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**Stabilisation and Reform in the  
Hungarian Economy of the late 1980s**

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**STABILISATION AND REFORM IN THE  
HUNGARIAN ECONOMY OF THE LATE 1980s**

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**STABILISATION AND REFORM IN THE HUNGARIAN ECONOMY OF  
THE LATE 1980s**

**Summary**

Dr. Adam Török, Hungary

The 1968 economic reform resulted in quite widespread liberalisation and decentralisation, but the following decade showed that these developments would not necessarily create a "socialist market economy". Basic deficiencies in the economic mechanism and failures in economic policy led to a lack of adjustment to changes in the world economy after 1973. By 1978, convertible-currency indebtedness had increased to such an extent, that the leadership had to embark on a "new growth path" and speed up the reform brought to a halt half a decade before.

This "new growth path" was in fact a path of slow growth and of tight restrictions, with an improvement in the external balance as the main target of economic policy. Some quite important reform steps were also part of the new course of economic policy, and the way in which they were implemented shows how reformers' ideas were put into practice after a process of coordination of viewpoints between the leadership and the reform camp. Instructive in this respect was the 1980 price reform, which tried to initiate market-oriented economic development essentially by simulating international price trends. Subsequent experience showed that this simulative pricing system greatly distorted enterprise-level behaviour patterns and the system quietly died out in 1987.

More substantial reform steps were taken in the field of enterprise management with the setting up of enterprise councils as representative bodies responsible for enterprise strategy. These developments yielded partly counterproductive results because of the formation of "redistributive coalitions" consisting of directors and enterprise council members. Traditional power relationships within and between enterprises upset by the creation of a legal framework for new

types of small enterprises, either. It is nevertheless true that the mushrooming of such small firms from 1982 helped to mitigate shortages and to create additional incentives to work.

Monetary policy had a clearly restrictive character in the first half of the 1980s. Although it proved unable to cope with monetary demand management problems stemming from the segmentation and underdevelopment of the money markets, it contributed to the significant improvement in external balances in 1979-1984. The most frequently used tool of monetary management was direct or indirect credit rationing in the one-level banking system. The partially quite strong impact of reform economists' ideas on economic policy could be seen from the fact that a two-level banking system with independent commercial banks was created in early 1987. The generally restrictive economic policy environment, the insufficiently transparent system of refinancing as well as some important inequalities between the newly created commercial banks led to an at least temporary deterioration of the efficiency of capital allocation.

Quite significant liberalisation and deregulation took place in the system of foreign economic relations, but the strict regulation of convertible-currency imports was only temporarily eased because of current account problems. The moves to improve the efficiency of the central regulation of trade with the CMEA-countries did not prove successful enough in creating a dynamic equilibrium between enterprise-level export expansion and import needs in this field.

The 1985 party congress decided to abandon restrictions and opted for a "dynamisation" policy. The failure of this policy in less than a year revealed a series of underlying structural and other macroeconomic problems. A stabilisation programme was elaborated and adopted by Parliament in 1987.

The keywords of this programme are institutional changes, a redefinition of the role of planning, less centralised

macroeconomic management using mainly monetary tools and a programme for "market construction". The difficulties facing stabilisation policy can be seen from practical experience with the tax reform which failed to introduce really uniform fiscal treatment for enterprises or for the working population and even created new fiscal disincentives to work.

"Market construction" will probably be better served by the new legislation governing corporate enterprises. This was expected to create equal conditions for different forms of domestic and foreign property ownership and a gradual micro-level opening of the economy towards the world economy. The original stabilisation package did not contain the far-reaching liberalisation programme requested by representative bodies of the enterprise sector in an explicit form. It was modified in the form of two alternatives presented in July 1988. The more radical one contained quite decisive liberalisation measures with possibly serious consequences for employment and the current account, but promised considerable structural change and accelerated adjustment. The other scenario foreshadowed slower liberalisation with tensions rather in the structural than in the employment and external balances fields. The new leadership has to aim simultaneously at economic stabilization and reform.

## INTRODUCTION

This study tries to analyse reform and stabilisation efforts in Hungary from the late 1970s when it became evident that the reform process started in 1968 had lost almost all of its initial impetus. The 1968 reform "eliminated centralised, bureaucratic planning based on compulsory instructions, and initiated a transformation of the systems of functioning and management in the economy" (Berend, 1988, p.3). Even though the New Economic Mechanism was a result of considerable compromises (the investment system, the regulation of wages as well as foreign trade remained quite strongly centralised) it promised significant improvement in economic efficiency and living standards. But the 1972-1974 "rearranging" of the reform and the lack of adjustment to changes from 1973 in the world economy led to a stalemate in economic development. This is the point where we start our analysis.

The author deliberately concentrates on "technical" details of reform and stabilisation since he is persuaded that the political and social acceptance of continuing the reform is a decided fact, even though a significant part of the population seems not to be interested in its rapid implementation. What is at issue in Hungary is not the fundamental question of the reform which has been extensively discussed from the late 1970s) but those economic problems that have a decisive importance for economic policymaking and political decisions in the near and medium term. Therefore the apparent "technical" or even "technocratic" bias of the paper reflects the actual state of Hungarian economic and reform thinking (for a more theoretically-oriented analysis of socialist economic reforms, see Kolodko, 1988).

1. **The Hungarian Economy in the 1980s:**  
**Misunderstood Trends, Aborted Reforms**

The economy of Hungary has been repeatedly exposed to sudden crises during the last decade or so. Although the period between 1979 and 1984 brought significant improvement in various respects and the international debt situation of the country seemed to be under control, developments in 1985 and especially in 1986 made clear that the vulnerability of the economy had not diminished and conditions for effective structural adjustment had not been created. The government could master only a minor part of the problems in the economy in 1987 and it became evident that already existing, but not really clearly defined reform and adjustment strategies would have to be reevaluated and put into a short-term stabilisation framework.

This critical period of the Hungarian economy is rooted partly in a certain failure (understood in structural terms) of the industrialisation strategy of the 1950s and 1960s, partly in economic policy decisions taken by the government after the first oil shock and partly in the inherent deficiencies of the economic mechanism. Since half of the country's energy needs had to be covered from imports (mainly CMEA), energy price rises were a major shock. The government considered these price changes only temporary and its conception of integration into the world economy was based on a determined reorientation towards CMEA-markets (Csikós-Nagy, 1988). Efforts to offset the external shocks were therefore based not on effective structural adjustment but on increased foreign borrowing. The apparent "golden age" of Hungarian economic development between 1974 and 1978 (see Charts 1-5 in the Appendix) was possible only due to a significant increase of foreign debt. Several high-cost, capital-intensive investment projects were constructed in energy, iron and steel and heavy chemistry industries, financed mainly by foreign debt.



Hungarian economic development switched to a less growth-oriented path in 1978 when the leadership finally acknowledged the durable character of changes in the world economy. External economic balance became the key target of economic policy and words like stagnation or restriction found a place in the official vocabulary of the government. The Sixth Five-Year Plan (1981-1985) assumed a continuing external balance oriented stance in economic policy but it did not describe changes necessary to stop the build-up of debt. Conditions for an acceleration of economic growth with a clear external and structural background were not made clear either. Economic development took an unexpectedly unfavourable turn at the beginning of the 1980s mainly for external reasons (the credit embargo towards Eastern Europe, recession in the world economy, the withdrawal of practically all foreign deposits from the National Bank of Hungary etc.). A rescheduling of foreign debts was avoided only by running down reserves as well as an increase in detailed, case-by-case governmental intervention into the economy (i.e. in contradiction with the officially accepted principles of the 1968 reform).

But same impressive results, stemming not from an underlying improvement in macroeconomic performance but rather from a strongly short-term oriented economic policy misled Hungary's leaders as well as a considerable part of international public opinion. The impression became prevalent in decision-making at the highest level in the country that the economy had left consolidation and adjustment behind and that conditions were ripe for a growth-acceleration policy. The government considered itself able to carry out successful demand management and it was thought that faster GDP-growth would automatically mean faster growth in net exports, mainly to the convertible-currency area. This change of course in economic policy promptly led in less than a year to an even worse crisis. Foreign debt rose further and it became evident, only one and a half years after the adoption of the Seventh Five-Year Plan (for 1986-1990), that these plan targets could not be fulfilled and that an economic policy insisting on them would lead the country into inevitable catastrophe. The five-

year plan was "suspended" and preparatory works began with the aim of introducing a complex stabilisation package based on a critical evaluation of economic and social trends of the 1980s and an integration of some of the important reform ideas already present in Hungarian economic thinking.

#### **A. Main Development Trends (1980-1986)**

The fundamental target set in 1978 was largely fulfilled by 1980. According to this, domestic use had to be entirely covered by GDP produced. While this ratio had stood at 0.90 in 1978 it was increased to 0.98 by 1980. These two years can be considered a rather special period in modern Hungarian economic history, for it was a period of rapid transition from the former growth policy based on development objectives formulated in physical terms and a consolidation strategy (for which this term has never been officially used) abandoned only in 1985. But the international supply of credits began to dwindle in Autumn 1981, and Hungary was faced with a complete credit embargo from the West for almost one year after the December 1981 events in Poland. 1982 was the first year when Hungary was directly confronted with the threat of insolvency. Almost simultaneously, that year international interest rates went well over 15%. Western creditors introduced unprecedented credit restrictions, and almost all foreign deposits (amounting to at least 1.5 billion USD) were withdrawn from the National Bank of Hungary. Everyday liquidity problems became so critical by Summer 1982 that Hungary officially announced import restrictions in conformity with GATT rules (these restrictions remained in force between September 1982 and June 1984). The government could finally master the exceptionally delicate financial situation with drastic administrative measures the application of which led the economy several steps back from becoming a market economy.

This success created the illusion on the political level, however, that the economy was able to face any challenge of external origin if sufficiently strong central management were applied. It also proved misleading in the sense that the

problems of the early 1980s were considered to originate mainly from the world economy and the solutions found to them are solutions to the longer-term adjustment problem, too. Economic development in the next two years (1983 and 1984) maintained the appearance of a successful consolidation with quite stable growth, not very high inflation rate and an improving current account (see Charts 3-5 in the Appendix). It has to be seen, however, that some disturbances in the growth process became obvious already in 1983 with a temporary fall in GDP-growth. An underlying "Achilles' heel" of Hungarian economic development was a further modification of the structure of domestic use to the detriment of investment. The volume of gross investment fell every year: by 1984 it was almost 15% below the 1980 level.

The improvement of the convertible-currency trade balance was accompanied by a steady worsening of the terms of trade (see Charts 1-2 in the Appendix) due to the forcing of exports to the West, with very little attention paid to the profitability of exports. The apparent decrease in the amount of gross foreign debt reflected largely the appreciation of the dollar (the majority of Hungarian liabilities were denominated in weakening currencies like the DM, yen and Austrian schilling). But the illusion of a constantly improving macroeconomic performance and external balance was questioned by only a few economists. Although the political attitude to these was rather tolerant in general, an article by Tamás Bauer in late 1982 (Bauer, 1982) dealing with the shadowy sides of the apparent economic successes and calling for "a second economic reform" caused a more than minor political scandal followed by the dismissal of the whole editorial board of the monthly in question.

It became obvious by late 1984 that a part of the political leadership considered continuing restriction burdensome for the population and unnecessary. Growing political pressure in this sense contributed to a stronger feeling among economists that there would be a complete change in economic policy quite soon. This change was officially

announced by the 13th party congress in May 1985, when "the programme of acceleration" was adopted. This was, however, only one of at least three basic options of the political and economic leadership (FR, 1987, pp. 60-61).

The first one could be called an "active adjustment" strategy. This would have meant the maintaining of positive external balances with a concentrated effort toward rapid implementation of real structural adjustment. This development path would have been based on the then fairly good rating position of Hungary on international lists of debtor countries. Namely, it would have had for result an increase in foreign debt because of dropping most unrentable exports for convertible currency. This path would also have increased the burdens on the population for it would have meant an increase of the share of investment in domestic use with no acceleration in GDP-growth. Thus this alternative seemed to be overtly refused by most politicians.

The second could be called "a strategy of accelerated debt repayment". The immediate aim here would have been the fastest possible improvement of trade balance and of the current account. This option would have been certainly justified by efforts aimed at increasing international financial security for Hungary (to put it in a quite profane way: some sort of a remote imitation of the very radical Romanian strategy of debt reimbursement, cf. *Mizsei-Rosati*, 1988) or, by such an assessment of economic perspectives that the first option is unlikely to produce important structural changes within a reasonable lapse of time.

Both these versions would have meant a clear option for diminishing external burdens of the economy and against an immediate "dynamisation" of it. However, the third, the so-called "dynamisation" strategy was aimed above all to stop stagnation. It was based on the presupposition that the economy would be able to improve its growth performance with a proportionally much slower increase in convertible currency imports. This improved growth performance would then be

sufficient for a considerable increase in exports and in domestic consumption as well. But this strategy did not take into account at least two important facts: it underestimated the extent to which the government could intervene in unfavourable trends of external economic origin, and it was not based on a realistic assessment of typical enterprise-level patterns of behaviour. The majority of Hungarian enterprises tended to see dynamisation as a transitory strategy with slow inflation and favourable conditions for increasing imports. Thus they immediately began pushing (i.e. mostly bargaining) for more imports, more credits and more possibilities of investment.

The growth of the economy, however, could not be speeded up: indeed, 1985 was a year of negative growth, which is rather exceptional in post-war Hungarian economic history. Some important reasons for this seem to have been the following:

1. A significant part of the increment in domestic demand was for unsubstitutable convertible-currency imports and not for domestic production. Unsubstitutability can mean two things here. Either these imports were physically not purchaseable on domestic or CMEA-markets like high-tech goods for instance, or similar products could have been received from domestic or (to a much smaller extent because of contingent problems) CMEA-suppliers but usually at lower qualities and higher prices. Thus in the latter case substitutability of imports was rather a question of the rentability of imports.
2. Cooperative relationships between domestic enterprises deteriorated because of regulation requiring direct convertible-currency exports and because of enterprise-level liquidity and payment problems. These were arising due to inadequate monetary demand management which could but increase monetary dichotomy with the simultaneous existence of excess supply of and excess demand for money

in the economy (see this later in a detailed way, cf. also *Huszti*, 1987, pp. 206-208).

3. Some key elements of the production and export structure (as for instance agricultural products, petrochemical goods, iron and steel etc.) suffered unexpectedly high price losses on the world market. Thus economic policy striving for an increasing share of convertible-currency exports in GDP could rather contribute only to a further decrease in terms of trade in the given structure and could not really achieve "export-led" GDP-growth. It turned out, in fact, that export-led growth has a completely different sense amidst the fast structural changes in world economy to be observed in the 1980s than at the beginning of the century when countries like Canada, Australia or Brazil could produce very impressive growth rates owing to "staple" exports or "staple" growth (cf. *Caves*, 1971).

All these factors brought about a sharp deterioration of Hungary's net exports and a sharp increase of foreign debt. By the first half of 1986, the application of the third, so-called "dynamisation" strategy led to one of the worst possible "growth scenarios" in reality. This scenario had been forecast only by very few experts<sup>1</sup>, but probably even they could not have foreseen the macroeconomic damage caused by it. As we saw earlier in this chapter, none of the three major options for economic strategy contained a combination of stagnating growth and fast worsening external balances. This combination destroyed much of the positive results of the consolidation period between 1979 and 1984 (see Charts 1-5 in the Appendix). Thus the set of tasks faced after 1986 was even more complex. This set of tasks, analysed in the next chapter,

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<sup>1</sup> It is interesting to note, that the preliminary theses of the 1985 party congress stimulated a very herevent discussion among economists. Though many of them had promised a written contribution to the discussion of the theses, finally only two studies were prepared, probably owing to the experts' skepticism as to the readiness of the political leadership to give enough attention to their assessment of the situation (*Lengyel*, 1987a, p. 141).

included older ones (perhaps that of structural adjustment being the most important of all) that economic policy and the economy had been carrying with them since 1978 and new ones (like that of the threatening debt crisis, fast growing social tensions, increasing inflation and a worsening imbalance between exports to and imports from the main external markets of the Hungarian economy). The next chapter will begin with an analysis of how the main questions and answers were formulated by these two rather distinct camps.

## 2. Reform Proposals and Initiatives

The development of the Hungarian economy described in chapter 1 was clearly perceived by different groups linked to economic policymaking as a process leading to crisis. The exact number of such groups is not easily identifiable and many of them cannot practically be located on the "map of science". The framework in which they seem to act can still be presented. According to (Kovács, 1984), two basic camps can be distinguished: 1. politicians; 2. reform economists. The first of these is more or less pushed to reforms by development while the second thanks its existence to its participation in the preparation of reform steps. The two mainstreams of Hungarian economic thinking in the 1980s can be attached to these two camps. In a very simplified but comprehensible manner: the reforms proposed can be linked to the second and those realised to the first camp, and the reform process is a result of constant bargaining between the two (Kovács, 1984).<sup>2</sup> Bargaining takes place on several levels and through varied channels, but it is more or less a game between parties one of which is mainly concerned with what science suggests and the other with what seems to be allowed by politics.

### A. The Reform Camp

Szamuely (Szamuely 1982, 1984) distinguishes two waves of earlier reform thinking in Hungary. The first can be dated to the years 1954-57 and ended with the aborted reform proposal of the so-called Varga-committee created to that effect in early 1957. The second began in 1964 and resulted in the 1968 economic reform. It would not be too mistaken to say that the third one started in the late 1970s as a response to the growing economic problems of the country, but this wave involved a more radical strand (cf. Bauer, 1982) requiring a

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<sup>2</sup> It has to be emphasised, however, that the two main groups are mutually not completely exclusive (their "intersection" consists of some governmental experts clearly belonging to the reform camp) and they do not cover the whole sphere of economic science in Hungary.



"second economic reform". This is - as we shall see - much more than a mere play with words, and is one of the most significant elements of the philosophy of the so-called "radical reform". Radical reformers make, however, only one part of the "Reform Camp".

The intellectual structure of this can be presented starting from two recent contributions by Hungarian authors. Kornai (Kornai, 1986, pp. 1724-1734) sets up a typology of different visions of market socialism which is rather internationally oriented so it does not only contain views and ideas of Hungarian economists. Four such schools exist in Kornai's approach: 1. Oscar Lange's "Market Socialism"; 2. "Naive Reformism"; 3. "Galbraithian Socialism"; 4. "Radical Reformers". It is practically only the latter that has exerted a really significant influence on post-1968 reform thinking in Hungary. Almost exactly this group is quite profoundly presented and analysed by Lengyel (Lengyel, 1987), albeit Kornai's term "radical reformism" does not appear in his text.

Lengyel emphasises that the four models distinguished by him hardly have any points of linkage (Lengyel, 1987, p. 27) and this clearly is an exaggeration. Even his presentation of these "sub-schools" contains a not misunderstandable tint of "plus ça change, plus c'est la même chose" type thinking which with the question of its justifiability still left aside is clearly not equally proper to the four groups.

The four models of Hungarian society and economy in the 1980s can be summarized as follows:

1. A special, centralised Soviet-type socialism with redistributive character and hierarchical paternalism, whose essential character was not radically changed by reforms in or after 1968.
2. A negatively dualistic system in the sense that it is a product of mismanaged and misunderstood reforms in which several important disadvantages of centralised plus

inflexible and decentralised plus uncontrollable systems are united.

3. Dualistic society based on a dualistic economy in a country where official sectors live peacefully together with unofficial ones (like the "informal economy") and the existence of which is mutually based on each other. In this approach, "official" society and economy are nothing more than by-products of an organic historical development towards a market-based and liberal system so that any attempt to reform and incorporate them in the "unofficial" ones could eventually result in a destruction of the latter with far-reaching historical consequences.

4. More or less only the second part of the arguments of Group 3 is valid in the sense that Hungarian society and economy are subject to practically the same mechanisms as Western ones, albeit in different forms. Monetary regulation here is partly replaced by regulation through bargaining (not on prices but on regulators and other rules of the game in the spirit of the 1968 economic reform) and economic power of the state is much less efficient than what could follow from its degree of centralisation. A high degree of stability of the system (without the interference of the international economy, of course) is granted by the fact that practically every player can win in the game if his attitude is clear and predictable to his partners. This is clearly not a zero-sum game but its positive sum is fed from outside through growing indebtedness.

Lengyel seems to convey the impression that the four groups are internally consistent. This may not be completely true. Kornai's theory of shortage, redistribution and bureaucratic coordination is in this approach coupled with the political scientist Bihari's theory of a monolithic state into which civil society is almost completely integrated. Socialism in this view is the process, by which small Central and

Eastern European countries are re-integrated in the mainstream of traditional Eastern European development characterised by political overcentralisation, institutional rigidity and low economic efficiency (Lengyel, 1987, p.29). This approach is, however, clearly different (not in its core, but as to its field of validity) from Kornai's theory. It is also significant, that Kornai - after giving a very profound analysis of how socialist shortage economies work - does not intend to formulate precise reform proposals. Bihari, on the contrary, elaborates a complete model of what a reformed socialist society and political system would and should look like in Hungary (Bihari, 1988) and his pamphlet titled "Reform and Democracy" even contains some elements<sup>3</sup> which were incorporated into recently adopted official programmes for the reform of the political system.

Group 2 with prominent members like economist Bauer and political scientist Gombár<sup>4</sup> adopts the following position according to Lengyel: reforms carried out in Hungary since 1968 are in fact nothing more than pseudo-reforms with a tranquillizing role that have lead to a stalemate in the economy and politics. This issueless situation gives a rather high degree of freedom to efforts aimed at short-term improvements in the situation of specific groups, but every longer-term and genuine reform effort is contained by a "down-to-earth" realism that not only needs but clearly requires the preponderance of short-term thinking. This approach involves a generalised concept of reform (i.e. partial reforms are not only unnecessary but rather dangerous for economic and political stability) and this is why it seems to refuse pragmatically-minded reform efforts actually so frequent in Hungary.

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<sup>3</sup> For instance: separation of state and party, increased legislative role of the Parliament, reform of the election system, legal independence for several civil organisation forms etc.

<sup>4</sup> We would be inclined to say that Bauer's works can not really be subject to such a tentative of typologisation. But with this consideration left aside, he could rather be linked to Group 4.

Members of Group 3 (economists Gábor, Galasi, Kopátsy, Zsolnai, sociologist Hankiss etc.) seem to argue for a more or less autonomous development of the already quite strongly<sup>5</sup> market oriented society and economy. Some of them suggest that any reform initiated by the political leadership would necessarily be a product of "centralisateur" thinking and would therefore distort "self-organising" patterns of behaviour in conformity with market rules whose validity is not system-specific.

The oppositional attitude of Groups 2 and 3 towards reforms can be easily misunderstood and its presentation by Lengyel could create the impression that they belong to the political opposition of reforms. Many of the economists belonging to Groups 2 and 3 start from a deep critique of Hungarian politics and the economy denying the reform-serving character of many measures introduced in the 1980s. This is why they point at a certain uselessness of tactical reforms that they judge according to the supposed contribution that they make to really strategic changes. They only casually and hesitantly adopt the attitude that is characteristic for Group 4. Namely, that every reform step can be useful in creating irreversible preconditions for a strategic change. "Adherents" to this group are mostly former experts of the Ministry of Finance (L. Antal, L. Lengyel, L. Bokros, Gy. Surányi, E. Voszka, E. Szalai, I. Csillag) as well as economists with a more or less long scientific career with the Institute of economics of the Academy of Sciences (M. Tardos, L. Szamuely, K.A. Soós). This is the group whose members have presented the most practical views on economic reform with a really direct influence on economic policymaking. Most of these economists have governmental experience and this might be one of the reasons why a central term of theirs is "bargaining". As has been pointed out, this term is not related only to the market and research done by some of them revealed some interesting

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<sup>5</sup> It has to be stressed: not according to Western standards, but rather in a "Balkanic" way with a low degree of monetisation and market institutions remaining underdeveloped.

features of a "logic of collective action" in an indirect but centralised socialist economic mechanism. So they could perhaps not exaggeratedly be called Hungarian "Olsonians".

One of the key ideas of this group is the distinction between "plan bargaining" and "regulator bargaining" introduced by Antal (Antal, 1979, 1985). This means that in economies where competition is imperfect and some important markets (like capital markets) are practically nonexistent, reforms are unable to weaken the preponderant role of bargaining on other things than prices (like regulations, quantities to be delivered, import licences, export promises, investment funds etc.). Another important distinction - also stemming from the same author - can help to understand this phenomenon. Classical "Stalinist-type" socialist economic mechanisms work in a centralised way and the government's influence on microeconomic processes is rather direct through detailed plan indicators and bonuses (or sanctions) linked to their (non-)fulfilment. The Yugoslav economy is governed in a decentralised and indirect manner while the essential of reform programme in Eastern Europe in the 1960s was - but it had been put into practice only in Hungary - the introduction of a centralised economic mechanism using indirect regulators (taxes, exchange rates, wage tariffs etc.) applied on a normative and as far as possible not on a case-by-case basis.

While in a centralised and direct mechanism bargaining is aimed at changing plan targets for a sector or an enterprise, or at reaching preferences in exchange for the fulfilment of a target important to the government bargaining in the decentralised system tends to change the proportion of normative and case-by-case regulators to the detriment of the first i.e. to increase the scope of enterprise-level intervention by the government. "Just the history of the Hungarian reform of twenty years ... shows that departure from the directive planning system does not mean necessarily a changeover to a market economy, not even to a regulated one. What is changing ... is the way of assertion of the central

will, the realisation of central governmental decisions" (Szamuely, 1988, pp. 4-5).

## **B. The Government and the Reform**

It is in fact a misleading euphemism to speak of government when we try to give a brief appraisal of what happened in the field of economic policy. The most important economic decisions during the past 40 years have always been made on the level of top Party organs (Politburo, Central Committee) but their implementation was carried out by the government and it was always the latter that had apparent responsibility for these decisions.

The first signs of a governmental attitude showing readiness to reforms after the temporary freeze in the reform process starting in 1972 (cf. Berend, 1988) could be seen in December 1978 when the Central Committee adopted a new economic strategy (called the "new growth path") originally aimed at stopping the increase of hard-currency indebtedness. This resolution contained some quite precise ideas of re-starting the 1968 reform. The period between 1979 and 1987 can be called a "pre-stabilisation period" with quite cautious reform steps still not directly emanating from governmental reactions to actual problems of the economy. Since they may already be well known to readers they are only briefly reviewed here with special emphasis on what they had been meant to achieve and what were the results. The latter are already points of direct linkage to the 1988-1990 stabilisation.

### **B1. Price Reform**

The 1968 reform which abandoned mandatory planning did not completely break with the centralistic tradition in the field of pricing. Three categories of prices were introduced (with so-called free, maximised and officially fixed prices). The 1968 reform did not eliminate the substantial difference between producer and consumer prices (so the "two-level" price

system was maintained) and since conceptions of a currency reform including the short-term introduction of Forint convertibility were practically dropped by the mid-1970s the price system remained - contrarily to the original reform ideas - highly isolated from the world market. Perhaps the main reason for this was the fundamental change in international prices from 1973, which put the system under enormous and fast growing pressure.

The role of prices as stimuli to a more rational use of resources and to a more market-oriented behaviour of economic actors became a key element in the first part of the new reform package, the "price policy conception" elaborated in 1979 (an interesting comparison between this and Soviet ideas of price reform can be made on the basis of *Vernikov, 1988*). This new concept was built around an efficiency criterion served by linking domestic prices to external ones on the one hand, and around a liberalisation target served by weakening authority control of prices on the other (*Nagy, 1988, pp. 18-19*). This logic doubtlessly meant a breakthrough in Hungarian pricing policy for its official acceptance equalled an overt recognition of pricing based on market principles and open towards the world economy. The incarnation of this logic was the "system of competitive pricing". Its elaboration and failure can be highly instructive for understanding why awkward market simulation instead of consequent "market creation" is not necessarily a useful step towards making clear and efficient markets prevail in the economy.

The system of competitive pricing was based on the assumption that domestic demand and exports to socialist countries would be successfully regulated. Thus the only field for enterprise growth would be exports for convertible currency, and microeconomic performance in this respect would determine the extent to which enterprises could try to increase profits on the two other markets (domestic plus CMEA).

The new pricing system was built on a "fix-point" which in monetary stabilisation programmes of the 1980s like those in Argentina or in Israel turned out to be the exchange rate. Hungarians, however, preferred to choose the price of a product fundamental for the world economy and having an exact equivalent on the domestic market - Saudi light petrol FOB Ras Tanura (Nagy, 1988, p. 22). The pricing of the majority of raw and other materials was based on convertible-currency import prices. A pivotal element of the system was the so-called "export-dependent" pricing principle for manufactured goods. The whole machinery industry, clothing industry and some important enterprises in heavy chemistry belonged to the scope of validity of this principle. The principle said that within branches in question every enterprise with convertible-currency exports equalling more than 5% of domestic sales had to apply the pricing formula in accordance with which prices and rentability in convertible-currency sales had to serve as a hallmark for other sales as well.

The system considerably "softened" already in 1980, the year of its introduction because the authorities applied several sectoral and enterprise level exceptions to these clear rules. In subsequent years a strange sort of firms' adjustment to this regulation (i.e. not to the world market) became more and more widespread. Those which were near the 5% limit very often succeeded to get below it by abandoning less rentable convertible-currency exports so a rather general trend of turning towards softer markets was neatly observable. Others forced barter agreements with apparently high export prices in order to be able to increase domestic prices under the coverage of "rentable" hard-currency exports. But probably the key reason why the whole system gradually lost importance and finally extinguished in 1987 was that firms with substantial exports to the West "threatened" the authorities with "increasing" the efficiency of these sales by simply dropping one part of them. These usually successful "persuasion" efforts resulted in a situation where the functioning of the new pricing system was completely distorted by subventions or other preferences given to important hard-



currency exporters. It turned out that the given pricing system can help to apply rentability criteria for convertible-currency exports only as a one-way street. Less rentable exports can really be eliminated but their replacement remains open and cannot be achieved with the given set of regulators in a normative way.

The increasingly formal character of the 1980 pricing system became widely evident by the mid-1980s and it is interesting to see how authorities or/and enterprises tried to reform it without changing the system itself. Two such initiatives can be mentioned.

The so-called "Price Club" was established in 1984 for enterprises belonging to the "export-dependent" pricing system but wishing for greater freedom in determining their prices. Enterprises had to apply for membership in this rather grotesque Club which was "founded" to become a grouping of enterprises with genuinely market-conform pricing behaviour. Application for membership had to include a detailed presentation of pricing, marketing, production and R & D practices and a promise not to exceed the prices of competitive imports. The fulfilment of this latter promise was regularly controlled by authorities but it often proved to be an impossible task. Out of several million sorts of goods produced in Hungary only several tens of thousands had a clearly identifiable counterpart on the world market. So product substitutability was frequently a matter of subjective judgement by staff members of the National Board for Prices and Materials.

The other effort was made by a group of machinery firms in order to break the pricing cartel of domestic iron and steel producers (Nagy, 1988, pp. 54-56). These firms realised that while Hungarian iron and steel enterprises nominally follow world market prices in their domestic sales to machinery industry, occasionally imports can be obtained for 10 to 40% less than these "official" prices. So machinery enterprises just found that the Hungarian pricing system

served to protect their domestic suppliers from following "informal" price cuts quite usual on international markets. Even if the government and the Chamber of Commerce apparently endorsed the machinery firms' initiative, admitting that artificially high domestic iron and steel prices negatively affect the competitiveness of machinery exports, iron and steel producers could defend their positions (and prices) by showing that exact documentation existed only for quite high "official" world market prices.

The system of "competitive pricing" is nothing more than an episode in the Hungarian reform history of the 1980s<sup>6</sup>. The official abandonment of this system in March 1987 was only a recognition of the fact that further streamlining of the pricing framework based on a mere simulation of the market leads nowhere and is unable to replace an efficient market regulation system with generally valid antimonopolistic rules of pricing and competition. The observance of these rules in a socialist economy with clear and efficient markets would then be less of a legal obligation than a result of openness to import competition.

## 32. Steps Towards Institutional Reform

The establishing in 1980 of a single Ministry of Industry from the earlier Ministries of 1. Heavy, 2. Light plus 3. Iron, Steel and Machinery Industries respectively was a reform measure very favourably commented around the world but its content proved not to be far-reaching. In fact, the structure of the new ministry preserved some important features of the earlier system<sup>7</sup>. Proof for the continuing preponderance of

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<sup>6</sup> Moreover, "the 1980 pricing principle ... (was)... not only a step forward but also one back showing that the developers of economic mechanism lost confidence in the genuine functioning of the genuine market." (Bauer, 1982, p. 29).

<sup>7</sup> 1. Hungarian ministries have one State Secretary as the first Deputy to the Minister. The only exception to this is the Ministry of Industry with three State Secretaries for the fields covered earlier by the three separate ministries. 2. So-called background institutions (research institutes computing centres etc.) preserved at least the same size as

capital- and energy-intensive industries is the fact that the two successive ministers of industry between 1980 and 1987 were a former general secretary of the Iron- and Steelworkers' Trade Union and a former director of a huge mining enterprise.

The quite slow institutional reforms between 1980 and 1987 included the degradation of the Ministry of Labour to the rank of a National Office for Labour and Wages headed by a State Secretary as well as the separation of the Hungarian Mail from the Ministry of Communications and Transport among other changes. These reforms did not touch the role and the institutional weight of key governmental bodies responsible for economic policy. So a system was maintained in which the National Planning Board was a sort of "super-ministry" headed by a Deputy Prime Minister and the Ministry of Finance held the responsibility for fiscal regulation and the budget. However, the National Planning Board was less of a classical planning institution than a "Ministry of Economic Affairs" since directive planning was limited to such sectors of the economy as infrastructure, housing etc. (but planning in this sense rather meant a distribution of budget funds related to specific targets). The Planning Board rather acted as a background institution preparing the sessions of a special kind of economic policymaking cabinet (called State Planning Committee). The situation was complicated by the fact that two more or less parallel bodies existed with not always clearly distinguishable profiles. One was the Economic Committee with a responsibility for day-to-day operative decisions (like issuing of import licences in times of strangling currency shortage, determining the ranking list for extraordinary import demands etc.) as a governmental body and the other called Economic Policy Committee created by the Party and rather destined to economic strategy-making. A certain part of the responsibilities of the latter two was obviously shared by the Planning Committee.

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before 1980, and their sectoral structure also remained practically unchanged.

### B3. Policies Influencing Forms of Entrepreneurship

A special bill adopted in 1982 gave rise to quite original types of small enterprises mostly based on cooperative-like ownership forms. These - called GM and VGM (literally translated Working Communities and Intra-Enterprise Working Communities, respectively)<sup>8</sup> have been a product of a rather ambiguous governmental attitude insisting on a central control of micro-level wage and purchasing power growth on the one hand but wishing to stimulate non-state entrepreneurial dynamism on the other. While the GM's have been a certain kind of small cooperative enterprises with the possibility and the right to transform themselves into "normal" cooperatives VGM's have showed themselves a rather original device. Members of these usually worked extra hours for the state enterprise employing them but this time not as its employees but as members of a subcontracting enterprise which was the VGM. The tricky thing was that they were paid 2 to 4 times more per hour than in their normal working time because they were not subject to the official wage regulation system as virtual members of a non-state firm. The spreading across the national economy of VGM's could clearly eliminate some not unimportant shortage and capacity utilisation problems, but it did not fulfil expectations linked to their upsetting traditional intra-enterprise political relationships.

This law led to a temporary growth of small enterprises<sup>9</sup> (their number grew from hardly more than 2,000 to more than 35,000 between 1982 and 1986), which in turn helped to reduce supply shortages in several fields of the tertiary sector and sometimes in production, the government's position towards

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<sup>8</sup> VGM's can be created only within state enterprises. Cooperative members are entitled to create analogous small enterprises but differences between these and VGM's will not be discussed here.

<sup>9</sup> Increasing official tolerance could be observed towards private entrepreneurship, too. The share of private production on national income had increased from 2.6% to only 3.5% between 1970 and 1980, but it reached already 7.0% in 1986.

them has remained quite unclear. Their fiscal burdens were increased several times (under the slogan of "creating equal competitive conditions for all sorts of enterprises") and the problem of their identity is far from being solved<sup>10</sup>. But these disparate reform steps make real, profound and general reforms more difficult to carry through. The growing number of special situations and rules increases the number of such potential opponents to further reforms. More and more people enjoyed or have access to special privileges stemming from one special rule of the game or another and can therefore be at most only intellectual but not practical supporters of further reforms.

More strategic changes in governmental attitudes towards enterprises were the elimination of many monopolistic enterprise conglomerates called "trusts" (their number decreased from 24 to 9 between 1980 and 1985 with more than 4000 new enterprises emerging either as their successors or as ones gaining independence from other state enterprises, *Wass von Czege*, 1988, p. 133) and the introduction of formal self-management in a large number of state enterprises.

The 1985 act on enterprise management boards can be considered a compromise between the suggestion by the reform economists that state enterprises should have legal independence from ministries and the government's wish to share responsibility for the results of economic policy with the microsphere. In the new system state-owned enterprises (except for some of strategic importance) were invited to elect their boards of management from their own members and enterprise directors legally became employees of these boards. The supervising ministry was authorised to refuse to accept the new director elected in which case further elections with new candidates were to be held but this practically never happened. The strategy of the enterprise was to be worked out by the board and its "tactical" realisation became the task of

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<sup>10</sup> The tax reform introduced at January 1, 1988, diminished net personal incomes from VGM's usually by almost a half. So a quick drop in the number of such enterprises is already observable.

the director. This new scheme, however, did not change the informal dependence of enterprises on the authorities. Moreover, in many firms, directors and boards formed "Yugoslav-type" redistributive coalitions for they quickly realized that salary increases of members of the management boards depended on the director's decisions while the bonuses of the director are decided upon by the board.

The forming of these coalitions proved again that "radical reformers" were right to assume that any change in the management system of state enterprises would be inefficient or even counterproductive if it did not create a strong interest for every employee to increase the enterprise's assets. This idea of the creation of "asset-interest"<sup>11</sup> of enterprises (cf. Antal, 1985) is favoured by many reform economists and means a revision of the key principles of the 1968 reform. This principle involves substituting the profit target for the plan fulfilment target for enterprises.

Apart from the basic question about the character of the "target function" of enterprise development another aspect of Hungarian enterprises' working conditions has not been made more clear by these measures with rather short-term yields for the economy. Enterprise formation in Hungary is at least theoretically still governed by the 1875 Corporation Act with some clauses completely outdated and some others repealed after 1945 for political reasons. So any change in the form of functioning of Hungarian enterprises (as, for instance, the rather progressive Bankruptcy Act of 1987) would in theory only add to the legal confusion in this matter existing till the adoption of the new Corporation Act (this bill specifying the legal status and exact property form of enterprises was due to be adopted in Autumn 1988).

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<sup>11</sup> Which would mean that enterprises' interests would be mainly linked to increasing the value of assets instead of increasing profits (but being unlimited to simply distribute them among enterprise members thereafter).

#### **B4. Capital Markets and Monetary Policy**

Monetary policy in Hungary before 1981 was characterised by a rather liberal attitude towards overall liquidity growth. The increase of M1, M2 and credit stock was usually faster than nominal GDP growth (Huszti, 1987, p. 105) and savings showed a still higher dynamism. Monetary circulation decreased until 1978 and after 1981. Anti-inflationary policy was carried out mainly by means of increasing the exchange rate of the Forint vis-à-vis convertible currencies till 1982 (this revaluation of the Hungarian currency was also a result of the country's joining IMF and the World Bank a precondition for which had been the creation of a unified exchange rate). The only tools of macroeconomic demand management were rediscounting, credit rationing and interest rate policy carried out by the National Bank in the one-level banking system. Domestic monetary policy was effected by means more and more out of keeping with the tasks the monetary system had to perform for opening the economy towards international financial markets. Indeed, administrative character of monetary policy was increased in the late 1970s in order to reestablish balance-of-payments equilibrium. But subsequent developments showed that "... measures taken in order to enlarge and diversify international monetary relations cannot be built on a rigid domestic monetary system contained and compressed in an administrative way" (Huszti, 1987, p. 82). Official acceptance of this fact gradually led to a partial liberalisation in the monetary sphere, especially concerning capital markets.

The economic mechanism introduced in 1968 made the allocation of capital mainly a task of sectoral ministries and central planning (in cases for investment projects of national importance for the latter). Enterprises were also entitled to carry out investment projects with their own financial resources, albeit under more or less strong indirect central control through the National Bank. The inefficiency of capital allocation in this system was increased by the considerable financial weakness of the majority of enterprises.

Ideas to reform the system of capital allocation went in four directions:

1. A comprehensive reform of property forms and capital management by the state, based on holdings.
2. Creation of a two-level banking system with independent commercial banks free to collect deposits and giving credits on a capital market where the only sign of state presence is a Board of Supervision of Banking Activities.
3. Creation of a two-level banking system with a strong link to the National Bank and operating on a highly regulated capital market subject to gradual liberalisation.
4. Maintenance of a one-level banking system and centralised credit allocation along with rapid liberalisation in the enterprise sphere.

The solution finally chosen by the government was a combination of proposals 2 and 3 with a considerable emphasis on 3. It was preceded, however, by other financial liberalisation measures of a rather limited scope. The creation of bank-like innovation funds (so-called "small-banks") became possible in 1982 and a bond market open to enterprises and partly to the population was created in the next year.<sup>12</sup> The aggregate value of bonds in enterprise property did not exceed 2 billion Forints and those owned by the population totalled approximately 7 billion Forints at the end of 1986 (*Antal-Várhegyi*, 1987, p. 277). While the amount of enterprise-owned bonds is almost without significance (about one-twentieth of the total capital of joint ventures - called "corporations" - created with exclusively Hungarian

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<sup>12</sup> Even if already more than 200 enterprises have issued bonds these are not very actively traded yet. There is still a lack of institutional framework for bond transactions and only a few bonds seem lucrative enough (some of them even served forced saving like "telephone bonds"). Bond rates change every week, but changes usually take place in only some bond rates within a scope normally not exceeding 1 percentage point.



participation), bonds represent a non-negligible part of the population's savings. At the end of 1986 bonds represented around 2.5 per cent of total savings deposits but already 20 per cent of those with at least two years of maturity. Developments in late 1987 when expectations linked to the introduction of the tax-reform as of January 1, 1988, led to a quasi-halt of the growth of savings deposits but demand for bonds was still maintained at a rather reasonable level and the stock of population-owned bonds now probably approaches 10 billion Forints.

The most far-reaching change in the financial system certainly was the establishing of legally independent commercial banks as successors to the National Bank's several specialised credit departments on January 1, 1987. This reform step was essentially based on the realisation by the government of the fact that "... the (Hungarian A.T.) system of financial institutions is unable to cope with a series of important problems<sup>13</sup>. These are among other things the creation of enterprises in general, financing of small enterprises, realisation of innovations, financing of leasing and of projects necessary for increasing exports or even simple discounting. It can be increasingly felt under the restriction that the cut in demand apparently on a global scale - which in practice is unable to handle projects already decided or started and loss-making production - has a set of tools inappropriate to resolve the above-mentioned problems. New tools and institutions would also be needed." (Antal-Surányi, 1987, p. 7).

The five commercial banks with a general profile<sup>14</sup> were created in the form of joint-stock companies with 100% of stocks owned by the state. They are generally authorised to

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<sup>13</sup> These problems were brought about by strongly restrictive demand management and gradual financial as well as operational liberalisation for the micro-sphere from 1979.

<sup>14</sup> Apart from the two partly foreign-owned banks (Central-European International Bank Ltd. and Citibank Budapest) other 10 quasi-banks ("specialized financial institutions") existed that time.

offer a wide scale of banking services and they cannot formally be obliged to give credits to any enterprise asking for them, but they are not entitled to carry out operations in foreign currencies and are not allowed to offer services to the population (Ligeti, 1987, pp. 17-18).

The first result of the appearance of new commercial banks on the Hungarian financial scene was undoubtedly inflationary. The amount of credits given to enterprises soared in early 1987 due to the striving of new banks to put hands on a part of the financial market under restructuring (JA, 1988, p. 24).

The way in which the new commercial banks have been functioning is crucial for the macroeconomic set of conditions in which the 1987 stabilisation programme is supposed to operate. To what an extent can they be useful for the "market construction process"<sup>15</sup> which is a pivotal point of the whole stabilisation package? This contribution essentially depends on how new banks can turn the rather administrative character of the credit allocation system into one genuinely based on business principles and market-oriented rules of behaviour. However, extent to which a real "entrepreneurial" competition between commercial banks can develop was limited at the very moment of their creation by several factors (Bokros, 1987a, pp. 25-28).

1. Huge differences in capital stocks (if that of banks 1 and 2 is approximately 100 each, then bank 3 has around 35 and banks 4 as well as 5 only 15 to 17).
2. Important regional and size inequalities in national networks of branches.
3. Rules of monetary creation and refinancing are the same for all the five banks (of quite different size) in question. Refinancing by the central bank

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<sup>15</sup> Market construction will be discussed later in Chapter 3.

is clearly administrative since based on volume and sectoral criteria (medium and long-term refinancing by the central bank is automatically available only for projects especially marked in the annual national economic plan or linked to World Bank projects).

The lack of real independence for commercial banks also points at an obvious lack of autonomy of the central bank (and so of the banking system as a whole) in determining monetary policy. Part of the institutional framework for carrying out monetary policy has undoubtedly been created with the appearance of new banks but this in itself cannot efficiently take the place of the missing tools of a market-oriented monetary policy (Bokros, 1987a, p. 30).

Some distinguished foreign observers (cf. *Balassa, 1986, Marer, 1988*) are very careful in analysing the restriction between 1979 and 1985 (which was re-started in 1987) avoiding a global critique of it. It is clear that the rather modest Hungarian set of monetary policy tools often permits only a choice between drastic restriction or stimulation of economic growth by loosening the regulation of aggregate demand. Yet it seems crucially important to note that evidence both of excess liquidity and a lack of it has been a consistent feature of recent Hungarian economic experience. Thus demand management on the traditional basis described earlier has almost always proved inefficient.

Endemic reliance on foreign borrowing creates the false impression of a chronic lack of domestic liquidity. What really happened was just the opposite. The relatively generous crediting policies in the 1970s - partly linked to ambitious investment projects in energy production, petrochemical industry, agriculture etc. - created excessive monetary demand for which supply counterpart existed neither in volume nor in structural terms. This created a constant demand for net imports in convertible currency and when restrictive measures came (cf *Bauer, 1981, 1987*) the government proved unable to

take back earlier surplus liquidity already spent on imports. What it could do was restrict actual liquidity. This quite often made life for enterprises even more difficult and increased their financial dependence on the central bank or on the budget. All this ended up in unfinished investment in which a considerable amount of foreign loans was "frozen in".

The central bank management of liquid demand was quite unable to pour liquidity only into sectors with an urgent need for it and drain it off from sectors where it was in excess. It became more and more obvious that many enterprises were creditors and debtors to the banking system at the same time. This fact has been closely linked to another: namely, that losses of enterprises covered finally by a growing budget deficit (especially from 1985) did not have their counterpart in increased savings since treasury bills did not exist for financing the budget deficit from savings<sup>16</sup>.

The inefficient functioning of monetary policy in Hungary points to the necessity of increasing the scope and the role of financial markets. This could help to diminish forced savings by relatively buoyant enterprises but would not completely eliminate these savings. Some savings of this type only apparently have a forced character and thus are not likely to be completely drained off by capital markets. For instance, some money not spent on convertible-currency imports is kept ready for such expenditure. Such variations in enterprise-level liquidity have a clearly tactical character and may not result in increased supply on the capital market. The appearance of such excess liquidity can mean a major disturbance to capital markets in a socialist economy when it takes place simultaneously in many enterprises - as a result of an import-stopping or an export-forcing campaign, for instance.

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<sup>16</sup> Treasury bills were introduced in the spring of 1988, but without considerable success so far.

This underlines the fact that the very existence of capital markets does not imply that demand management will be efficient so long as non-monetary intervention in enterprise decisions by the authorities is not completely eliminated. Another important precondition for successful monetary demand management is foreign economic policy serving a serious opening of the economy towards the world market as well on the export as on the import side.

#### **B5. Foreign Trade and Capital Imports**

Formal liberalisation of economic relations with the West was only periodically accompanied by measures permitting a real opening of the economy on the micro level. The widely known fact of Hungary's joining IMF and the World Bank in 1982 had a huge importance from a political point of view and also for overcoming the external financing and liquidity crisis between 1982 and 1984, but it cannot be considered in itself a sign of a genuine opening towards the world economy.

More or less formal liberalisation measures included a gradual increase of the number of enterprises authorised to conclude direct trade deals in convertible currency (as of January 1, 1988, practically every enterprise can be granted the so-called "right to foreign trade"), the abolishing of profile restrictions for trading enterprises, the creation of trading houses and several steps towards a quite high degree of liberalisation of joint venture regulations (from 1986 joint ventures can be established even with a more than 50% of foreign participation, and profit repatriation as well as taxation rules are more or less also in line with international practice). But case-by-case import licensing was never lifted completely - it was exceptionally strong between September 1982 and June 1984 on the basis of a waiver obtained from GATT because of balance of payments and liquidity difficulties - and a subventions-based export-forcing policy has been existing instead of export-oriented industrial and trade policies. So increases in exports were mostly results of efforts trying to squeeze more and more from the given and

rather obsolete production and trade structure without an appropriate exchange-rate policy as well as an innovation and capital-market-developing policy background (cf. Balassa, 1986, chapter III) and with an overall decrease in export rentability. Every enterprise with relatively important convertible-currency exports has been in a good bargaining position with the government. Promises to increase exports could serve as a ground for obtaining more subventions, several preferences (as the possibility of increasing wages or primes not subject to normal punitive taxes linked to wage increases exceeding centrally determined rates) or simply licenses for more imports. So governmental efforts to increase convertible-currency exports had quite serious consequences for the state budget especially in 1985 and 1986.

Another important field where no progress in liberalisation was achieved is trade with CMEA-countries. In this trade export push (mainly in "hard goods") is traditionally very strong on the Hungarian side and it usually exceeds the volume and value of what can really be imported. Pricing rules in this trade also make export subventions necessary (first of all in machinery and agricultural exports) so that receiving a contingent or export-license in the transferable rouble trade almost automatically means more subventions. Enterprise concentration in this trade is high with mostly bigger enterprises with a considerable political weight interested in it, so withdrawing subventions or not granting export licenses can sometimes be a politically delicate matter.

Normative regulation of these exports is rather unsuccessful as well from the trade balance as from the state budget viewpoint. This regulation system was introduced in 1985 and was partly changed in the beginning of 1988. It is based on the following principles (Nagy, 1988, pp. 128-129; cf. Meisel-Mohácsi-Salgó-Szegvári-Török, 1988) most of which had also characterised the former system, too:

1. The necessity of increasing rouble-exports is judged on a case-by-case basis by authorities (National Planning Board, Ministry of Foreign Trade, Ministry of Finance).
2. Profits earned by an enterprise from rouble-exports will be established in the end of each year starting from the difference between incomes from and direct costs of sales on other markets. So enterprises have practically no word to put into how sales prices on CMEA-markets will develop on the micro level (since prices for export and import are usually established between the two Ministries of Foreign Trade but these prices have no direct links with prices finally paid or received by enterprises involved).
3. Profits from rouble-exports can in principle not exceed those reached in other sales (but exceptional treatment in cases where simulation of rouble-exports is judged necessary by authorities is not excluded).
4. Direct costs of rouble exports can not exceed prices obtained for these sales on the enterprise level.

As can be seen, the system is quite complicated and gives ground to widespread bargaining. Moreover, it stimulates enterprises to "rechannel" profits to rouble exports from other sales in order to diminish eventual levies on profits from these exports (because the logic of the system requires that rentability be relatively high in other sales with these rentability indicators determining "ex-post" rentability in rouble exports). So profitability in other sales can show itself artificially high. Another weak point of the system with doubtless inflationary effects is that price increases in convertible-currency exports and in domestic sales due to inflation almost automatically lead to increases in subventions for rouble exports.

A structural weakness of Hungarian foreign trade which economic policy has been unable to handle is the problem of "trade conversion between two markets" (Török, 1988b).

Exporters and importers are supposed to behave according to completely different market patterns in convertible-currency and non-convertible currency (i.e. mostly transferable rouble) trade, which leads to a difficulty situation when an enterprise is a net importer from one type of market and net exporter to the other. Namely, regulation stimulates rouble-imports and convertible-currency exports (between which a linkage on the micro-level is common in the petrochemical or the iron and steel industry i.e. the structurally weakest sectors of industry in Hungary). These stimulation efforts, however, have an effect counterproductive for structural change as well as that they lead to increasing rouble exports what (first of all in machinery, clothing and other light industries and in agriculture) supposes a further increase in convertible-currency exports through the opposite mechanism (i.e. convertible currency imports - rouble exports) with sort of a vicious circle kept on going. This mechanism increases the nominal or structural openness (as usually measured by the export/GDP ratio) of the economy towards both markets but has clear consequences in worsening overall and marginal rentability of foreign trade.

### **C. Reform Steps vs. Reform**

By the end of 1986, at least three preconditions for launching a stabilisation package were united. The economic situation had worsened sharply through 1985 and 1986 with balance of payments and budget deficit problems drastically aggravated. Economic science interested in a strategic and fundamental reform had arrived at a point where ideas were judged more or less consistent and mature enough to be converted into practice: the intellectual basis of reform economics along with some social support had both developed strongly. Finally, the party leadership and the government had come to realise that half-way, awkward and inconsistent reform steps were useful for image-building abroad but could not really serve a market-oriented modernisation of the economy. It also became clear to all that reform ought to be linked to stabilisation in practice and that the latter was



inconceivable without a decisive reform. Tactical reforms in the 1980s had taken place without considerably improving (or perhaps even worsening) the fundamental balances of the national economy. The stabilisation programme dates from September 19, 1987.

### 3. Crisis and Stabilisation

In 1986 the convertible-currency trade deficit reached -401 million USD, the current account deficit -1.400 million USD, the budget deficit 47 billion Forints (with a nominal GDP of 1.089 billion Forints) and the gross convertible-currency debt of 15.0 billion USD. It is worth mentioning, however, that the apparent crisis of the national economy wasn't already accompanied by a clear growth crisis. The 1985 acceleration programme "resulted" in a 1.7% growth in GDP-volume for 1986.

Development in 1987 showed the impact of restrictive and trade-balance improving measures taken at the beginning of that year. While there was an acceleration in GDP-volume growth (3.7% in 1987) and convertible-currency debt increased to 18.0 billion USD, partly due to the depreciation of the US-currency, external and domestic balances showed some improvement. Thus trade balance in convertible currencies had a deficit of -361 million USD, the current account one of -850 million USD (a 550 million USD improvement from the previous year), and budget deficit was up to 35 billion Forints. Even if these developments were signs of a slowing down of unfavourable macroeconomic trends it became clear that basic imbalances at the national economic level could not be completely eliminated in the given economic policy, institutional and structural framework. The acceptance of the fact that the economy and the society were heading towards a crisis of an always less latent nature became more and more widespread.

#### A. Understanding the Crisis

When the reasons for the present economic crisis in Hungary are examined a clear distinction has to be made between the "target functions" of economic policy in various periods, i.e. before 1979, between 1979 and 1985, then after the 1985 party congress and finally in the stabilisation period (to be more precise: the period starting with the

adoption of the stabilisation programme by the Parliament) from 1987. The hierarchy of economic policy targets and all the changes in it cannot be clearly seen throughout the period we have tried to analyse but we can agree with Wass von Czege that the three main goals of economic policy were: "maintenance of the ability to meet international financial commitments; reestablishment of the equilibrium in foreign exchange (...); maintenance of the standard of living" (Wass von Czege, 1987, p. 122).

Targets linked to ensuring the short-term survival of the economy and the management of more or less obvious crises of different kinds (liquidity crisis, structural crisis in various sectors of industry, housing crisis and several other phenomena linked to state budget, infrastructure, macroeconomic regulation etc., problems which have not been called crises yet in publications on the economy) have certainly also had a growing importance since 1982 with the approximately one-year interruption from May 1985 as far as some of these "partial crises" are concerned.

Some authors point out that the functioning of the indirect and centralised economic mechanism inevitably leads to a situation in which macroeconomic growth or expansion creates preconditions for a crisis. In this system redistribution in favour of politically important ("heavyweight") enterprises sooner or later starts to increase external indebtedness and when the accumulation of the latter has reached an intolerable level customary norms of behaviour in the society and economy will be upset (Szalai, 1988, p. 60).

In this situation the leadership will begin to lose those of its partners whose readiness to cooperate is based on their interest in profiting from redistribution. The system of strategic coalitions (with the government or against it, for the reform and against it etc.) becomes rather blurred or gives way to purely tactical coalitions. But tactical coalitions are usually not strong enough to give decisive

support to reform efforts or against them. Thus a curious situation emerges in which no interest group can be discerned that would surely either gain or lose from a reform programme. "Nobody can be clearly perceived for whom or against whom a reform package could be elaborated" (Szalai, 1988, p. 61). This is a crisis of crisis management. This means that completely new methods of crisis management based on really wide coalitions of interest are urgently needed.

The decrease of national wealth available for distribution<sup>17</sup>, the segmentation of large bargaining groups with ad hoc and individual bargaining gaining ground, a loss of inner consistency of the economic administration as well as some rather unrealistic illusions stemming from partial successes in macroeconomic management (from which just the above mentioned ability to maintain basic supply can be emphasised) are all factors leading to a decrease of the manageability of the economy by the government (cf. Szalai, 1988, p. 63).

The macroeconomic management system that emerged after 1978 was characterised by two basic contradictory elements.

- a) The economic administration saw its power extending due to a more direct central regulation of convertible-currency exports, wages and investment. Nevertheless the restrictive policy reduced the proportion of domestic use of GDP to disposable GDP only by pushing domestic use down (since productivity failed to rise sufficiently).
- b) The system could eliminate the most evident economic losses. It could also gain support from some groups within the party and/or from intellectuals by implementing some reform steps that we have to consider integral elements of the new course in macroeconomic management.

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<sup>17</sup> The loss of performance and dynamism is shocking when compared with the pre-1979 period but an improvement to some extent can be seen from 1985 (Bokros, 1987b, p. 1446).

These partial reform steps were, however, doomed to fail because they pointed beyond the limits of "reformability" of the actual economic system and they turned out to be in conflict with the interests of bureaucracy (Révész, 1988, pp. 672-673).

Thus a deeper understanding of the crisis of the economy in Hungary does not only require a correct idea of macroeconomic trends but also a good picture of how consecutive reform steps have followed each other while being in contradiction with the "finality" of the reform process itself. It is unnecessary to make a philosophical detour in this study but some similarities between the way in which the reform process has worked in Hungary and the self-conflictive or negatively recursive "Möbius-Hofstadter" type loops can perhaps be pointed out (cf. Hofstadter, 1980).

## B. Reform and Stabilisation

Speeding up the reform process on a new basis that would create the preconditions for consistency in the reform programme is also a prerequisite for successful stabilisation. It can be seen from the stabilisation experience of many countries (for instance Turkey, Chile, Israel, Spain, Argentina, India etc. cf. Török, 1988a) that stabilisation cannot be successfully carried out without creating an economic structure and clear markets which could help the economy to stay on the stabilisation and adjustment path. Stabilisation and adjustment can mutually help each other and reform can serve both. As far as the case of Hungary is concerned, reform has many elements in common with stabilisation, but whereas stabilisation is a rather short-term task (or problem), adjustment a more strategic one, reform does not necessarily have a similarly perceptible time dimension. Reform tasks are partly those of stabilisation: "The fundamental problem of the stabilisation period is that market reform, a tightening of money supply (the Hungarian economy has to produce an export surplus equalling 5% of GDP in a few years' time), and a partial elimination of domestic

imbalances<sup>18</sup> (budget deficit, disturbances in inter-enterprise relations and cooperation, shortage phenomena, a weak payment discipline) have to be carried out simultaneously". (Antal, 1988, p. 252). A successful realisation of these tasks would be an important achievement in stabilisation terms, but not necessarily a breakthrough in the reform.

Stabilisation is a precondition of reform, but these two notions have to be understood in different terms. "Stabilisation can be considered accomplished if a balanced and stable as well as socially accepted development ... can be achieved and maintained without forced measures". (Antal, 1988, p. 253). This situation could be brought about when the increase of indebtedness had been stopped with imports free to grow to a certain extent, budget deficit had been kept below a 15 billion Forint (at 1988 prices) or less than 1.5% of GDP limit with approximately 3% of GDP-volume growth and a 5% inflation rate as a maximum. Successful stabilisation also requires successful adjustment to the world economy on a continuing basis. The stabilisation targets described above are presently more or less widely accepted in Hungary (the data themselves stem from Antal, 1988, but can be found in other publications too) but the scope and the contents of economic policy measures leading to them are not always understood in a realistic way. Thus it may be useful to examine some of the most important constraints of the stabilisation path before analysing the stabilisation programme of the government.

### C. Macroeconomic Constraints To Stabilisation

The failure of the "dynamisation" policy decided upon by the 1985 party congress was a result first of all of the fact that the "designers" of this policy considered the growth potential (or potential GDP) of the economy to be rather

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<sup>18</sup> These imbalances should be understood according to the terminology now prevalent in Hungary, i.e. in a rather wide sense with some notions of balance (or imbalance) lacking a clear statistical interpretability.

large. Therefore they concentrated their efforts on the elimination of apparent bottle-necks that seemed to prevent the narrowing of the gap between actual and potential GDP. But the segmentation and the rather limited interchangeability of the three main markets (convertible-currency markets, domestic market, CMEA-market) for the Hungarian economy imply that an elimination of supply bottle-necks almost necessarily leads to an expansion towards "softer" markets (i.e. CMEA, and to a lesser extent the domestic market). Competitiveness on these markets depends largely on import contents purchased for convertible currency. Thus GDP-growth is realised in such a way that the share of "convertible" production and services within GDP decreases while the share of "convertible" inputs in domestic use increases. It is rather instructive to see how the elasticity ratios of foreign trade volume growth to real GDP-growth changed between 1984 and 1986.

In 1984 (the last year with an ostensibly good Hungarian performance in convertible-currency trade) the ratios of rouble-export growth, convertible-currency export growth, rouble-import growth and convertible-currency import growth (all in volume) to real GDP-growth were 1.040, 1.014, 0.996 and 0.952 respectively. This shows that GDP-growth was maintained partly due to a continued "opening" towards the CMEA-market, nevertheless the economy was able to produce more convertible output from a smaller amount of convertible inputs. The 1985 picture shows a general impact of a negative real GDP-growth (-0.3%) on similar elasticities. But these with respective values of 1.081, 0.899, 1.027 and 1.001 also witness of a strengthening trend of opening towards CMEA-markets on the export as well as towards convertible-currency markets on the import side with a growing part of convertible inputs transformed into GDP-growth that was realised from CMEA-exports. However, 1985 was still not entirely a year of growth-oriented economic policy.

1986 then very clearly shows (with respective elasticity values of 0.971, 0.956, 1.032 and 0.972) that GDP-growth in case of a central "braking" of the increase in rouble-exports

can be also based on an expansion of domestic demand. Thus the concept according to which a strongly growth-oriented economic policy plus excessive stimuli for convertible-currency exports can serve economic growth and external balance targets simultaneously well had to be definitely dropped. It became obvious that growth policy cannot be carried out without an efficient market construction policy and also that different growth policies and growth paths cannot be simply labelled "quantitative" and/or "qualitative". The term "qualitative growth" proved misleading for judging Hungarian economic dynamism several times, for it turned out that a halt in GDP-growth as a counterpart to an acceleration can be rather benignly called "switching to a qualitative growth path" without an exact knowledge of what this meant for the input and output structure of the GDP (classified by the three main markets). It is not the case that growth based on increasing rouble import and diminishing convertible currency inputs as well as growth realised through an increase in convertible currency export and a decrease of rouble sales can be called "qualitative".

A serious appraisal of the character of the growth process can be based only on a wider analysis of all the basic macroeconomic balances. The logical result of the growing segmentation of the three main markets from each other was that the volume of freely usable inputs and resources diminished instead of increasing and outputs grew just in a non-freely usable direction (which was, ipso facto, not sufficient for offsetting input growth in the given structure). Crisis management and therefore stabilisation will have to focus much less on growth than on developing proper markets and structural reforms.

The basic constraints<sup>19</sup> fixing the desirable path of stabilisation are presented and analysed by Bokros (*Bokros*,

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<sup>19</sup> These constraints are formulated in a target-like form, but it has to be understood that each of them has to be inevitably coped with thus the fulfilment of the target is the constraint.



1987b, pp. 1454-1456). We accept his approach as a not disputable starting point as far as the fundamental constraints are concerned but our view differs from his in some not very unimportant details. While sticking to the framework and the structure of his analysis it can be tried to fill them in a somewhat different manner, above all as far as antiinflationary policy is concerned.

Bokros' scheme of constraints consists of six elements (a-f) to which we can add a seventh (g). A brief review of the scheme is the following:

- a) A macroeconomic structure efficient by world market standards. This formulation by Bokros seems to lack a sufficient degree of clarity. The structure itself cannot be a constraint or a target; what is needed is an economic system capable of creating it in the shortest possible lapse of time.
- b) A stop in the increase of external debt and a subsequent diminution of the latter (from the early nineties).
- c) A restriction of domestic use.
- d) An increase in the level of enterprise-level investment thus (considering c)) a decrease in the standard of living.
- e) It follows from c) and d) that consumption has to be reduced. This would need a higher increase in consumer prices than in nominal incomes and a dynamic growth of deliberate (i.e. non-forced) saving. A result of these would inevitably be an inflation higher than in 1988 but widespread shortage as well as price and/or wage stops could be avoided. It would be of utmost importance, however, that the government should publicly commit itself to the policy, stressing its short-term inconveniencies and longer-term benefits (in terms of a

change in the structure of consumer prices and thus consumption).

- f) A change in structure without a substantial improvement of macroeconomic performance would inevitably result in increasing unemployment. Since the elasticity of social infrastructure in Hungary is likely to remain very low, it has to be accepted that stabilisation will be accompanied by an increase of structural as well as by the appearance of global or, according to Malinvaud's terminology, "classical" unemployment (cf. *Malinvaud, 1976*). This is likely to become the politically most delicate element of the stabilisation package.
- g) A stop of the net outflow of resources in CMEA-trade<sup>20</sup>, with an accompanying significant improvement in Hungary's terms of trade and a fast growing export surplus. It is rather evident that neither capacity utilisation considerations on the Hungarian side, nor the taking into account of import needs of the partner countries wouldn't make an immediate elimination of this surplus feasible. A reduction of the economy's openness towards socialist countries is not obviously required, but either a stopping of most unrentable exports or a considerable increase in most competitive imports of "hard" goods (like cars, other relatively high-quality consumer goods, raw materials etc) would be unavoidable in CMEA-trade.<sup>21</sup> This could be, in turn, promoted by a significant reform of the CMEA-system (above all in the financial field) which cannot be discussed here in detail. It is essential, anyway, that the further development of Hungary's trade with CMEA-countries should not be a

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<sup>20</sup> Limits to the quantitative growth of imports from CMEA-countries are a very hard constraint of a non-budgetary character to GDP-growth (cf. *Köves-Oblath, 1981, Török, 1986, pp. 154-155*).

<sup>21</sup> This "unavoidability" is practically a too strong constraint as far as increases in imports are concerned. Recent problems in Hungarian car imports from the USSR and Czechoslovakia show the vulnerability of the country vis-à-vis CMEA-imports on which domestic supply is dependent.

factor making constraints a), b) and c) insupportably tight. If, for instance, net rouble exports cannot be diminished domestic use has to be reduced still further. It is also highly probable that these exports will act against lowering convertible-currency indebtedness (through the import content of these exports) and will also impede a speeding up of structural change because of the significant number of enterprises in strongly energy- and material-intensive sectors involved in these exports (cf. *Török*, 1986, Chapter IV).

The Bokros approach to the main constraints to targets of stabilisation policy completed with constraint g) seems to give a sufficient framework for proposing stabilisation measures and is in line with international experience concerning stabilisation. A recent research project of analysing and comparing with each other stabilisation policies of eight countries<sup>22</sup> carried out in the Institute of Economic Planning of the National Planning Board of Hungary distinguished four key (and complementary) fields of such policies. These were monetary policy, with emphasis on aggregate demand management serving anti-inflationary purposes, fiscal policy with lowering budgetary expenditure by streamlining the state sector rather than increasing budget revenues, labour market policy usually with less state concern for employment than before but with a more liberal attitude towards the "informal" sector and finally foreign economic policy with more realistic exchange rates as well as deregulation in trade policies and liberalisation of capital imports (*Török*, 1988a, p. 551).

The constraints presented by Bokros are in line with international experience except for e). An anti-inflationary stance seems to be a dominant element in stabilisation policies and recent research also pointed out that temporary price and wage freezes can be useful for calming inflationary

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<sup>22</sup> Yugoslavia, Brazil, Argentina, Chile, Italy, Spain, Turkey and Israel.

expectations (cf. *Rockoff*, 1984, p. 246, *Török*, 1988c, p. 12)<sup>23</sup> if they are not destined to replace effective antiinflationary policy and if they are not meant to conserve an autarchic price structure. Further argument against Bokros' pro-inflationary argument are that 1. accelerating inflation would more than proportionately increase inflationary expectations, in an economy with imperfect money and capital markets, so that private capital would be converted into foreign currency (on the black market, of course), or invested in real estate, precious metals, and objects of art etc rather than held in officially approved (and superficially attractive) forms of saving<sup>24</sup>; 2. a deliberately and overtly inflationary policy would evidently run counter to trade policy and the liberalisation of imports, since demand for convertible-currency imports would inevitably soar even in spite of considerable devaluations leading thus - if the constraint e) concerning the avoidance of shortages is to be maintained - to an inflationary spiral possibly threatening hyperinflation. A macroeconomic treatment of the latter (cf. *Dornbusch-Fischer*, 1986) would clearly have to face other constraints (probably tighter ones) than is the case for Hungarian economic policy now. Spontaneous inflation is probably inevitable for a successful monetary stabilisation, but it is important that it not be generated still additionally by the government.

What could be suggested instead of constraint e) in Bokros' scheme is an anti-inflationary constraint built on the so-called "fix-point" approach - though one different from that apparently used when the 1980 pricing system was introduced. Thus the "fix-point" could be the Forint price of the USD (i.e. the exchange rate) with a quite limited freedom of movement after a considerable devaluation. A firm exchange rate policy should be coupled with tight money supply

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<sup>23</sup> "Wage and price controls can help to curb inflation in a less painful way, but only if underpinned by budget cuts" (Hype on inflation. *The Economist*, July 16, 1988, p. 59).

<sup>24</sup> Such as savings deposits with interest rate bonuses, bonds, treasury bills.

management (in line with constraints b), c) and f)). It should be kept in mind, however, that excessively strict monetary policy can be equally damaging. This situation might be a "prelude" to a temporary deflationary psychosis with a sudden increase in moneykeeping and a drastically low supply of capital. A deflationary state of the economy would be probably very short-lived with huge structural differences between money supply and demand. Then a new - and probably even stronger - inflationary wave could begin at any moment when the government tries to revive the economy with a monetary injection. The tricky thing is that in this case aggregate demand would be likely to increase to a much larger extent than the value of the monetary injection but the size of this special multiplier could hardly be estimated ex ante (Török, 1988c, pp. 10-11).

The huge structural differences between the supply and the demand for money in a socialist economy with imperfect money markets (cf. Soós, 1988) make it necessary that stabilisation be based not only on anti-inflationary policy through aggregate demand management but also on a very circumspect money supply management with sectorally selective credit rationing (carried out by a selective interest rate policy). This sectoral selectivity could probably be gradually dropped only when capital markets become less segmented.

Tight monetary policy could also make it possible that enterprise-level losses be not financed by growing external debt via the budget deficit<sup>25</sup>. A problem stemming from already quite strong inflationary expectations is that public saving is inadequate and is not increasing fast enough to replace the part of current foreign borrowing used for covering the budget deficit understood as a gap between disposable GDP and final domestic use of it. It is extremely important that - as Bokros points it out (Bokros, 1987b, p. 1459). - tight monetary

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<sup>25</sup> When it is a primordial constraint for economic policy that budget deficit cannot be covered by simply printing more money, and its domestic financing has a very limited extent for the lack of necessary institutional tools (treasury bills, government bonds, etc.).

policy be accompanied by a selectively rigorous fiscal policy. The main items of Hungarian budget expenditure to be reviewed should include probably expenditure on housing, the armed forces, some huge state investment projects and last but not least on subsidies.

Such a fiscal policy should also be an integral element of the stabilisation package, together with liberalisation and deregulation serving market construction both in the financial and the foreign trade sphere. Preconditions for these will be examined as part of a more global approach to the market construction process. This latter itself is a fundamental element of the stabilisation package.

#### **D. The Stabilisation Programme**

The very disappointing performance of the economy led to a change on top of the government in June 1987 with Károly Grósz becoming Prime Minister. The stabilisation programme for 1988-1990 was elaborated during the summer of the same year and adopted by Parliament on September 19, 1987. A brief review of the structure as well of the contents of this programme will precede the detailed analysis of the stabilisation package.

The text of the programme is in fact a more detailed and more practically-minded derivate of a few-pages communiqué from the July 2, 1987, session of the Central Committee outlining the general tasks linked to stabilisation. The government programme starts from a general review of the "pre-stabilisation" period and formulates first the main lines of the stabilisation package (*SP*, 1987, pp. 60-61).

- a) Stopping the increase of convertible-currency debt as well as maintaining the external liquidity of the economy.
- b) Fostering production in a selective way with improving performance of enterprises, institutions and every participant in the economy. Consequent observation of the

"performance principle" (i.e. remuneration to depend only on performance) in every sector of the economy.

- c) Increasingly consistent, decisive, and responsible governmental work, with resolute measures to develop market mechanisms in the service of macroeconomic objectives.
- d) Moderating by all possible means the social tensions that would accompany stabilisation.

The structure of the programme corresponds to the four basic ideas outlined above. Chapter I describes the main direction and targets of economic policy action. Chapter II deals with production and structure problems, technological development and international adjustment. Chapter III shows how macroeconomic management, planning and "market construction" ought to serve stabilisation. Chapter IV concentrates on topics like the standard of living, social policy and regional development. Our attention will be focused on Chapters II and III. Chapter I formulates already fairly well-known targets whereas Chapter IV does not really face the whole scope of the social challenge to stabilisation and reform.

The keywords of Chapter I indicating the main elements of stabilisation and adjustment strategy are:

- Stopping the increase of convertible-currency debt with some of resources switched to exports. The main items of domestic absorption to be reduced will be public consumption, then private consumption and (to a much lesser extent) investment.
- Monetary policy will continuously coordinate credit policy with changes in the stock of savings; enterprise-level incomes will be made more dependent upon true performance and domestic financial stability will be maintained at any price.

- In line with the improvement of external balances the government will maintain a balanced domestic supply of goods. This will be served by stimulating entrepreneurship, by active pricing and exchange rate policies as well as continuous market construction and a fine-tuned regulation of imports. Priority in convertible-currency imports will be given, however, to productive imports in the open sectors of the economy.

- Economic growth can be achieved only on a basis of qualitative improvements in production, external competitiveness and an increasingly rational use of resources. Thus an acceleration of growth is hardly likely on the short run even if stabilisation goals are attained.

Chapter II outlines a structural policy closely following world market standards and requirements. This part of the programme seems to bear some rather remote resemblance to the "positive industrial policies"<sup>26</sup> observable in West European countries like Finland, Sweden, the United Kingdom, the Netherlands, Belgium and Spain. This sort of industrial policies can be regarded as a fundamental element of a "European version" of supply-side economics based less on fiscal than on structural and innovation policy carried out mainly by means of indirect guidance (cf. *Ballance-Sinclair*, 1983, see *Török-Kolláth*, 1986).

The structural policy subchapter of the programme stresses that direct structural responsibility of the government will involve only decisions

1. directly influencing stabilisation in a general manner;
2. to be taken on the basis of interstate engagements toward other socialist countries;

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<sup>26</sup> This term is part of an instructive scheme of modern industrial policies which includes "positive", "planned", "directive" and "market-oriented" industrial policies (cf. *Eliasson*, 1983).



3. concerning infrastructure, energy production and the supply of basic materials;
4. serving the development of human and technical R & D infrastructure;
5. precisising structural priorities by the government;
6. as to the closing down of capacities the case of which - due to their size or importance for domestic supply - would transgress the competence of enterprises directly involved.

This clearly shows a change in governmental attitude towards industrial policy but this sort of apparent "self-restraint" is still lacking legal guarantees on a longer run.

The programme also pinpoints key sectors (like telecommunication industry, computer industry, industries supplying the health sector, car production, food industry) that can be seen as production systems where world-market oriented integrated development is needed. A problem apparently not really perceived by the authors of the programme is that most of these sectors already had so-called central development programmes in the 1970s that resulted in large capacities only for rouble-exports.

Chapter III also stresses "self-restraint" by the government in economic policy matters which will be subject to close monitoring and even control by the Parliament. Thus a second redefinition of the role of planning (the first one had taken place with the introduction of the centralised-indirect mechanism in 1968) is also required. So planning will have fundamental tasks as to "determining decision alternatives open for the society, fixing and coordinating priorities, and creating the set of tools appropriate for the realisation of programmes decided" (SP, 1987, p. 71). Medium-term and long-term planning is thus meant to gain importance and the work of the National Planning Board is to be concentrated upon strategic planning, monitoring of macroeconomic trends as well

as on developing the economic mechanism<sup>27</sup> to the detriment of sectoral investment and production target planning. Financial planning will be more directly linked to budget policy, it will therefore be partly transferred to the ministry of Finance. One part of it, however, is likely to remain a task of the Planning Board (as, for example, the monitoring and modeling of the effects of financial or fiscal measures on savings, enterprise and household expenditure etc).

Market construction means in this context an increasing role for monetary policy, reduction in the segmentation of different factor and goods markets, and elimination of detailed and complicated systems of regulation. Tax, price and wage reforms as well as the development of forms of property will bring about a growing transparency of monetary flows, transactions and processes and these will also make it possible to compare directly all sorts of profits and incomes earned in any field of the economy. Liberalisation of prices as well as of capital movements will also promote the active market clearing process understood as a fundamental component of market construction.

Chapter IV emphasises that the distribution of incomes will follow relative performances much more closely than in the past. An acceleration of inflation would be unavoidable in 1988 due to the tax reform and to the elimination of unjustified price supports. Social policy will be renewed with the introduction of a new pension system stimulating savings by people still active and with efficient stimuli to participation in retraining programmes for people threatened by unemployment. The programme also promises improving health care plus more efficient housing and education policy but does not provide details of the financing of these ambitious plans.

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<sup>27</sup>. Lóránt sees "macroeconomic management" as the key function of the NPB in future (Lóránt, 1988, pp. 86-87).

## **E. Practical Consequences of the Stabilisation Package**

Those elements of Chapter III which have been put into practice in 1988 include tax reform as yet not accompanied by wage and price reforms, measures serving a new monetary policy also meant to help market construction and some institutional changes in the administration comprising the whole government.

### **E1. Tax Reform**

The stabilisation programme outlined a tax reform to be introduced only a little more than three months later so details had to be elaborated very hurriedly. This reform was meant to "create more real and clear conditions in the economy that are of a basic importance for economic regulation, the coordination of interests as well as the functioning of bargaining mechanisms" (Németh, 1988a, p. 12). The programme prescribed tax reform in a twofold way. A "general turnover tax" (of VAT-type) was to be introduced instead of the property and assets tax, accumulation tax, wages tax and one part of the profit tax all paid by the enterprises. This new tax was meant to cover a major part of budget incomes. It was also given an important role in pricing policy for it had to maintain a positive difference between producers' and consumer prices (in order to ensure the "positive two-levelledness" of the pricing system already claimed by designers of the 1980 price reform) and also a synchronous movement of the two sorts of prices.

Personal income tax was to be introduced in order to create a progressive proportionality between personal incomes and tax payments by the population to the budget. A fundamental requirement was that nominal incomes from the main job could not diminish because of the tax reform, but it also seemed rather evident (without being explicitly referred to in the stabilisation programme) that the introduction of this tax - without a parallel wage reform as well as any sort of compensation for income losses in secondary and tertiary jobs

- quite strongly served objectives linked to budget improvement, too.

The tax reform's primary aim was to diminish the undeniably heavy financial burdens on enterprises. While the structure of Austrian state incomes from taxes in the mid-1980s showed a 3% share of enterprise taxation, 32% of sales and turnover taxes, 22% of personal income taxes and 30% of social security payments, Hungarian data for 1987 show 34% for enterprise taxes, 24% for sales taxes, only 37% for personal income taxes and 28% for social security payments (Kollarik, 1988, p. 32, see Chart 6). Thus the two systems had opposite structures except for the last item. The Hungarian tax reform was elaborated in such a way that the "target structure" of tax incomes was supposed to show a significant decrease in the share of enterprise taxes (calculated new share: 14%), would left the share of social security payments unchanged with a significant increase in the amount of sales taxes (calculated new share: 36%) and personal income taxes (calculated new share: 14%). Thus the tax reform was meant to bring about far-reaching cuts in subventions to enterprises (because of their alleviation of an important part of fiscal burdens), a lower level of producers' prices (since one part of enterprise taxes became sales taxes) and a somewhat (by approx. 7.5%) higher average level of consumer prices.

General turnover tax was introduced on a value-added basis with four tax rates (between 0 and 25%) and deduction possibilities for investment and export (though on a narrow scale), coupled with a consumption tax levied on products on an individual basis in order to make "case-by-case" tax management possible. This turnover tax was widely discussed since the former sales taxes were also based on a "taxation by phases" principle.

Still more controversial was the highly progressive personal income tax (with marginal rates up to 60%) and with only minor compensation to families with more children as well as to the socially handicapped. The obviously equalitarian

bias of the new income tax rates made the new income structure strongly dissuasive from private or supplementary work<sup>28</sup>. Meanwhile the postponement of wage reform had for result that a new tax and therefore income structure was forced upon an old wage structure with a very limited freedom for enterprises to increase wages (a nominal wage increase had to be carried out for every employee - this was called "grossisation" of wages - in such a manner that new after-tax incomes from the main job had to be at least nominally equal to earlier net wages). Social aversion to the tax reform has been very strong and it certainly has not been helping to create a larger social basis for further reform steps. Some not minor technical details (a double taxation by profit and income taxes of private entrepreneurs in a very complicated calculation system for "self-taxation", for instance) and the not very successful preparatory propaganda speaking of "increasing social justice" also contributed to a generally not very far from hostile attitude towards the tax reform.

## **E2. Monetary Policy and Market Construction**

The beginning of 1988 showed a considerable tightening of monetary policy with the sudden withdrawal of more than 10 billion Forints in working capital credit from enterprises. This caused serious disturbances first of all in agricultural production: nonselective restriction by administrative means again damaged the business climate without weakening inflationary pressure or eliminating losses due to the highly imperfect nature of monetary and goods markets in the economy. It is instructive to see how the business climate changed between late 1986 and a year later, i.e. the eve of the introduction of the first elements of the stabilisation package. An extensive enterprise survey showed that in 1986 the first two important impediments to production were regulation (for 51% of enterprises asked) and input problems

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<sup>28</sup> Between January and May 1988 more than 10.000 private entrepreneurs and craftsmen stopped activities thus shortage problems in many sectors and several regions significantly increased.

(13%). A year later uncertainty of outlook (43%) and input problems (22%) were holding the two leading places. In March 1988 already 15% of industrial capacities were laying idle (JA, 1988, p. 33).

Thus either restrictive or stimulative governmental intervention will only make things worse unless market construction is speeded up fast. Also liberalisation can remain merely a word. Many central price controls were eliminated as of April 1, 1988, but in order to promote anti-inflationary objectives, however, the government asked enterprises for "cooperative attitude" and many of them postponed price rises.

Thus the development of properly-functioning markets seems to be the answer to several important questions still open to stabilisation-oriented economic policy. But the stabilisation programme outlined only some new principles for the regulation or guidance of prices and competition by the state. A possible set of principles of market construction is given by Vissi (1988, p. 10):

1. A new sort of integration policy not only in an intra-CMEA sense but also as far as economic cooperation with the West is concerned. This integration policy should be based on a set of norms and a regulatory mechanism capable of promoting a general external opening of the economy on a property basis<sup>29</sup> and ensuring the mutual character of this opening between Hungary and all the partner countries.
2. Regulatory mechanisms have to be subjected to a strict monetary and fiscal policy resulting in a relative scarcity of money. This could also contribute to the spread of patterns of business behaviour that at present are prevalent only in a part of trade with the West.

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<sup>29</sup> This means (from the foreign entrepreneurs' viewpoint) at least equal legal and administrative treatment of enterprises in foreign and in domestic property. See also principle 4.

3. Institutions and techniques of goods, capital and labour markets have to be simultaneously created in such a way that these markets do not become impediments to each other's development.
4. A conscious policy stimulating entrepreneurship has to be worked out and incorporated into economic policy in such a manner that it could promote the development of existing enterprises<sup>30</sup> as well as the creation of new ones.
5. Macroeconomic management has to eliminate all the present barriers to competition. A regulatory regime prohibiting any limitation of competition has to be introduced. The government must unavoidably keep some tools of limiting or controlling competition in its hands, but this has to be completely transparent and in conformity with internationally acknowledged norms.

It is very important to realize that market development has to proceed simultaneously in all the fields mentioned above. Tax reform should also be seen as part of the market-building process. It was the backwardness of other elements of the regulation of competition that was one of the reasons why the tax reform contained some elements (a special tax levied on entrepreneurship, special taxes on rouble exports etc) that are clearly counterproductive in market construction terms. If market construction proceeds in an unbalanced way, barriers to competition will be eliminated in one field while new barriers are erected in others. Competition-fostering policy will inevitably harm many sectoral interests as well as political and social ones but it will certainly not be enough if such a policy is applied only in areas where there will be weak resistance to it: it has to cover all economic activities.

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<sup>30</sup> This word should be understood here rather in the "venture" sense and by no means as big or medium-size state enterprises characteristic for socialist economies.

"Markt construction"<sup>31</sup> is thus a notion analogous with market clearing but one with a wider significance; it involves creating markets prior to clearing them.

Another aspect of the market construction process which will have to be made clear is that increasing competition will not necessarily lead to a decrease of prices on a given market. This cannot be considered a fundamental objective of market construction or an argument to make it widely accepted by the public since market opening and increased competition will fundamentally change the distribution of effective demand in the economy and will probably make successive devaluations necessary. Thus nominal price decreases would rather rarely happen and even real ones would not be perceived of as such by an important part of the enterprise sector and the population. It is necessary to educate the public to understand this.

The market construction process includes the creation of a legal framework for bankruptcy and for enterprise formation with a clear definition of enterprise, entrepreneurship, property, venture capital, etc. The first aim was thought to be served by the 1987 Bankruptcy Act but its application has yielded only quite modest results in practice. It turned out that without a transparent and generally accepted system for valuing assets and property, the assets of an enterprise that has gone into receivership cannot be distributed between creditors in an equitable manner and losers from this usually are smaller creditors (i.e. mostly smaller enterprises). The Act has been applied to only 3 big enterprises so far but only 1 of them (a huge regional construction company) went into complete liquidation. Most of the costs of the liquidation process had to be covered by the state budget and many credits were not reimbursed at all.

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<sup>31</sup> It might be worth mentioning that the expression itself stems from the early 80's and it was created probably in the National Board of Materials and Prices for justifying the increasing role of this Board in macroeconomic management.



The practical applicability of the bankruptcy act will probably become easier with the adoption of the Corporation Bill which was due to take place in Autumn 1988. This bill will create a "uniform regulation of corporations created by economic organisations (i.e. enterprises), citizens, persons from the country and abroad. The barriers to the creation of corporations jointly by enterprises and by citizens will be eliminated. A uniform regulation of joint ventures created by enterprises from capitalist and socialist countries together with domestic economic organisations will be introduced. New entrepreneurship forms and conditions will be more transparent, more conform with practice and more suitable to express the intentions of economic agents" (Németh, 1988b, p. 2). It is very important to note that the adoption of this bill will not be accompanied by any kind of enforcement regulation and it will therefore be impossible for subsequent decrees issued by governmental organs to correct or limit the field of validity of the bill. The bill will create a legal framework for small and medium size enterprises in mixed property and investment ventures. Foreign participation in the economy will be likely to increase significantly. The founding of corporations will no longer be subject to case-by-case authorisation but only to conformity with the legal framework (Németh, 1988b, p. 4). The new bill will also make possible the transformation of state enterprises into joint stock companies and limited companies. A step towards this (though still in the legal framework provided by the already existing Association Act and Enterprise Act) is the transformation of some huge state enterprises into holdings (Matolcsy, 1988, p. 75).

### **E3. Institutional Changes**

The stabilisation programme outlined quite important changes in the structure of government of which only a part took place before June 1988.

The number of members of the government dropped significantly with the abolition of the posts of four Deputy

Prime Ministers who had been supervisors of ministries. The independence and responsibility of the ministers thus increased. The two state committees for economic policy were also liquidated and a new narrow economic cabinet (the so-called Committee for Planning Economics with a name not really indicating the true profile of this body) was created with one of the remaining two Deputy Prime Ministers as its head ex officio (the other being Minister of Trade and Hungary's permanent representative to the CMEA). Several ministries (Ministry of Domestic Trade, Ministry of Foreign Trade, National Board for the Protection of Environment and Nature, National Water Board and governmental offices for local councils and for press and information) were abolished and new ones (Ministry of Trade, Ministry of Environment Protection and Water Supply, and - with a modification of the profile of the former Ministry of Health - the Ministry of Social and Health Affairs) created. The head of the National Planning Board is only a minister rather than Deputy Prime Minister so that this body seems to have lost its special legal status.

A post of Minister of the State was created. This post without portfolio belongs to Imre Pozsgay, a recently elected Pclitburo member with a role in government for coordinating and promoting further reform steps.

#### 4. Which Way To Go?

##### A. The Basic Alternatives?

The challenges of economic development trends in the first half of 1988, when both the current account and budget deficits increased further, called for an urgent reappraisal and redefinition of targets set by the stabilisation package. It became evident that all the aims cannot be reached according to the programme so some of them seem to have to be sacrificed. The question of how these should be determined and which are the real priorities in a complex set of objectives was debated at a mid-July session of the Central Committee.

Two basic alternatives were presented at the session (HVG, July 16, 1988).

##### Version A

Aims: a radical transformation of the economic structure, a dynamisation of R & D, a speeding up of the development of market mechanisms

Tools: a loosening of import regulations, considerable devaluation, increasing import competition, far-reaching liberalisation of monetary markets, in pricing and wage policy

Consequences: 80.000 to 100.000 unemployed in a year, consumer price index higher than 15% in 1989, a strong differentiation of wages and salaries with an overall trend of decrease in real wages

##### Version B

structural transformation subordinated to a shorter-term improvement in external balances with gradual reforms, central economic management maintained

a gradual loosening of import restrictions, slow liberalisation of the pricing system

30.000 to 50.000 unemployed in a year, a slowing down of inflation in 1989, more centralised wage regulation resulting in a smaller differentiation and a slower average decrease of real wages

Disadvantages: wide-range economic and social tensions in the short run, a growing number of loss-making enterprises, diminishing standard of living with a worsening political and social atmosphere

a real turn in economic policy cannot be achieved, danger of reversibility of reforms, macroeconomic management might be able to carry out measures corresponding to this version even without major institutional and other changes

Advantages: a probable speeding up of structural changes, a certain chance that the gap between dynamic economies and Hungary will cease widening within the next 7-8 years

a better handlability of social tensions and of economic relations with CMEA-countries

The debate on the two versions showed that opinion was clearly biased in favour of version A, but with reservations. A choice was due to be made at the October session.

## B Outlook

The short-term development of the Hungarian economy is primarily dependent on the fundamental trends in the world economy. It is indeed possible that the country's macroeconomic performance will appear better in the near future not because of any fundamental improvement in performance but because of the favourable impact of some international trends. A strengthening dollar, for instance, would tend to diminish the amount of net as well as gross Hungarian external debt without any significant change in macroeconomic performance, and the same goes for world market prices of goods having high shares in the export structure of the country. Increasing oil prices could have a favourable impact on Hungarian economic development on the short run, because they would help to increase convertible-currency export earnings by growing petrochemical exports and deliveries to OPEC-countries. Higher prices for Soviet oil would also diminish the extent of the "currency-conversion in foreign trade" problem and of the net outflow of resources in CMEA-trade for the economy. But it has to be understood that the commitment to irreversible reforms by the new leadership

might not be strong enough to continue the reform process together with rapid political democratisation if macroeconomic performance turns out to be better than expected. Recent political and economic history shows that apparent economic successes have several times tended to create an atmosphere of successful crisis management and consolidation. This atmosphere made really reform-minded top political leaders into a minority (the changes in the Politburo in 1972-1973 with R. Nyers and L. Fehér losing their posts or in 1985 with F. Havasi not re-elected to the chair of Economic Secretary of the Central Committee can serve as some evidence in this respect).

Thus we would be inclined to think that the new political leadership, which sincerely desires reforms, would face an unpropitious climate in which to press for reforms and easier short-term economic policy tasks in 1988-1989 if external economic conditions were to improve. A real turn in Hungary's economic history and in economic reform history is likely to be achieved only if apparent improvements in macroeconomic performance do not take the steam out of the reform process.

## LIST OF REFERENCES

This list will be given in a slightly unconventional manner. Since the major part of the literature used exists only in Hungarian (these are mainly publications from 1987 and 1988) their titles will be given only in English translation. These translations will be stemming from the English summaries of the articles (if any) to be found in nearly all of the periodicals dealing with economics that appear in Hungary. The reader will be able to find the original article on the basis of the name of the author and the usual bibliographical data. The omission of the Hungarian titles is thought to make the list more handlable. Where it happens, the reference is marked with H.

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Pocket Book), the 1988 edition of which contains data series ending with 1987.

FIGURE 1: Terms of trade for Hungary in the two types of trade (previous year = 100)

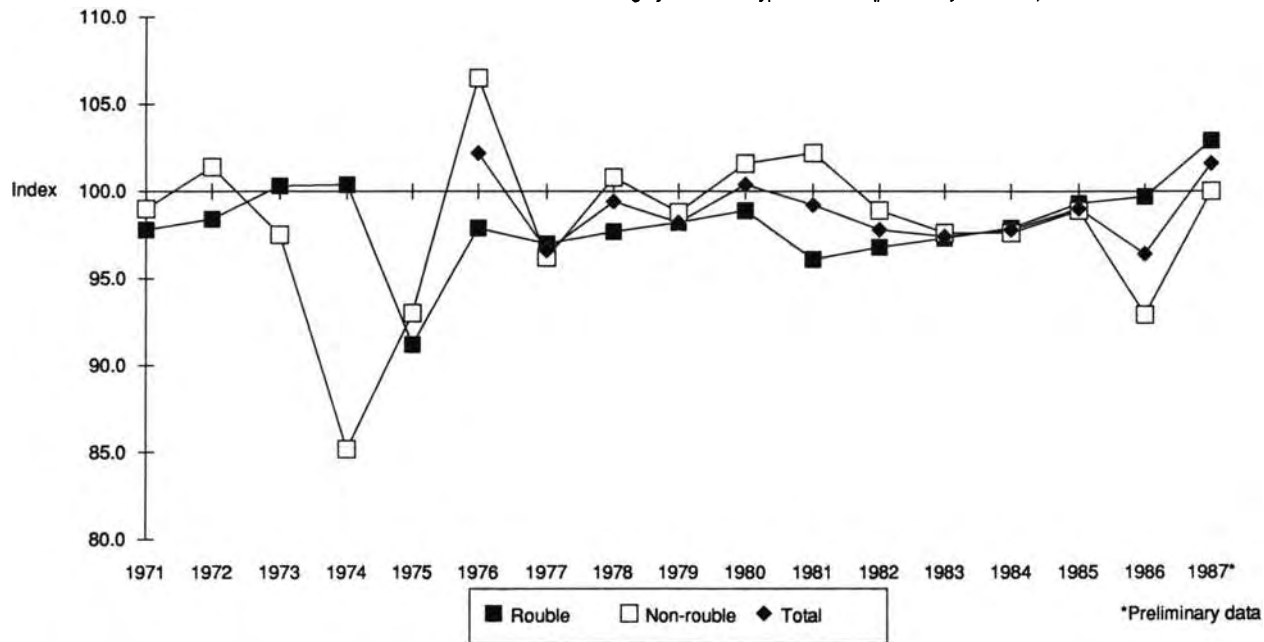


FIGURE 2: Indicators of Hungarian export and import in the two types of trade

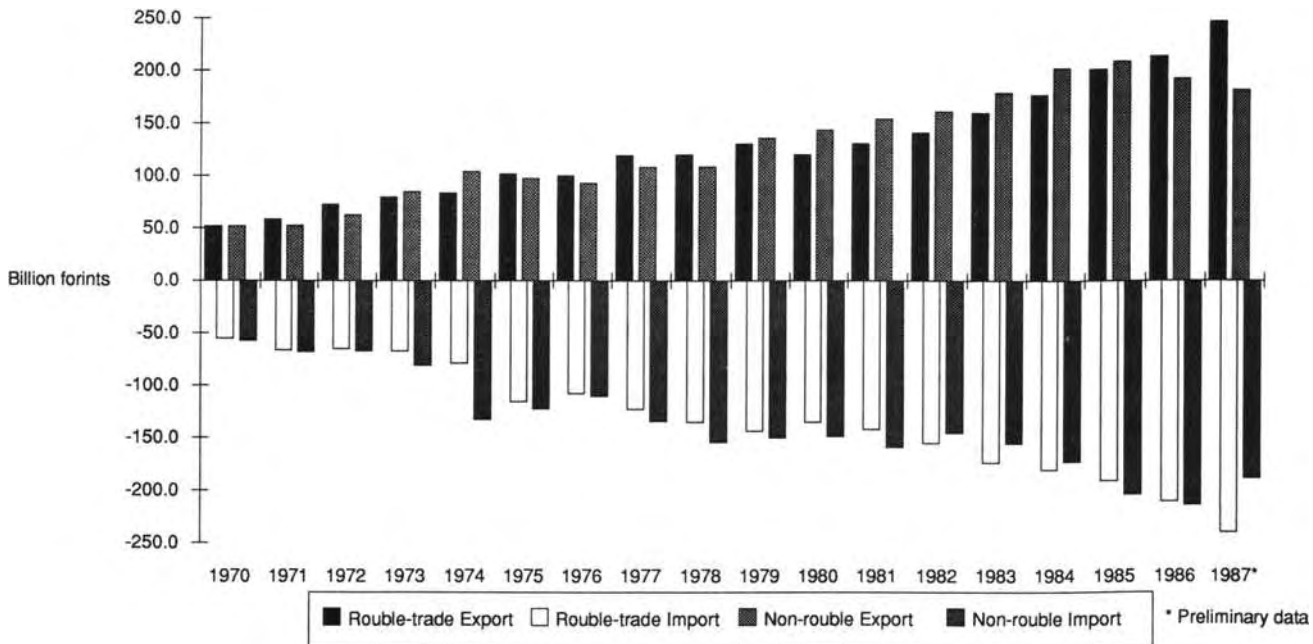


FIGURE 3. indicators of the Hungarian Economy (1970-1987)

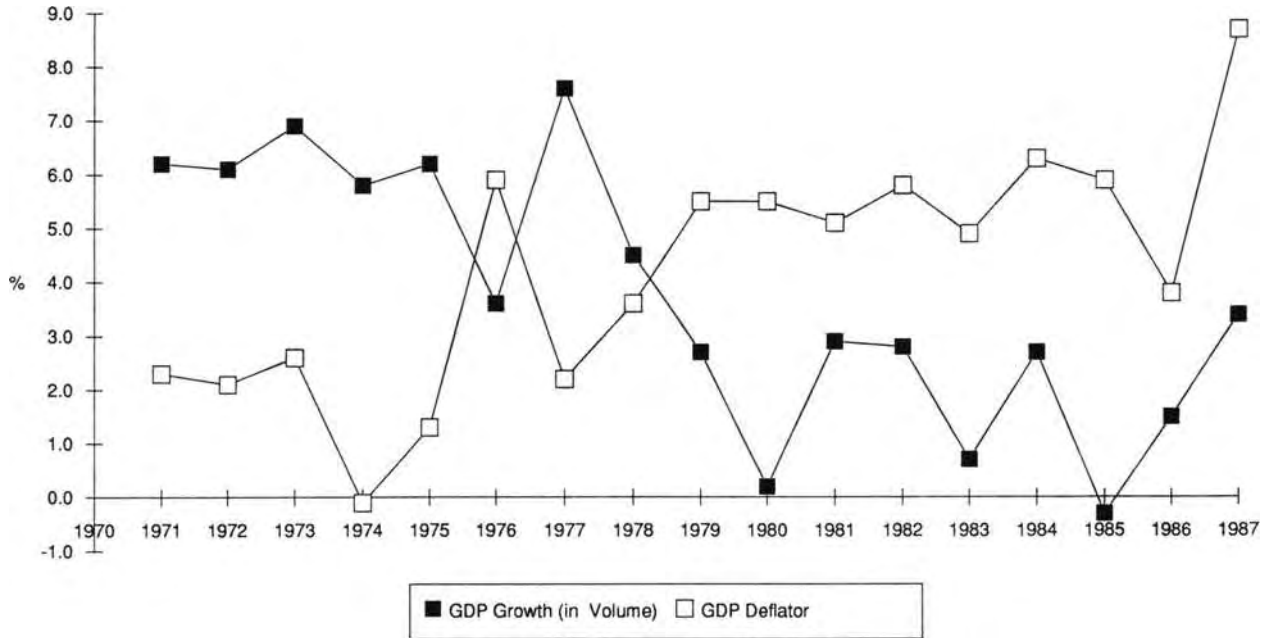


FIGURE 4: Indicators of the Hungarian Economy (1970-1987)

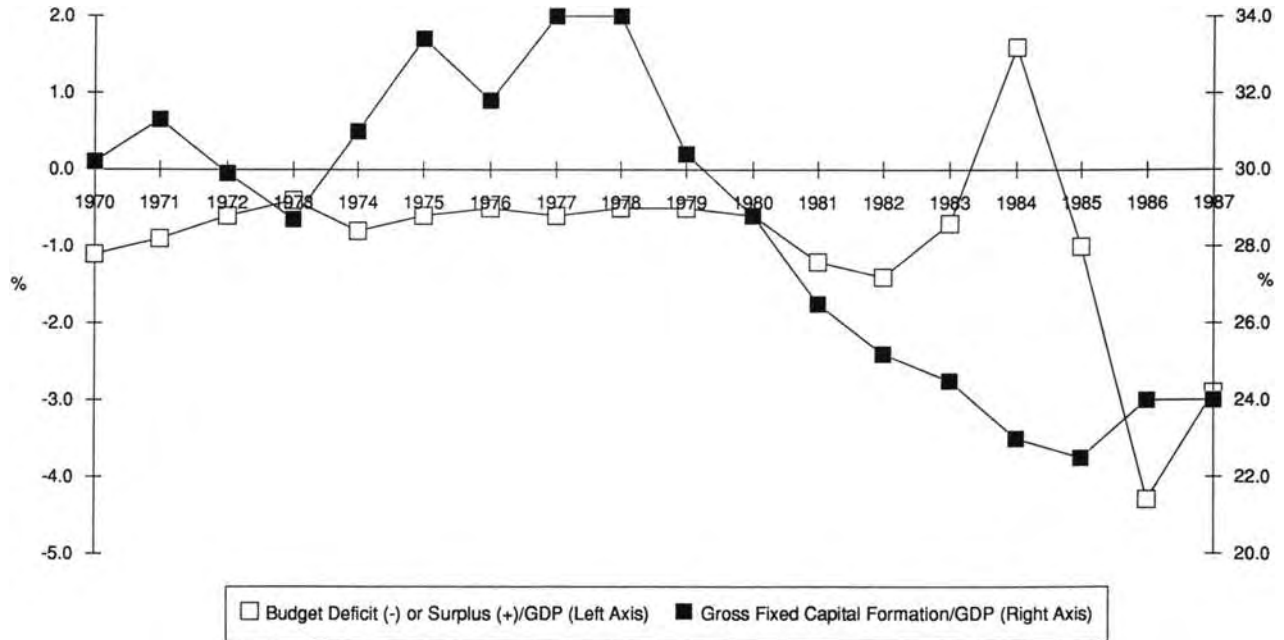


FIGURE 5: Current account in convertible currencies (1970-1987)

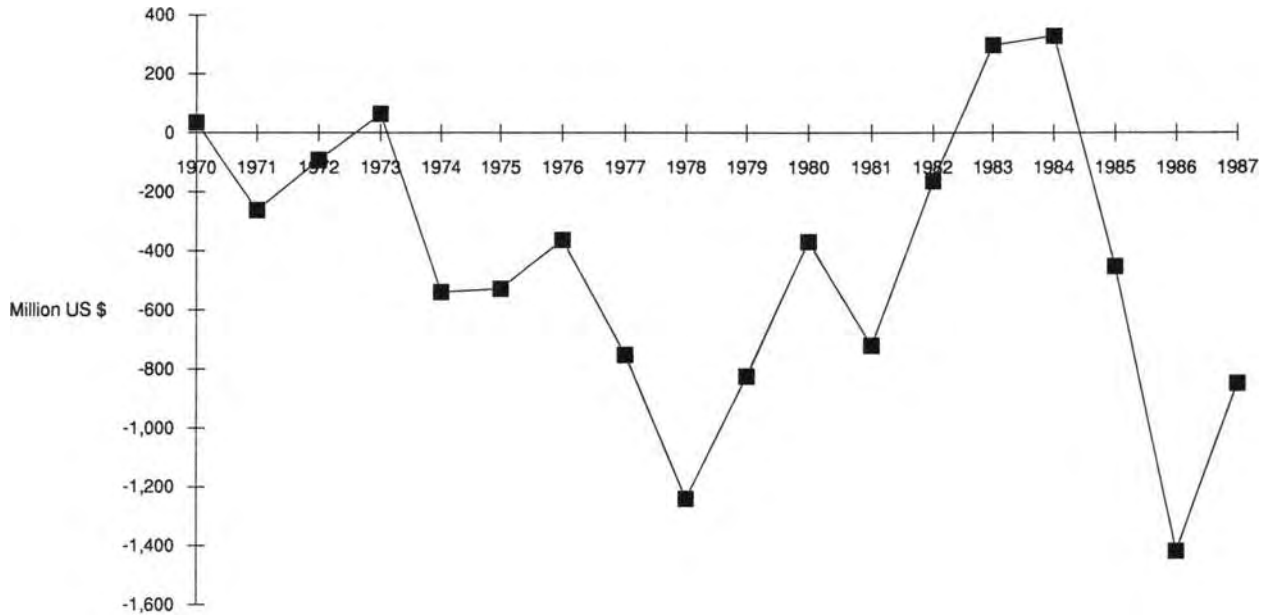
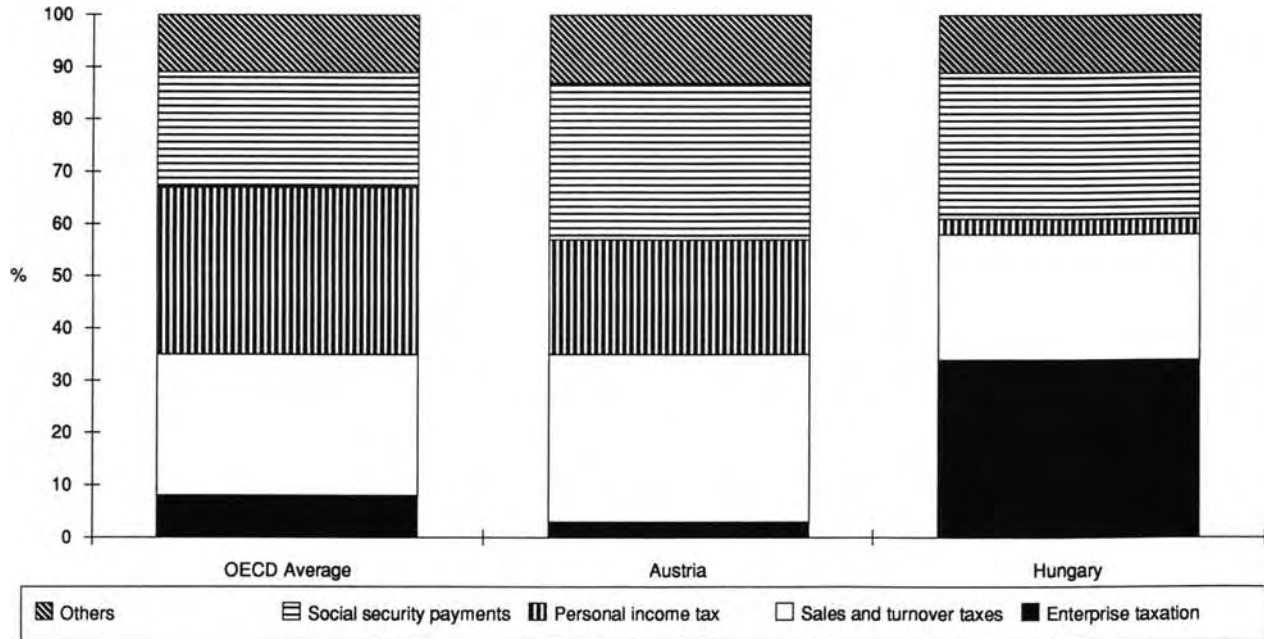


FIGURE 6: Structure of budget incomes from taxes (first half of 80's, 1987 for Hungary)





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