe* (New York: Continuum, 1999), 109.
[20] Ibid. 111.
[21] "Viktor Orban: and assertive Hungarian," *The Economist*, 2 March 2002, 47.
[22] Kenez, "The mood in Hungary," 14.

direction, but he lost the recent election by a slim margin to the Hungarian Socialist party.

CZECHOSLOVAKIA

Czechoslovakia was formerly dominated by the, "neo-liberal Civic Democratic Party (ODS)."[23] Prime Minister Vaclav Klaus was the presiding leader of this right-wing/conservative party. ODS is said to be neo-liberal when it comes to economic policies, helping to pass the voucher privatization program. This was a quick method of privatizing state-owned enterprises. "A novel feature of the program is the public sale of $37 voucher booklets containing 1,000 investments points redeemable for the stock of state-owned companies."[24] By mid-1993, $5.8 billion in assets were transferred to the public sector. The program also sold shares of land to the public, now, 100% of the land is privatized. Currently, a coalition of center/left Social, Christian, and Freedom Democrats holds the majority in Parliament.

The approach to the new transition must be accomplished with caution and speed. Property and businesses needed to be quickly privatized to overcome the problems that began to surface. Unemployment was the largest problem both countries faced following the fall of Communism. The unemployment rate in Czechoslovakia in 1991 "has risen to 8% and is certain to go higher."[25] As a result of this, production fell by 16%. In Hungary, 7.3% unemployment rate caused a 6.5% drop in production. [26] By the end of 1999, the unemployment rate was around 9% for both countries. Inflation was another set back for these two countries in transition. In Czechoslovakia, inflation "totaled 60% for all

[23] Kaldor, Democratization, 82.
[24] Church, "Shock of Reform Creating a Market Economy," 40.
[25] Ibid. 40.
[26] Ibid. 40.

1991,"[27] while Hungary was the lowest in Eastern Europe at 34%. Another dilemma Hungary faced was debt, "including a foreign debt of over $20 billion, the largest per capita debt in Eastern Europe."[28] In order to overcome this debt, mass privatization needed to be implemented. Additionally, "The greatest social consequence of Communism's collapse has been a huge widening of the gap between the poor and the well-to-do."[29] The working class was being threatened by wealthy investors from the outside, and income remained low (an average of $250 maximum a month for the past decade). "Having regained their freedom, what Hungarians want is simply a better life."[30] Now the task of fixing these problems begins.

The newly democratized countries had to develop quick privatization strategies. The key concepts of the former regime must be reversed. "Czechoslovakia seemed the most promising country to undertake a smooth transition."[31] The labor force there is highly skilled and their was little foreign debt. The first obvious method would be to sell the state-owned enterprises to the outside. By bringing in owners from the west, the corporations can have, "better access to capital and managerial skills."[32] Though the buyout costs will be high, the opportunities for the East increase. This "Wild East" strategy brings fast concentration on capital. Many Czechs and Hungarians did not agree with this strategy, for it increases their dependence on the outside. In Czechoslovakia, critics of the Wild East strategy say the most effective method would be Vaclav Klaus' voucher privatization system, as mentioned previously. This method prevents the sellout

[27] Ibid. 41.
[28] O'Neil, Patrick, "Hungary's Hesitant Transition," *Current History Journal* 137 (1996).
[29] Kenez, "The mood in Hungary," 13.
[30] Kaldor, *Democratization*, 119.
[31] Bara, "Privatization," 10.
[32] Ibid. 5.

of national property to foreigners. Whatever the method, the strategies must incorporate the working class, who are focused on protecting their own employment. "Managements and employee buyouts" is thought to be the "direct way"[33] to reach both countries goals and please the lower class. The Hungarian government thought otherwise and began to realize that the direct way was not effective. "During the 1994-1996 period, the government started running large deficits (7-8 percent of GDP) and inflation started to rise."[34]

This is where transnational corporations (TNC) began to emerge on the scene, and western investment was on the rise. "By the end of 1995, most valuable companies of the Hungarian economy had been taken over by TNCs. After that time there were about 1,500 Hungarian companies to sell." [35] Locals were deeply angered, saying Hungary sold the nation to multinationals, but this method was in fact bringing in serious revenue. Between 1991-1995, Hungary received roughly $600 billion HUF in hard currencies.[36] To say selling the country is morally wrong might be correct, but compared to how much money was being generated (50% of GDP is produced by TNC's), the payoff was well worth it for the economy of the country. Audi, a German car manufacturer, began producing car components in Hungary in 1993. Since then, the company has a total of $600 million US dollars invested in the country. In 1995, IBM began to manufacture computer components, investing a total of $150 million. Phillips, a worldwide electronics TNC, has pumped $125 million into the Hungarian economy since 1989. The downfall to this is that these three TNC's are not listed on the Budapest Stock Exchange, so local

[33] Ibid. 5.
[34] Ibid. 8.
[35] Ibid. 12.
[36] 6. Bara, *Tables and Charts*.

Hungarians can not invest in them.[37] On the bright side, the companies are providing jobs, employing 45% of the Hungarian workforce.

The transition of the electrical industry is a good example to look at to judge the success of privation. Before 1989, these industries were heavily controlled by the state. After the fall of Communism, foreign investors saw this as, "the most ambitious privatization program."[38] In Hungary, MVR was the dominant electricity company under Communism. In 1996, the company was broken up into 6 regional power distribution companies and all were sold to outside investors. Additionally, General Electric Lighting, a US based electricity firm, has produced $776 million for Hungary, becoming a key player in this industry.

The main goal for the Hungarian and Czech governments was to create a favorable business climate for these TNC's. What did they have to offer? Cheap labor. In Hungary, the wage level is 10% of the average of the rest of the European Union. For the TNC's, that is inviting. They can concentrate more money on capital goods and less on labor, which ultimately results in higher profit margins. Czechoslovakia has a highly skilled workforce, giving them an advantage over their bordering countries. On the negative side, TNC's have manipulated the labor industry by "massively cutting its purchasing power."[39] The working class has no power, which is unfortunate for them but beneficial for the MNC's.

Czechoslovakians strongly disapproved of government intervention in the micro economy, but the selling of state owned enterprises was done fast and effectively through mass privatization. "More than 100,000 properties, worth up to $4 billion, were given

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[37] Ibid. 6.
[38] Bara, "Privatization," 13.
[39] Gowan, "Communists," 45.

back to their former owners."[40] Privatizing small firms was easily done in Czechoslovakia. Since the price of these firms was low to outsiders, very few went bankrupt. Hungary on the other hand let small businesses grow with little intervention. "Czech privatization has been remarkable for the speed with which assets have changed hands."[41] The debt that remained for the larger industries was handled by the government, much to the dispute of the public. For example, Skoda Plezen is a Czech engineering firm whose debts reached 1.8 billion koruna (roughly $66.2 million US dollars) in 1993. The Czech government simply wrote off the debt.[42] Tourism also generated high profits for the country. In Prague alone, tourism totals around $5 billion US dollars a year. In the first half of 1994, 17 million visitors came to the Czech Republic, and that number has only gotten stronger in the past few years.

How successful has this transition been? By all accounts, the transition to a market economy has been extremely successful. Czechoslovakia sold 32 percent of their medium and small sized enterprises to outsiders, 22 percent through the voucher system. Hungary was even greater, selling 38 percent of their industries to MNC's. In Hungary, $909 billion HUF have been raised from 1991-1995.[43] The country has seen state-owned enterprises go from 1,857 in 1990, to 661 in 1995, and the number is now below 100. "In 1999, Hungary received 4.27 percent of its total revenue from state-owned enterprises and from government ownership of property."[44]

The governments of both countries are reducing their involvement with the economy. In Hungary, the government consumes only 10 percent of GDP, which is

[40] "The new Bohemians," 23.
[41] Ibid. 27.
[42] Ibid. 6.
[43] 6. Bara. *Tables and Charts*.
[44] Bara, "Privatization," 18.

currently almost even with its 1989 level of GDP. Inflation has also decreased since the breakup of Communism. Currently, Hungary's inflation rate is 6 to 7 percent, and Czechoslovakia's has gone from 8.5 percent in 1997 to 2.2 percent in 1999. Foreign direct investment from western countries and MNC's is flowing at a rapid pace. By 1995, Germany owned 36 percent of the FDI in Hungary, and the US was at 20 percent. The telecommunications and utilities sectors are completely privatized. The Czech banking system, once weak, shows signs of growth now. GDP is the ultimate measure of the success of this transition, and the Czech Republic's has gone from 97.7 percent in 1998 to 101.4 in 2000, surpassing their 1989 level. Currently, GDP for the Czech Republic is as 103 percent.[45] Unemployment still plagues both countries. Hungary's rate was below 10 percent in 1999, and the Czech Republic's rose from 8 percent to 11 percent for 2000.[46] Czechs have seen a decline in the unemployment rate this year (7.3 percent).[47] In order to combat the high unemployment rate in the Czech Republic, "the government continues to offer the employees and managers in the large enterprises a secure framework for the future."[48] The downfall to this is that many MNC's are going to have to "shed labor more ruthlessly in order to raise productivity and profits."[49] This problem must be fixed, or the effects of low wages and unemployment will begin to shake up the now thriving economies of these two countries. What will this do to the working class? Only time will tell us.

What the future holds for both countries is endless. Acceptance to the European Union (EU) is the first priority. 2004 is the expected year of entrance, and both countries

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[45] Czech Republic. Ministry of Finance. *Macroeconomic Forecast*. July 1992.
[46] 11, 12. Bara. *Tables and Charts*.
[47] Czech Republic. Ministry of Finance. *Macroeconomic Forecast*. July 1992.
[48] Gowan, "Communists," 50.
[49] "The new Bohemians," 25.

are ready. By getting in the EU, competitive pressure on the existing companies will rise. Economic competitiveness is something Hungary lacked on the global level years ago, but now is posing a threat to other MNC's outside Hungarian borders. 5-10 years ago, Hungary gave tax breaks to foreign investors for their investments in new corporations. The EU wants these breaks lifted, but Hungary continues to refuse, claiming this incentive is unique to their attracting FDI. This conflict has not yet been resolved, and if not done so quickly, it will deter future foreign investors.

Hungary is failing to gain support from other non-EU countries, but presses on. "So for no country has failed to benefit economically from membership."[50] Keeping that in mind, Hungary has basically been promised acceptance, so the cause for concern is minimal. Another advantage the EU brings to both countries is the benefit of trade. Getting into this organization will open the door for greater foreign direct investment. The flow of capital and FDI between member countries as well as with the rest of the world can only rise.

The Czech Republic and Hungary stand

80 percent privatized, so the process in not yet complete. Lots of work remains for the MNC's, working class, and government. In a 1995 survey, 42 percent of the Hungarians disagree with the fact that the changes in the economic system are positive, whereas 21 percent agree. The feeling is opposite up north though. 83 percent of the Czechs agree that the transition is positive.[51] An emerging problem though is the growing gap between the young and old generations. The older generation experienced Communism first hand. They were accustomed to starvation, poverty, and little opportunity. Their way of life was

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[50] Kenez, "Letter from Budapest," 16.

[51] Frydman, Roman, Kenneth Murphy, and Andrzej Rapaczynski. *Capitalism with a Comrade's Face.* Budapest: Central European University Press, 1998.

set, and change was not in their future. The younger generation of students is being given opportunities their parents never had. They have the chance to expand their horizons and make something of themselves. The education door, once bolted shut to their parents, has swung wide open and is providing many opportunities for the ambitious student. Through my personal interaction with the local students, I can see that they have a desire to overcome the lifestyle their family had. To them, Americans have a better way of life, but they realize this and want to achieve what we have. Instead of sitting quite as their grandparents did, the new generation is determined to make life better. Democracy only further fuels the young generation's intense desire for success. It gives them the chance to emerge on a global level as leaders of nation once so bogged down by Communism, now a nation of freedom and opportunities.

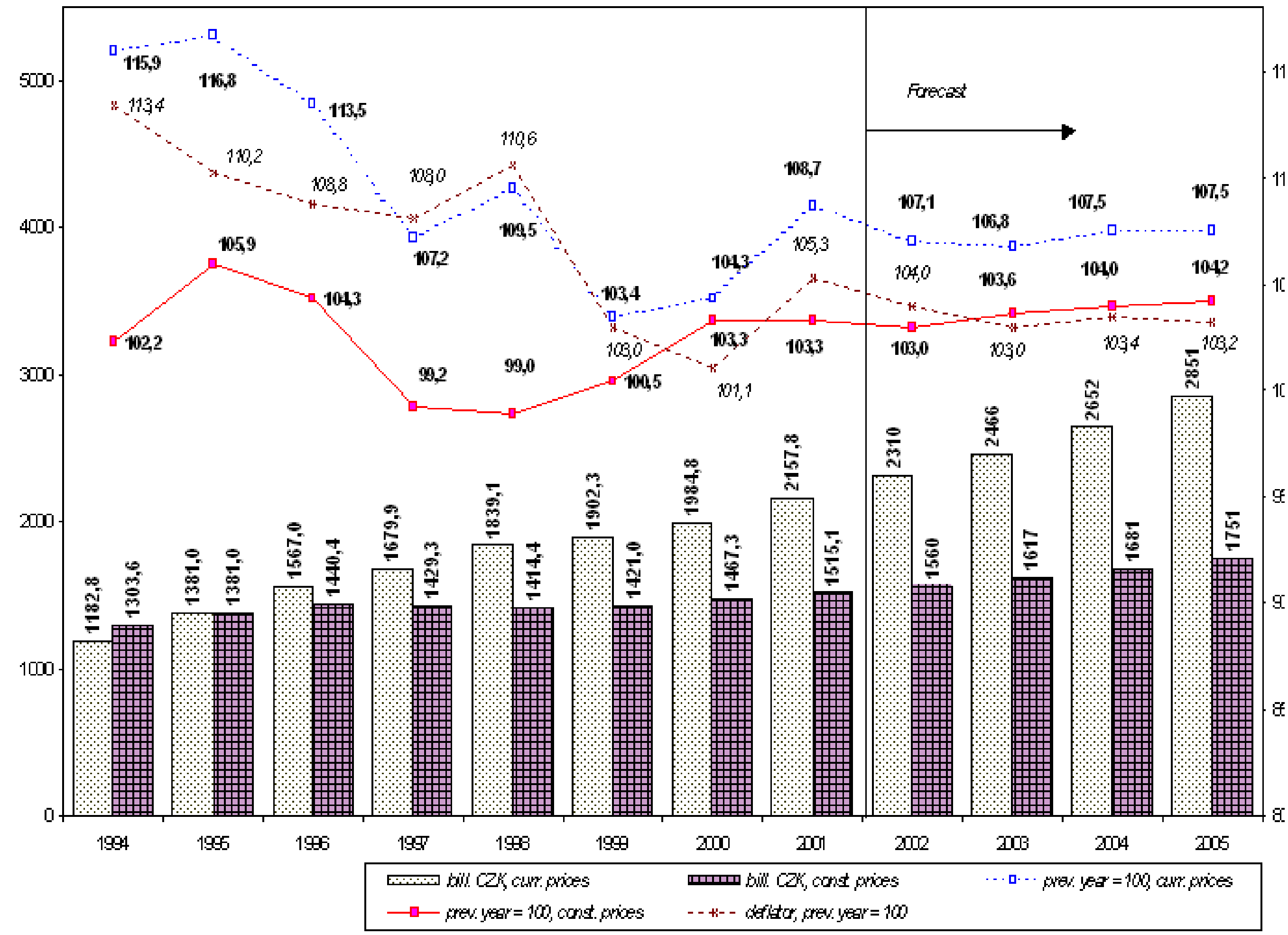
In conclusion, we have seen two countries rise from the pits of Communism to the pleasures of Democracy. Many say their country was better off under Communism, which could be true. What we do know is that both of these countries have emerged on the global market, and are finally beginning to get recognized by the world. Globalization has finally reached Eastern Europe, a place once so cold and isolated from the West. The transition to a market economy has been a rough ride, but now Hungary and the Czech Republic are reaping in the benefits. The process is not over yet, lots of work needs to be done, and time is on their side. It has taken 10 years to get this point, and the next 10 look to be more promising than the last.

Key Macroeconomic Indicators: Hungary

Description	**1999**	**2000**	**2000 1-6 months**	**2001 1-6 months**
GDP (volume index %, previous year =100.0)	104.2	105.2 e	106.1	104.2e
- Capital investments (volume index %, previous year =100.0)	105.3	106.5 e	107.1	104.2e
- Household consumption (volume index %, prev.year=100.0)	104.6	103.3e	103.2	104.50
Unemployment rate (%, annual average)	7.0	6.4	6.6	5.8
Consumer price index (%, previous year =100.0)	110.0	109.8	109.5	110.4
Industrial producer price index (%, previous year = 100.0)	105.2	111.7	110.7	108.0
Industrial production (volume index %, prev.year = 100.0)	110.4	118.6	121.0	107.3
Output of construction (volume index %, prev.year = 100.0)	108.3	105.9	105.1	108.7
External trade balance 1 (Million euro)	-2,799	-4,308	-1,753	-2,025
Current balance of payments (Million euro)	-1,975	-1,620	- 866	- 815
- Balance of tourism (Million euro)	2,078	2,533	1,047	1,195
Balance of general government (Billion HUF)	- 425	- 4492	- 213.92	- 145.92
Foreign Direct Investment 3(Million euro)	19,117	21,347	20,164	24,700
HUF/USD average exchange rate (period average)	237.3	282.3	268.3	291.1
HUF/EUR average exchange rate (period average)	252.8	260.1	257.6	261.6

Source: The Government of the Republic of Hungary

Gross Domestic Product: Czech Republic



Source: The Czech Republic Ministry of Finance