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Hungary facing globalisation:  
the challenge of competitiveness

Czédő Csaba

This 'think piece' is an attempt to survey the evolution of competitiveness in a small open economy from the perspective of the costs and benefits of globalisation. First an historical survey assesses the road leading to the current stage of transnationalisation. Then a situation assessment is presented, followed by a survey of challenges and factors of competitiveness. Finally, the general lessons are listed, which do not attempt to be exhaustive.

Hungary today is one of the most transnationalised economies among the medium-sized nations. The combined value of exports and imports accounts for 140 per cent of its GDP, and around 40 per cent of assets are in the hands of foreign owners. Four-fifths of the country's trade is transacted with European Union (EU) members.¹

Seen from a bird's eye view, Hungary is one of the major success stories of open-door policies. The country has emerged from the doldrums of communism. Exports increased tenfold in the period 1989-2007, with FDI stock at 60 billion euros as of the end of 2007. Sixty per cent of those exports consist of machinery and equipment, about twice the share of similar goods in Spain's or Greece's exports. Estimates from the Ministry of the Economy put the inflow of foreign direct investment (FDI) stock at approximately 53 billion euros in 2006, which in per capita terms puts Hungary in the number one position in the post-communist region.

Literacy in Hungary is universal, while secondary school enrolment is above 90 per cent and over 40 per cent of the cohort of 18- to 25-year-olds participates in tertiary education. This last figure constitutes about a tenfold increase against the figures in the last years of communism, when higher education was kept elitist and enrolment rates were among the lowest in Europe. Since 2004 Hungary has been a full member of the EU. This breakthrough was facilitated by the country's joining of the North Atlantic Treaty Organisation (NATO) in 1999, in a resolute break with the military alliance with Russia.
Time and space do not allow for a detailed account of Hungary's economic history. What matters from our angle is perhaps twofold. First, Hungary underwent a long period - 35 years - of reform socialist experimentation. The latter allowed for testing, and on empirical grounds, the ground sequentially rejecting inward-looking solutions and hostility to FDI. Second, the country has emerged from a decade of evolutionary change, which - contrary to the experience of several other countries, such as Russia or Poland - has not induced major shocks but has built on a fair degree of continuity, trial and error, and generally cooperative behavior among political and social agents.

These processes can generally be seen as contributory to sound macro-economic policies and gradual but continuous institution-building across the political cycles. In addition, a governmental system based on the German model of a strong prime minister has allowed unpopular reforms to be instituted in time.

While contemporary theory was firm in postulating the impossibility of any successful transition, in reality the Hungarian transition has been successful owing to the government's ability to act when it was deemed necessary to do so - while retaining democratic controls - and also because of the broad professional consensus among the major features of economic policy. The latter included the rejection of non-traditional forms of privatization. It focused on the importance of selling rather than handing out free of charge; the need to sustain the country's solvency even if this required unpopular balance-of-payments adjustments; and the need to rely increasingly on strategic FDI. This aspect held especially for the so-called strategic sectors, such as energy and banking, areas where the importance and ramifications of large foreign ownership have remained a source of discord even nowadays in some of the core EU members, notably France, Italy, Germany and Spain.

By contrast, the experimentation and ensuing conceptual clarification of the 1970s and 1980s, when third-way reforms were on the agenda, have helped to convince the core of the Hungarian economics profession as well as the bulk of the business community and policy that there is no viable alternative to fast privatization to foreigners. Lacking the richness of resources of Russia, and not expecting major price rises for oil and gas in the global markets, Hungary faced two basic options. One was wholesale sell-out to foreigners. The other could have been a model of a 'national path of development', where the features normally associated with FDI, such as the infusion of new capital, new management skills, new network possibilities, new on-the-spot learning, enhanced credibility of the new owners and many direct and indirect benefits, would have been acquired via a process of slow-learning. Though conceivable in theory, in reality this would take a very long time, and it is doubtful if the required sums, knowledge and ability to act would be timely available.

Furthermore, the prospect of membership in the EU, much more than actual membership itself, has orchestrated a powerful consensus in the policy-making elites and in the business community in accepting the need for some basic lines of argumentation and action, such as the need to give up inflationary policies, build institutions ensuring the rule of law, and accept fiscal discipline, or the imperative to iron out differences by peaceful rather than violent means (such as the killing of Serbian Prime Minister Zoran Djindjic in 2002, or the military conquest of the Supreme Soviet in Moscow in October 1993).

In this process the various phases of negotiations with the EU, such as the association agreement, the membership negotiations, the acquis screening and finally the formulation of the membership deal have all played a decisive role in shaping the actual face of Hungarian institutions and policies. The continuous intertwining, also across the political cycles, with the Commission and other EU-level fora, eventually allowed the bureaucracy to emerge as a guardian and promoter of European values, way beyond what the domestic political balance of forces of the day would have allowed for. Such issues as making public debt explicit in 1997, the abolition of capital punishment, or committing the central bank to price stability via an independent statute in 2001, have all been milestones of change.

In all, the country has been on the growth path for over a decade - from the second half of 1993 to 2006. Not even the rather harsh and heterodox adjustment package of 1995 has constrained growth, although some slowdown did occur. The driving forces of this recovery have been exports and investment, and the sustainability of the process has been established.

The period 2001-2006 has seen a shift that might be characterized in a number of ways. We may term it adjustment fatigue; or a shift towards populism, or a joining of the wave of laxity in fiscal matters inspired by EU core countries. The crux of the matter is that the middle of 2001 saw a major policy shift. What seemed at the time an innocent temporary move of the shuttle in a political business cycle, in anticipation of the onset of elections in the spring of 2002, has actually turned into a long-lasting moment of economic history. The election campaign did not come to an end by late 2002 as most observers would have expected. Instead, the policy of fiscal laxity was sustained until late 2006. With the promulgation of the convergence plan of September 2006, the Hungarian government finally gave the first clear signal of its being aware of the severity of macroeconomic imbalances that might undermine growth in the medium run.
The Hungarian economy successfully mastered the difficult double task of transition and EU integration in the period 1989-2002 (the accession treaty was signed in the Copenhagen Council of December that year). However, it proved much less capable of mastering the more conventional tasks of solid public finance or of adjusting to the normalcy of intra-EU bargaining. In a way, one may reverse this observation: political agents of various sorts have proved to be much too quick in adjusting to contemporary EU 'normalcy' - exemplified by lack of vision, concern for immediate welfare and popularity effects, and general myopia. The rejection of the Constitutional Treaty of the EU in 2005 by two of its original founding nations - France and The Netherlands - has clearly signalled the electorate's concern over elite politics and what the majority perceived as a lack of interest by those in power in their immediate real-life concerns, such as worsening unemployment, the growing difficulties of integrating multicultural societies, and welfare threats - alleged or real - from the liberalisation of the services sector, most notably financial services.

Owing to these complex processes the rules of the game within the EU have undergone a series of modifications. At one level, enlargement without prior intra-EU reforms could be mastered only if the redistributive practices were trimmed back - a feature only strengthened by the adoption of the EU’s Financial Perspective for 2007-2013. At a different level, the in the meantime the regular contravention of the stipulations enshrined in the Stability and Growth Pact, that is, the fiscal framework for monetary integration by the major players - especially France and Germany - went basically unpunished. Instead, the Brussels Council of March 2005 agreed to soften up the pact. These two developments were mistakenly interpreted by the policy makers in the new member states as the loss of the stick (enforcement mechanisms) and the carrot (EU transfers) for well-behaved economic policies.

One may well counter with the platitude that good policies in general and sound macroeconomic stances in particular are in no need of being rewarded by any external body, since these reflect the best interests of the nations concerned. Furthermore, it is equally true that in the medium run, markets in general and capital markets in particular severely punish those who do not play by the rules. However, the period 2001-2006 has become rather peculiar from this point of view.

For one thing, international markets were preoccupied with terrorism, oil-price shocks and debates over a possible soft or not-so-soft landing of the American economy owing to the soaring twin deficits under both Bush presidencies. For another, new member states tended to be lumped with the EU, especially knowing their revealed intention and contractual obligation to join the single currency, which would shield these small economies from currency speculation, exchange-rate volatility and risk premiums. Lastly, but not least, individual member states of the eurozone tended to be lumped together, with Italy for instance not having to pay the price of Mr Berlusconi’s populist policies. All these processes have awakened a false feeling of security.

Let me be clear: it goes without saying that the reasons for soft fiscal policies lay within the new member states, a statement that can be proved for Hungary as well. However, it would be hard to overlook the negative impact of French, German and Italian profligacy - producing deficits way beyond the Maastricht limits - on a country where fiscal stringency does not have currency, and where public opinion, contrary to that in many other nations, is not at all harsh on fiscal profligacy.

The continental European unwillingness to undertake the reform of a welfare state, which is beyond the financing ability of any government committed to sustainable public finance, and deprived by the single currency of any chance to inflate away claims, has spread quickly to central Europe. In the Hungarian case, detailed analysis could prove what was the ultimate decision, over and above ad hoc and temporary phenomena and considerations, which has turned the previous consensus over solid macroeconomics into a Polonaise consensus. The latter meant that both major parties adopted populist, expansionary, redistributive economic stances, thereby pushing each another into a corner. Whenever one side appeared to relent, the other would immediately exploit this ruthlessly, in the (false) hope of major popularity gains.

It is one of the oldest insights in the political economy of economic policy reform that reforms never materialise in a period when redistributory concerns dominate the policy agenda. And the latter has been the case in Hungary in the period from 1997 to 2006. Quite unsurprisingly, the last major reform in terms of institution building was pension privatisation in 1997. However, successive measures have in part reversed the benefits; furthermore, electorally motivated increases in public pensions in 2002-2005 have added at least an annual 2.5 percentage points of GDP to an already soaring general government deficit.

Under these circumstances successive Hungarian governments were betting on buying cheap external finance and time, a fact of life in the period from 2001 to 2005. This led to a situation where the external debt to GDP ratio rose from 52 per cent to 69 per cent by 2006, and is expected to grow to 72 per cent by 2008. This gives grounds for concern: in times of economic expansion - such as the 2001-2005 period, when growth never fell below 4 per cent per annum - both deficits and external debt should have decreased, preparing
for rainy days in general, and for the compelling need to introduce the currency in the immediate policy arena in particular.

In order to explain the inexplicable, one needs to refer back to the fact that structural reforms have come to a halt since 1997, the year of privatisation. For this reason the public sector remained largely unreformed; privatisation slowed down until the December 2005 sale of Budapest Airport. Red tape, slow management lacking incentives, and insufficient transparency and performance criteria, saddled the area. The quantitative expansion of education rarely followed market signals. Instead ideological postulates, imitation of continental Europe and regional policy considerations prevailed. Lavish early retirement schemes, perhaps inevitable in the early transition years of 1989-1993 to soften the market shock on the labour market, succumbed for an additional decade and a half. This created an unbearable burden for the basically publicly funded pay-as-you-go schemes. Disability schemes misused just as much as in the worst cases of continental Europe, such as Italy and The Netherlands. Some large public firms, for instance the national company or local transport firms, or the national airline, could accumulate wastering losses of net asset value without any serious consequences for them. Not so for public finances.

By contrast, monetary policy was relatively successful in the period 2001 to 2006. To cut a long story short, while inflation targets tended to regularly missed - which is likely to be the case in the 2007-2008 period - according to the forecast quoted below - the rate of CPI, stuck at 3.9 per cent in the years from 1999 to 2001, has gradually been coming down to 6.7 per cent in 2004, 3.6 per cent in 2005 and about 3.9 per cent in 2006. While fiscal adjustment in 2007 will induce a temporary increase to 6.0 per cent, this will come down to 4.1 per cent by 2008, according to the National Bank of Hungary. The Monetary Policy Board's December 2006 declaration to raise interest rates despite the price hikes forecast is a clear indication of monetary policy's conviction regarding the temporary nature of those increases.

A similar assessment is reflected in the improved assessment of Hungary's macroeconomic policies and prospects issued by the rating agency, Standard Poor's, immediately upon the adoption of the budget and the convergence plan for 2007-2009. The exchange rate of the forint, which was maintained during the period 1931-2001, gradually stabilised during 2003-2005; the fact that capital account items had been fully liberalised by 2001, with the commitments taken up by Hungary upon joining the Organisation for Economic Co-operation and Development (OECD) in 1995.

Decelerating inflation and stabilising exchange rates, together with an open trade regime and FDI-friendly overall policies, enabled an investment upsurge during the ensuing macroeconomic lull. Laxity have not deterred direct foreign investment. As a sign of growing maturity in the investment sector, two features were observed during the period from 2000 to 2006. First, two-thirds of FDI flows come from re-investments, that is, those who have found a way to stay but tend to expand their businesses rather than simply withdraw profits. Second, and no less important, outward foreign investment has been gathering momentum. Big Hungarian and locally based multinational corporations, such as OTP Bank (previously the National Savings Bank), MOL, a giant, but also a number of transnational corporations (TNCs) started to see the country as a bridgehead for their expansion into neighbouring countries such as Romania, Slovakia, Serbia, Bulgaria and Ukraine. This is bad from the current account perspective, however, since FDI is less and less cover the imbalance. Nevertheless, it is a sign of maturity when a locality not only as a recipient, but also as a source, of capital flows.

One of the potential dangers in such an FDI-led development path is the presence of a dual structure, where small business and the large corporate hardly co-operate. In a case such as this, capital-intensive development translates into jobless growth, with the wealth created extremely unevenly distributed. This has not been the case in Hungary. First, with the passage of time subcontracting and local sourcing have gradually improved, not least due to import liberalisation and the competition that has ensued. The traditional division between less demanding local and more demanding foreign markets disappeared for most activities. Second, TNCs contributed significantly to Hungary's social security system. Unemployment figures have regularly been below EU averages, coming down from 8.6 per cent between 1996 and 2005 to 7.0 per cent between 2001 and 2005, while EU averages were 9.8 and 8.8 per cent respectively for the same periods. Not least importantly, the 30 largest owned firms contribute about 40 per cent of Hungarian research and development (R&D) spending. This is, of course, less than is needed or ideal, in successful advanced economies, such as those of Sweden or Japan, thirds of R&D comes from the business sector. Still, FDI's contribution to industrial upgrading is by no means negligible: rather, it must be seen as a driving force behind structural upgrading in production and export sales.

This is the more manifest as these R&D expenditures take place in pharmaceutical, electronic and IT sectors, to mention just a few, as well as in the traditional engineering industries. The improved performance of these services is conditioned basically by major investments by foreigners, amounting for over 80 per cent of asset ownership.
CHALLENGES FOR COMPETITIVENESS AND REFORMS

It should be clear from the above that Hungary has virtually reached the limits of spontaneous development, while the first- and second-generation reforms of the 1990s have delivered what they could. After a decade, a new wave of structural reforms is needed, despite the fact that major parties on the left and right have aligned themselves with the practice of protecting the status quo as a social accomplishment. This reasoning is obviously false, since the sustainability of the financing of those arrangements is not given.

For one thing, while Hungarians do expect lavish provision of public finances, in line with other European citizens, they are not really willing to fund those via the acceptance of a lasting tax-high services deal along Scandinavian lines. This unwillingness follows from the generally low level of transparency in public finances, noted by all external observers. For the man in the street, the relationship between the amount of public dues he pays and the quality and quantity of public services he receives is minimal. For instance, in a country of some 10 million people, just 1.9 million individuals pay over 90 per cent of total personal income tax raised. By contrast, according to the records of the National Health Centre, 13 million persons (3 million more than the total population) hold cards that entitle them to free medical care. During the first serious performance check in Hungarian hospitals in the summer of 2006, cases were encountered such as that where one person, at least on paper, had died no less than seven times and first been analysed and treated with costly procedures (this according to the new minister for health).

In a way this is a typical continental European Catch-22 situation, where myopic politics has major difficulty in managing any change that would hurt particular interest groups. The probable solution is a decade-long incremental reform that will, in the end, produce a better balance between means and ends.

More urgent, it seems, is the remedying of the fiscal disequilibrium. Hungary will, in the foreseeable future, have to join the single currency, owing to the terms of its accession agreement, but also following its own best interests. Small open economies find rescue from exchange-rate and interest-rate vulnerability emanating from international capital markets by joining currency blocs. Thus the question is not if, but when. Following the procrastination of the years 2001 to 2006, this time is unlikely to be before the next government is well into office, around 2013. But in order to qualify by then, 2009-2011 will have to show a credible and sustained improvement in terms of deficits, debts and inflation alike.

In order to master this challenge the Hungarian government faces two separate, though related, tasks. First, raising revenues and cutting expenditures in a sustainable fashion, by introducing fiscal rules and severing the budgeting procedure, has been started in 2006. This process will have to continue and strengthen in the upcoming years. Second, any sustainable fiscal equilibrium presupposes that major sources of imbalances, such as the uncontrolled functioning of public enterprises, the lack of new public management in the state administration, the over-extension of municipalities and the institutions under their jurisdiction (thus outside the control of fiscal authority), and yes, the above-mentioned welfare state elements, all need to be reformed. The term implies an expenditure pattern that is cost-efficient and in line with the ability of the Hungarian state to raise revenue.

Let us recall: in a country with an open capital account, and broad tourist and other exchanges, in the internet age, when money is no longer equal to gold bullion, but a sign on the computer, tax revenue is crucially dependent on the willingness of subjects to comply. Not only big firms, but also the man on the street, flees to safe havens, from Liechtenstein to Luxemburg and the Bahamas, if the burden of public dues becomes crippling. Daily experience in Germany and France, and the tax amnesty in Italy in 2005, amply demonstrate this point.

Therefore, the third generation of reforms will take a long time and move in the direction of a slim and selective state provision of goods and services away from the universalist ideas of the second half of the twentieth century. Enabling the state to raise revenues, by broadening the tax base and strengthening enforcement of lower tax rates, is the way ahead. The fact that such reforms have been launched in all EU states is grounds for greater optimism than extrapolation from the experience of the past decade would seem to warrant.

From the point of view of competitiveness it is important not to relapse into the conventional discussion over unit labour costs and statutory tax rates, especially since the latter often differ significantly from effective rates levied. For Hungary, full membership of the EU and the emerging new policy line, which is becoming more congruous with the introduction of the euro, may be a basic comparative advantage. Geographical location, in line with new economic geography theories, should matter. After all, Budapest is closer to Munich or Milan than Berlin or Rome respectively, and the Munich-Milan axis has been one of the engines of continental European growth for over two decades now.

High enrolment rates in higher education and near-universal secondary education also count among the pluses, despite some problems of quality. Acceptable levels and improving physical infrastructure, consolidated political life and a generally peaceful social atmosphere all count among the lasting advantages of location. Also the mood...
This holds both for the political class as a whole (notwithstanding the reliance on populist calls when convenient), and even more for the population at large. The decade-long experience of working with foreigners (including at TNCs), as well as the ensuing possibilities for travel, professional advancement and, not least, remuneration that is close to international levels, has made it impossible for anyone to use TNCs as a bogeyman. Also, governmental policies, although never entirely free from red tape, tend to be generally and lastingly generous to foreign investors. The possibility of relying on the EU regulatory framework, and as a last instance, the European Court of Justice with its supranational prerogatives, will all render Hungary an attractive investment spot for several years to come.

It would be one-sided if we did not explicitly mention the weak points affecting competitiveness. First, looking from the perspective of an advanced OECD economy specialising in technology-intensive production, it is worrisome to see the improbably low level of R&D spending in Hungary. The state and companies together have never managed to spend more than 1 per cent of GDP on R&D in the past 15 years - compared to close to 3 per cent in the pre-1988 period - and this feature is unlikely to change in 2007-2009, based on what we know of the convergence plan. This is worrisome, since there can be no adaptation of technological progress in the long run without a certain level of local skills. Second, the quantitative expansion of education has brought about the replication of the continental European experience of quality decline and structural mismatch in a number of establishments, although not across the board. In concrete terms employers can, and indeed must, be selective in screening graduates from various institutions, all state accredited (though that is no longer a quality-control item). Knowledge of foreign languages, especially a good command of them, is not yet as widespread as transnationalisation requires. Third, a lot remains to be done regarding the quality and types of our regulations, from customs administration to court practices, and from public procurement to a user-friendly working style in government departments. And although corruption, measured by court cases and other proven standards as against allegations, is nothing like as bad as its name would suggest, it would be positively misleading to deny the relevance of the issue or the need to fight against it more intensively than in the murky days of early privatisation.

LESIONS FOR DEVELOPING NATIONS

What kinds of conclusions can be drawn from this condensed story of Hungarian globalisation?
globalisation. Opening up the capital account has, in fact, enabled the country to get a realistic exchange-rate level; and to finance the disequilibrium that emerged in part owing to fiscal policy, but in larger part owing to the nature of catching up and modernisation.

ENDNOTES

1 Unless otherwise indicated, the sources of all data are the Country Report: Hungary (update, November 2006) of the Economic Intelligence Unit; and National Bank of Hungary statistics, available at www.mnb.hu.
6 The renewed emphasis on what the French call economic patriotism, or the Germans see as the need to ensure social control over major firms, or the Spanish practice - never promulgated but conducted - of not letting foreigners acquire controlling stakes, are all cases in point.
7 L Csaba, Transition in and towards Europe, Zeitschrift für Staat- und Europaisen-
10 Available from the ministry of finance [online], at www.pm.gov.hu. The updated version of December 2007 differs only in minor respects, such as the sequencing of measures aimed to achieve the same quantitative targets on the same trajectory.