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**Modified Planned Economies at
the Crossroads: The Case of
Hungary**

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INTRODUCTION

The WIDER project named "Economic Reform and Stabilization in Socialist Countries" promises food for thought mainly for those interested in relationships between reform ideas and practice on one side and (mostly poor) macroeconomic performance on the other. The example of the Hungarian economy offers a not neglectable degree of insight into the working of both kinds of phenomena but their interrelationships have proved increasingly hard to explore during the last year of the project. The summer of 1988 when the first studies (Török, 1989., Rosati-Mizsei 1989) on stabilization and reform as well on external adjustment were completed was the time of political euphoria with **politically** quite promising reform and not much dimmer stabilization perspectives. But it turned out not so many months later that, as a matter of fact, 1988 has to be considered a year of also rather great macroeconomic significance. It was a year partly of misunderstood or mismanaged reforms as well as the widespread understanding of their such character and partly of a very contradictory but not in all aspects bad macroeconomic performance.

This at least intellectually exciting year of 1988 and the first few months in 1989 determined our framework for analysis to a great extent. Thus we opted for an approach

which tends to consider pre-1988 macroeconomic development and reform efforts as a basis for a deeper presentation of what exactly happened in that year in the field of economic performance, reform thinking and practice with far-reaching changes in the scope and tasks of stabilization policy.

The Hungarian economy's specialization pattern and international economic orientation almost did not change in 1988 at all. But the perception by administration and research of the Hungarian ground for action in the world economy also underwent significant changes in the very same year. It turned out that the economy is able to respond to external challenges but there is a strong trade-off which makes this response possible only at the price of rapidly growing internal imbalances in the existing macroeconomic system. Structural and balance problems in the two main Hungarian foreign trade flows (trade in convertible currencies and in roubles) have thus turned out to be manageable only by really profound reforms reaching out far beyond the field of international cooperation onf the national economy. It became wholly clear only in 1988 that the net outflow of resources in intra-CMEA trade cannot be stopped by quasi-administrative measures of "supply-management" but by nothing less than a complete reform of the pricing and payments system of this trade.

Our analysis of pre-1988 reform thinking and economic policy (of **Török** 1989., Ch. 1) still showed quite deep antagonisms between what was termed the "Reform Camp" and the government. Quite unexpectedly, major parts of the two "opposite" sides have since formed a peculiar coalition bridging at least some of the intellectual gap between government and political opposition. Somewhat exaggeratedly: the by far unclear political picture in the country is significantly complicated by the emergence of vested interests within politically very multicolour professional groups. The stabilization policy to be followed is described in not very different terms by a State Secretary or by an oppositional economist while this economic concept is strongly criticised by both a sociologist of the opposition and an "apparatchik" of let us say the Ministry of Health and Social Affairs.

Being quite strongly convinced of the truth of our judgement that actual economic and political development in Hungary might be very instructive for any country trying to find the way to a genuine market economy by something more than mere reform rhetorics we also think the transitional character of this phase of economic and social development makes it nearly impossible to seriously reflect upon the medium-term perspectives of Hungary. A quantitative framework for such a "prospection" certainly exists if debt reimbursement needs are considered. We will also make use of

this analytical tool but the whole of our analysis would tend to suggest - if rightly presented and correctly understood - that the Hungarian economy and society are just beginning to find themselves in a completely new situation with a huge number of as yet unknown challenges. What we intend to do is more of trying to show some of these challenges, inquiring into their origin rather than reflecting upon how the economy and society could respond to them. The experience of 1988 and early 1989 clearly proves that economic policy cannot be successful in trying to react to challenges whose scope and nature it is still unaware of.

1. Long-term trends and short-term tensions in Hungarian economic development

It would be a simplistic approach to link actual equilibrium problems of the Hungarian economy and society uniquely to longer-term development patterns saying that actual problems necessarily are their results or consequences. We rather insist on a methodical assumption that clearly separates **macroeconomic trends** like growth, structural changes, transformation of the final use structure of GDP, changes in external balance indicators, etc. that give a development picture comparable with any other economy in the world from the **analysis of** such more or less **short-term phenomena** that are not atypical for a country in a period of transition towards a market economy. This is why we try to give a "two-level" analysis of the Hungarian economic (and partly social) development. The first level will be that of a higher degree of aggregation but also that of a much more "historical" or retrospective character while the second level will provide a static but deeper insight into how the "semi-market" type Hungarian economy has worked. The aggregate analysis presents trends of the 1970-1987 period whereas the "static" picture will be given mainly on a 1988 basis. The choice of 1988 as the year for "X-raying" the Hungarian economy is based not only on the availability of data. This year is quite widely seen as something of a turning point where government and

microsphere equally had to tackle problems of a new character while part of the "traditional" ones tended to disappear. The question of whether the new problems really are markers showing the beginning of another chapter in Hungarian economic history cannot completely be answered yet. Looking for the elements of a possible answer will allow us, however, to find the most important components of a macroeconomic projection until 2000.

1.1 Macroeconomic trends of development patterns in the post 1970 period

1.1.1 Growth pattern

The **growth picture** of the economy significantly changed during the 1970-1987 period. This fact is partly due to an evident slowdown of economic growth in the long run, partly to the increasingly hectic character of the growth pattern. Whereas annual figures of GDP-volume growth changed only within a scope of 1.0 percentage point between 1971 and 1975, this indicator increased to an "impressive" 6.6 percentage points for 1976-1980 and did not go below 3.2 percentage points even for the period 1981-1985. This clearly shows that the growth pattern became more uneven. Can these fluctuations be interpreted as signs of a new growth pattern or do they simply result from the lack of one?

In the period between 1975 and 1987 there was only one year when the growth rate changed by less than one percentage point from the previous year. 1982 can thus be considered as the only year of "stable" growth after 1975. The growth machine of the economy was accelerated or slowed down in every other year of the 12-year period but the question as to whether these changes of speed constitute a clearly cyclical growth path still remains open.

The first significant slowdown of growth since 1971 occurred in 1976. The latter can be deemed the starting year of the growth cycle between 1976 and 1980 which reached its peak already in 1977 with 6.7%. This rather asymmetric growth cycle entered its downward phase due to the fact that economic policy-making tried to stop the country's indebtedness by stressing the more "qualitative" character of growth (which meant a slower one with more emphasis on external equilibrium) from 1978. This cycle reached its lowest level in 1980 with 0.1%. The share of domestic use in total GDP increased from 104.0% in 1976 to 109.2% in 1978 but it amounted to only 102.2% in 1980.

The burden of the downward phase of the cycle was carried mainly by investment; the relative decrease of which had to offset the relative increase of household consumption as well as the rather stable share (10.1-10.4%) of public consumption. Although inventory growth peaked (together with

external disequilibrium) also in 1978 when it amounted to 7.2% (1976: 4.1%, 1977: 3.2%) of the GDP and it slowed to 1.7-1.9% in the subsequent two years, the relative fall in investment is quite conspicuous. Its share within GDP increased from 31.8% to 34.0% between 1976 and 1977, remaining on the same level also in 1978. It sharply decreased in the two last years of the cycle reaching only 28.8% in 1980. It is, undoubtedly, worth mentioning that this downward trend in investment had been the basic component of the next cycle with investment per GDP amounting to only 22.5% in 1985 (and even after a relatively fast increase to no more than 24.8% in 1987).

The cyclical character of the next medium-term period in economic growth in Hungary is far from evident. Data for 1981-1984 show a rather stable GDP growth with rates between 2.7% and 2.9% (1983 with 0.7% is more of an exception in this respect than the "bottom" of the cycle). The terminal year of the cycle was, as a matter of fact, 1985. The negative growth (-0.3%) experienced in this year conveyed a rather clear message to the leadership: economic policy with the improvement of external balance as the main target had lead to a growth crisis thus making a reconsideration of the list of economic priorities an utmost necessity.

The relatively stable growth reached during the 1981-1984 period was realised with a permanent surplus (except

for 1981) of total GDP over the domestic use of it. The proportion of domestic use to total GDP peaked in 1978 with 109.2% but from then on it continuously decreased until 1985 (1979: 103.3%, 1980: 102.2%, 1981: 101.1%, 1982: 99.2%, 1983: 98.1%, 1984: 96.8%, 1985: 97.9%). This decrease took place largely because of the markedly growing foreign debt pressure on the economy. The share of household consumption within total GDP almost permanently increased during the same period. Its proportion to total GDP amounted to 61.3% in 1981, 61.5% in 1983 and 62.8% in 1985. With a continuing quasi-stagnation of the public consumption share within total GDP it becomes increasingly clear that investment (or enterprises willing to invest) paid a not unimportant part of the price for high debt by receiving a continuously smaller part of GDP. In fact, the share of investment within GDP fell from 26.5% in 1981 to 22.5% in 1985. This latter figure is exactly 10 percentage points less than that of 1979 (i.e. the first year of restrictions), marking thus the introductory phase of a later period when divestment became a quite usual phenomenon in the Hungarian economy - divestment without true structural change.

The lowering of the investment rate was in a way due to a situation issueless for the leadership in a certain sense. The relative increase of household consumption was accompanied by significant price rises from 1979 and political stability was seen as a keyword even for economic

policy-making. Price rises exerted a rather unfavourable influence on the political atmosphere in the country and wastage as well as loss-making production were mostly blamed for them. So government largely operated with a strong emphasis laid on the rentability criterion - but only as far as the enterprise sector and its investment activity were concerned. Public spending with subsidies as a not unimportant part of it could thus be saved from significant cuts and official propaganda praised the virtues of less but more rentable investment. The structural aspect of the fall in investment expenses as well as its influence on relationships between the enterprise sector and the state budget weren't as yet made quite clear. Thus, questions as to the price to be paid later for the 1981-1985 equilibrium-cum-growth policy still remained unanswered (or even unasked).

In the years 1982-1985, altogether 76.3 billion Forints were transferred abroad on a net basis as shown by annual surpluses of total GDP over the domestic use of it. This would have amounted to 7.3% of 1985 GDP at current prices (or to 9.0% of 1982 GDP at current prices) while GDP in nominal terms increased by 21.9% between the two years mentioned. So between approximately one-third and two-fifths of incremental GDP or one-third of total investment in 1985 was absorbed by debt repayment during the 1982-1985 period.

The unusually long 1981-1985 restriction period came to an end as a result of the "growth acceleration" programme adopted by the 1985 party congress. The roots of this "dynamization" strategy could be found in some politically not completely unmotivated ideas of a section of the governmental experts. According to them the economy was able to step on an "export-led growth" path with convertible currency exports serving as the "locomotive" in speeding up the growth process at the same time as curbing indebtedness (for an analysis of this strategy cf. **Török**, 1989; pp. 6-7).

The macroeconomic performance of 1985 does not really reflect the change in course of economic policy. The main reason for this is purely technical in character: the decisions taken in late spring by the party congress were put into practice by the administration only in the summer (but rather only in the autumn) and many of the new regulators and other economic policy tools did not appear before the beginning of 1986. It is probably true, too, that the very disappointing 1985 growth performance also served as an argument of persuasion for the "architects" of the new growth policy.

The initiative of dynamization can be partly linked to the successful lobbying of big enterprises (**Szalai**, 1989; pp. 45-48) but their influence on economic policy-making clearly diminished in 1986. This very contradictory year

brought an upswing in economic growth (and thus it could be interpreted as the first year of a new growth cycle) but also quickly increasing macroeconomic tensions. With a GDP-growth of 1.5% at constant prices, this was the first year after 1982, when the domestic use of GDP surpassed GDP created in the economy. This ratio amounted to 101.4% but the surplus of domestic use over GDP produced was the result of the proportional increase of every main component of the use of GDP. The share of household consumption increased to 63.9%, that of public consumption to 10.7% (1985: 10.1%) and the relative weight of investment to 24.0%. It seems rather evident that the government abandoned restrictions on a large scale making use of the international financial support earned with the earlier restrictive policies successful from an external equilibrium point of view.

Radical cuts in public spending and thus a growth standstill were considered necessary by some experts pointing at the alarming current account problems already in late 1986. The Chamber of Commerce, however, successfully resisted this (Szalai, 1989; p. 49). Industrial lobbyists could reach a substantial widening of preferences for and increases of subsidies to convertible-currency exports. Growth in 1987 was really based on an expansion of dollar-exports - accompanied by the sharply deteriorating position of the state budget. The 1987 GDP-volume growth of 4.1% was reached. Domestic use still amounted to 100.5% of GDP but

the share of both consumption items fell by 0.4 percentage points and the relative share of investment (24.8%) increased again almost reaching the level of 1982.

1987 could be interpreted as the "peak" year of the latest growth cycle only with substantial reserves. This year's economic growth was the result of an abortive effort to improve macroeconomic performance in a practically unchanged set of structural and institutional conditions. 1987 was the last year when growth and macroeconomic performance were understood more or less as results of a rather autonomous economic policy whose ground of action is limited only by external constraints. The scope and nature of internal ones were realised by economic policy-making only in 1987-1988 to the full extent and this fact alone explains why 1988 is considered a turning point not only in Hungarian economic development but also in economic policy.

1.1.2 Structural development

It is just because the growth pattern of the economy conceals many atypical tensions of and constraints to economic development in the case of Hungary that macrostructural development trends cannot be interpreted here in the usual way. Hungarian development has shown in the last two decades the "normal" features of an economy on the way from the medium to the high level of development but

only in the structural sense. Thus a "disindustrialization" process seems to be under way from the late seventies with a rapid increase of the share of the tertiary sector within GDP.

The macrostructural development of the Hungarian economy shows quite "unconventional" features. Perhaps construction can be mentioned initially - this sector is usually very sensitive to general growth perspectives but its share did not dwindle during the strong restrictions of the 'Eighties. The explanation for this is mainly the accumulative function of private housing construction supported by a generous credit policy (sharply criticised

Table 1: The Relative Share of Main Sectors of the Economy within GDP at Current Prices, 1970-1987 (GDP=100)

	Industry	Construction	Agriculture	Material	Non-material services
1970	37.1	8,1	17.5	25.8	11.5
1975	42.3	9.0	17.2	19.6	11.9
1980	33.8	7.4	16.2	30.3	12.3
1985	34.0	7.2	15.4	28.8	13.6
1987	28.7	7.5	14.7	34.9	14.2

Source: A népgazdaság fejlődésének főbb mutatói (Main indicators of the national economy's development). KSH, Budapest, 1989. pp. 12-13.

nowadays for subsidising private accumulation at the expense of the state budget instead of genuinely pursuing social policy goals). Another factor of explanation is that restrictive measures concerned rather enterprise level investment than huge central investment projects using relatively more construction capacity.

In Hungary the share of industry changed according to the experience of several much more developed OECD countries but there are also striking structural dissimilarities. The relative share of agriculture diminished only at a very slow pace unlike in many industrialised Western economies where this share has already reached a low usually less than 10%. This phenomenon, however, need not be considered as a sign of structural "backwardness" for Hungary given its extremely favourable endowment with natural resources for agricultural production. More striking are structural trends in the tertiary sector where it is rather uncommon in developed economies that material services (like telecommunications, transport, forestry, trade, etc.) show a **"negative dynamism"** in periods of above-average industrial development (1970-1975, 1980-1985). There can be seen a peculiar "tradeoff" between industry and material services in the structural sense. The data in Table 2 convey the impression that material services can develop faster than the national economy average only at the expense of industry and vice-

versa because construction and agriculture are structurally quite inelastic ("sticky"). Sources for expenditure in the material services field can be found mainly in the state budget which is unable to generate them elsewhere than in industry (agriculture and construction were more subsidised than taxed during recent years by government). This fact means that redistribution between the main sectors leads either to "deindustrialization" even in the promising sectors of industry or to a growing backwardness of material services.

1.1.3 Ownership structure

The 'Eighties brought about rather significant changes in the **enterprise structure** and **ownership patterns** of the Hungarian economy. New forms of enterprise appeared, "ancient" ones made their reappearance and a slow but remarkable erosion of the state sector took place. These processes mean a certain rupture with the quiet state of things in the 'Seventies, but their results are still far from clear and the transition from the old to the new enterprise structure and ownership pattern of the economy will still certainly be accelerated by the creation of their new legal framework (Corporation Law, Transformation Law, Law on Enterprises on Foreign Property). The transition period in these respects began in the early 'Eighties with a

Table 2 (continued)**Remarks:**

* / Budgetary institutions are scientific, health care, cultural, etc. "non-profit" organizations whose expenses are wholly or partly covered by the state budget. They may be operated formally like state enterprises but in practice they never generate profits.

** / Auxiliary are such profit-earning activities of the population in which formal employment is not involved and means of production usually belong to the official employer of the person carrying out the auxiliary activity. The main item in this statistical category is the so-called household farming by members of agricultural cooperatives.

Source: A népgazdag fejlődésének főbb mutatói (Main indicators of the national economy's development). KSH, Budapest, 1989; p. 29.

decree creating new legal forms of small enterprises and was put forward by consecutive legal measures providing for more operational freedom for private business.

A clear but as yet not very fast diminution of state enterprises within gross output is neatly observable, but this trend does not involve budgetary institutions. The share of the cooperative sector has by and large remained stable, but "classical" cooperatives lost ground in favour of newly established small cooperatives, mainly in industry.

The faster than average development of auxiliary activities points to the existence of a certain legal vacuum between the so-called socialist sectors of the economy and genuinely private enterprise operating eventually within or attached to a state enterprise or cooperative. The dynamically growing "independent" or private sector of the economy did not really mean private enterprise but rather only self-employment with some employees in sectors of ventures interested mainly in industrial services or tourism. The expansion of the private sector paradoxically shows the limits of this form of ownership in the Hungarian economy of the eighties since the decreasing share of the state sector and the almost complementary growth of the relative weight of the private sector did not really constitute reprivatization or any other sort of net capital flow to the latter. The gross value of fixed capital in the

national economy amounted to 2,805 billion Forints on December 31, 1987. The share of the state sector was 69.2%, the unproductive property of the population (mainly private apartments) made out 21.0%, 8.9% fell on the cooperative sector and the rest (0.9%) belongs to private entrepreneurship.

The fact that private entrepreneurs are unable and rather unwilling to invest into capital-intensive activities also means that the capital-labour ratio is very low in their case and they can generate proportionally high incomes from labour. The income capacity in terms of labour units in the still quite embryonic Hungarian private sector is obviously higher than in other sectors of the economy.

As far as their share in GDP is concerned, state enterprises lost ground faster than in gross output. The share of "classical" cooperatives in GDP also dwindled at a faster pace. New types of enterprises such as small cooperatives as well as the private sector increased their share more in GDP than in gross output. It is quite significant that the share of the private sector within GDP in 1987 was already surpassing that of auxiliary activities even if data on gross output still show a certain degree of dominance of these over the private sector.

Table 3: The Structure of GDP According to Types of Enterprise and to Forms of Ownership
(in percentage)

	1981	1982	1983	1984	1985	1986	1987
Types of enterprise							
State enterpr.	62.6	62.1	60.6	59.5	58.4	56.7	56.8
Cooperatives	17.0	17.1	16.8	16.4	15.6	15.1	14.3
Small ent. and cooperatives	0	0.1	0.5	0.8	1.4	2.2	3.5
Budgetary inst.	10.3	10.3	10.7	10.7	11.0	11.2	11.1
Auxiliary activities of the population	7.0	6.9	7.2	8.0	8.3	9.0	8.3
Independent	3.1	3.5	4.2	4.6	5.3	5.8	6.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Forms of ownership							
State	72.9	72.4	71.5	70.6	70.0	68.6	68.8
Cooperative	19.9	20.0	19.7	19.4	18.9	19.2	19.3
Auxiliary activities of elsewhere employed	4.1	4.1	4.6	5.4	5.8	6.4	5.8
Private	3.1	3.5	4.2	4.6	5.3	5.8	6.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: A népgazdaság fejlődésének főbb mutatói. KSH, Budapest, 1989; p. 29.

If shares within gross output and GDP are compared and it is accepted that the "income-generating capacity" of a given type of enterprise or property is shown by the size of the difference between its share in GDP and in gross output, state enterprises or the state sector in general are the worst placed. There is a clear advantage over these for cooperatives, while small cooperatives are placed still somewhat better. The advantageous position of auxiliary activities is explained by the fact that they are concentrated in intensive agriculture and in services and are thus quite independent from deliveries of productive inputs. Their rentability is high also due to their concentration in market segments partly or wholly abandoned by the "socialist" sector (vegetables, honey, other "small-volume" agricultural products, spare parts, special machinery, repair services, etc. in industry) which put them in a certain kind of "monopolistic position" in some small market niches where shortages had been strongly prevalent.

The share of the private sector within gross output and GDP will be increasing due to the new corporation and transformation legislation but the private sector will probably absorb more capital-intensive activities also in medium-size industrial enterprises or relatively unsuccessful cooperatives, and this will undoubtedly hit the average income-generating capacity of this sector. It is

also likely that mainly loss-making state enterprises will be open to some kind of reprivatization or to a partial change of ownership. It can also be expected that auxiliary activities will find their legal place either in a reformed cooperative sector or in the private sphere so that it will be easier to define their form of ownership.

It is important to note that the existence of a legal framework for the creation of new types of enterprises did not lead to a deep transformation of the enterprise structure of the Hungarian economy in the 'Eighties. More than 98% of the assets of all the enterprises still belong to traditional state enterprises and cooperatives (Laky, 1989; p. 14) and even the very fast development of small enterprises and corporations in 1985-1987 did not change the as yet marginal role of the latter in this respect.

1.1.4 Pattern of income distribution

Quasi-stagnation of the share of GDP within gross output (about 38 per cent) was in fact a resultant of several contrasting trends. The share of households as well as of incomes centralised by the state budget within domestic use showed a rather steep increase between 1982 and 1985. The part in domestic use of household incomes from work increased from 42.5% to 44.6% during this period while the growth in the case of centralised incomes was from 37.4%

to 40.1%. Incomes retained by enterprises and cooperatives still made out 16.5% of domestic use in 1982 but only 13.0% in 1985. Thus, redistribution was clearly "discriminative" against the microsphere's interest but their typical behaviour had been less that of increasing assets from profits than distributing a significant part of them among workers and members of the management. This is why the government also tried to carry out a restriction of household consumption in an indirect manner by cutting net enterprise incomes.

This picture evidently changed after 1985 when dynamization brought about a relative decrease of household incomes from labour (1986: 44.3%, 1987: 43.2%) and a fluctuation of enterprise incomes centralised by the budget. The part of these incomes within domestic use fell from 40.1% to 36.5% in 1985-1986 but it showed a fast increase to 39.0% in 1987. This was clearly a response by the government to the failure of the dynamization policy without a further deterioration of income positions of the microsphere. The share of incomes retained by enterprises and cooperatives within domestic use remained stable at 13.2% in 1986 and 1987. The growing centralization of incomes by the budget was made partly at the expense of household consumption but it is also a result of a significant decrease of net imports within domestic use. The growth of the debt burden in 1986 and 1987 made such an intervention necessary in the short

run. It is less evident, however, that this kind of redistributive policy could serve the improvement of external balances very effectively.

The pattern of domestic use during the eighties permanently showed that none of its main items proved able to initiate the structural changes inevitable for the necessary improvement of internal and external balances of the economy. **Household incomes** increased in this period somewhat faster than domestic use but the households' savings propensity failed to improve at all. Household consumption per domestic use increased from 61.2% to 64.1% between 1982 and 1985 and it fell by only 1 percentage point the next year remaining stable in 1987. It has been proved that the marginal savings propensity in Hungary depends mainly on the changes in real purchasing power of incomes from work (**Petschnig**, 1989; p. 4). Marginal savings propensity is calculated as a ratio of the change in monetary stock to the change in disposable money. This ratio was less than 1 in 1979, 1989, 1982 and 1987 which were the years (with no exceptions) of real losses in the purchasing power of incomes from work.

The development of savings by the population showed four distinct periods between the early 'Seventies and 1987. The first period lasted until 1978 with an annual growth of savings of more than 10%. The restrictions between 1979 and

1982 resulted in a slowing down to 8/9% on an annual basis but growth rates reached 11 to 13% again in 1983-1986. 1987 seems to be the first year of a new period when savings in Forints became less and less lucrative for several reasons (**Petschnig**, 1989; pp. 5-7). Inflationary expectations have become stronger, consecutive devaluations foster the conversion of assets in Forints (illegally) into foreign currency, real estate or high-value consumption goods. In the case of the latter "shortage expectations" also play an important role. The phenomenon of "shortageflation" is common in countries like Poland or - on a different level - Yugoslavia (cf. **Kolodko-McMahon**, 1987). The Hungarian case might be equally interesting for an analysis of how "shortage expectations" appear along with inflationary ones when the macroeconomic situation deteriorates and what types of tradeoffs might exist between the two until the point when they are combined to such an extent that the term "shortageflationary expectations" becomes really justified.

The role of inflationary expectations in the changes of the savings propensity of the population had been quite strong before 1986-1987 but in a hidden form. Petschnig demonstrates in a very impressive way that the part of truly deliberate savings increased at the slowest pace among all types of savings from 1976 while "quasi voluntary saving" like car purchase accounts, housing deposits and other "voluntary" forms of saving with a low degree of practical

liquidity increased at rates much less dependent on inflationary or other expectations (cf. **Petschnig**, 1989; pp.9-10). She also shows that the development of saving propensity has been the slowest already from the early 'Seventies in really "market-like" forms of savings (like savings books or cash accounts). It can be seen from these findings that a very important part of the population's savings were "forced" to some extent even in Hungary but these forced savings had forms more or less similar to types of deposits to be found in market economies. It is interesting to note that the conversion of savings from bank deposits or (since 1983) securities into cash always gained a considerable momentum when inflationary and/or shortage expectations became stronger. The share of cash within the population's savings amounted to 31.3% in 1975, it reached only 25.0% in 1978 when the impression of continuously increasing welfare was still prevalent among the population, but soared to 42.3% in 1980 with stagnation expectations becoming general. The share of cashkeeping within savings went down to 25.6% in 1982 when a not insignificant part of the population became able to find additional sources of income in secondary jobs, but from then on it almost permanently increased to 40.1% in 1987. The increasing avoidance by the population of monetary forms of savings wasn't even hampered by the introduction of securities in 1983. The share of these increased from 0.6% to 7.5% between 1983 and 1986 jumping to 30.3% in 1987 but these savings

increased only to the detriment of the stock of savings books. The share of these within the population's savings fell from 71.5% in 1983 to 29.6% in 1987.

1.1.5 Inflation

The saving and spending behaviour of the population and thus the whole income distribution pattern of the economy was strongly influenced by inflationary and shortage expectations and the **inflation process** itself. The index of consumer prices increased in a manner slightly different for each social stratum. The overall increase of consumer prices between 1978 and 1987 reached 7.3% in the annual average and the same index showed also 7.3% for workers, 7.2% for cooperative peasants, 7.2% for double-income households, 7.3% for intellectuals and 7.2% for the retired (KSH, 1989; p. 37). The 1979-1975 annual average of 2.8%, the 1975-1980 index of 6.3%, the 1980-1985 annual rate of 6.8% and the 1984-1987 annual average of 7.0%, did not contain any significant social differences, either.¹

¹ These calculations by the Central Statistical Office are subject to increasing professional and political criticism. This is based on the fact that fast changes in relative income positions of several social groups like, above all, the retired necessarily lead to a fast transformation of their consumption baskets. This is why inflation rates computed on the basis of an earlier basket become rather pointless. Another strong argument against these average rates of inflation is that the degree to which different groups of the population are sensitive to inflation changes much more between groups formed with other criteria like the number of children per household, etc.

The structure of the inflationary process by **types of expenditure** shows the way inflation is generated in Hungary somewhat better.

Price increases were concentrated on products with luxury or excise duties (drinks, etc.) in the early 'Seventies, thus the slow inflation of that period partly served budgetary or income structure rectification purposes. Food became the main inflationary item in the second half of the decade which already shows the impact of subsidy cuts and therefore the appearance of some factors of cost inflation. The less than average price increases for durables make it probable that demand for these goods did not yet soar - at least no signs of a rechannelling of savings into the purchase of such products were seen. The early 'Eighties already show a combined impact of cost and demand shift inflation in the case of energy expenditures and services, while the less than average increase of durables' prices created a precondition of a shift of savings into durables (real estate or residence has traditionally been a lucrative form of wealth accumulation for the population but their prices don't figure in officially computed rates of inflation).

The social impacts of inflation continued to widen in the 'Eighties when price increases involved subsistence services occurred also due to significant cuts in subsidies,

but lack of sufficient capacities and thus of competition brought about a situation where practically only the population's solvent demand was able to limit price increases initiated by enterprises or cooperatives offering services.

The acceleration of inflation in the Hungarian economy of the mid-eighties can be attributed to the combined effect of not less than five factors:

1. **Cost inflation** because of cuts in subsidies.
2. **Demand shift inflation** because of the lack of price cuts ("stickiness of prices") for products with diminishing demand. This is very visible in the case of textiles and clothing, whose prices have increased by goods to a growing extent. Above average price cuts for 33.1% between 1984 and 1987 while their consumption per head decreased by 1.1% in the same period (overall consumption per head increased in 1984-1987 by 7.8% with an average price growth of 22.3%);
3. **Degree of profit orientation** of the enterprises. It is far from obvious that socialist enterprises would show a strong preoccupation with profit. Generally speaking, the intensity of the profit motive depends on the degree of economic reform;

Table 4: Rates of Inflation for Different Types of Expenditures
(consumer prices, annual averages)

	1975/1970	1980/1975	1985/1980	1987/1978
Food	1.9	8.5	6.3	7.3
Drinks, tobacco, cosmetics	4.3	5.7	5.7	6.8
Clothing	3.0	5.7	7.9	8.1
Heating, energy	3.0	5.5	7.9	8.8
Durables	2.5	5.9	4.3	5.7
Other industrial products	2.9	5.9	7.6	7.4
Services	2.9	4.0	8.2	7.7
All expenditures	2.8	6.3	6.8	7.0

Source: A népgazdaság fejlődésének főbb mutatói. KSH, Budapest, 1989; p. 37.

4. The **easing of price regulation by the state** in an economy with only a small number of really competitive markets. Steps of macroeconomic liberalization and market construction seem unavoidable even if these could entail other inflationary effects as well (like the continuing decentralization of monetary management with the necessary increase of refinancing or the inevitable participation of the state budget in the financing of enterprise insolvencies as well as of the

creation of new enterprises);

5. **Inflationary expectations** lead to speculative increases in inventory stocks, in wages and prices (rises of the latter are also based on anticipated fiscal, monetary or regulatory rigour and on rates of interest which contain an inflationary risk element to a growing extent). These expectations also result in a soaring - legal and illegal - demand for convertible currency thereby increasing pressure for devaluation.

Efficient anti-inflationary therapy should find a treatment for all the five factors of inflation. Such a policy was initiated only in early 1988 but its highly contradictory results already belong to the reasons why 1988 can be considered a year of transition with many macroeconomic problems unknown before.

1.1.6 International debt

One of the most important components of the macroeconomic situation the Hungarian leadership had to face in 1988 was the **debt problem**. It would be unjustifiably simplistic to say that indebtedness permanently increased from the early 'Seventies with the only interruption being between 1980 and 1983. As a matter of fact, it was just in these years when government and enterprises had to realise the double face of balance of payment and debt problems.

Indebtedness towards CMEA-countries (mainly the Soviet Union) had become crucial just before the early 'Eighties making clear the quite strong tradeoffs between the development of Hungarian debts in convertible and non-convertible currency.

The development of Hungarian debt went in adverse directions for convertible and non-convertible currencies. Indebtedness in roubles peaked in 1983 also due to the decrease in the dollar debt. The latter decreased until 1985 and then soared due to exchange rate fluctuations of major international currencies since the Hungarian debt mainly exists in JPY, DEM and ATS which depreciated when USD evaluated before April 1985 and evaluated afterwards simultaneously with the depreciation of the USD.

The phenomenon of "currency conversion in foreign trade" was the principal reason why indebtedness in one type of currencies could decrease only at the price of growing debt in the other. The improvement of the current account in convertible currencies could take place in the early 'Eighties owing to significant import cuts but also to a structural shift in the domestic use of rouble imports to the detriment of domestic consumption which served as a basis for increasing petrochemical or iron and steel exports to the West. The opposite of this kind of development took place to some extent in 1985-1987 when Hungary repaid debts to CMEA countries by quickly increasing net exports (or more

Table 5: The Current Account, Gross Debt, Net Debt, and International Reserves of Hungary
in Convertible and Non-Convertible Currencies
(million USD, rates of exchange as of the end of the given year)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987
Convertible currencies										
Current acc.	35	-528	-368	-728	-77	297	331	-457	-1419	-847
Gross debt	1000	3929	9090	8699	7715	8250	8836	11760	15086	17739
Net debt	424	1925	5388	5474	4943	4594	4083	5018	7790	10904
Reserves	...	1492	2446	2005	1233	1863	2556	3543	3639	2378
Non-convertible currencies										
Current acc.	-59	-122	-209	-169	-236	-262	-59	401	133	262
Gross debt	...	295	1224	1327	1274	1367	1260	1229	1109	1026
Net debt	174	186	699	789	891 †	1005	921	642	510	208
Reserves	...	132	113	28	66	45	19	215	174	319

Source: Figyelő, 1989.04.20. p.15.

precisely, not cutting exports according to the fall in imports) much faster than planned. These facts point to considerable structural weaknesses in production and trade which mean that Hungarian comparative advantages are based on a very precarious "role of transition" between East and West in addition to its cost structure and resource endowment. But this role cannot be maintained in the future since imports of raw materials from CMEA countries will probably diminish and the conditions of this trade are not likely to improve for Hungary.

The 1985-1986 initiative of dynamization exerted a clearly negative influence on Hungarian debt positions in convertible currencies, gross debt in USD doubled between 1984 and 1987. Approximately 50% of this was due to depreciation of the USD² but serious problems of Hungarian international economic performance were also revealed in this spectacular increase in foreign debt. Gross debt in convertible currency still amounted to 23.7% of GDP in 1972, 39.1% in 1980, 42.2% in 1984, and already 62.9% in 1987. Debt service ratio calculated from convertible currency exports of goods and services reached 28.4% in 1978 and not less than 50.4% in 1987.

² Net Hungarian debt increased by USD 6.1 billion between 1985 and 1988, out of which USD 3.2 billion were a result of the exchange rate changes (Figyelő, 1989.04.17; p. 3).

1.2 1988: A controversial turning point

The macroeconomic trends analysed so far necessarily concluded to a point where government was already forced to try to put the economy on a new growth, internal and external balances path with changing monetary, fiscal policies and a new concept of the market. 1988 was the first year when some of these efforts became really clear. Economic trends and results of this year show an indisputable improvement in the macroeconomic performance but also some new problems and tensions linked to the transition towards a more or less "market-like" economy. A review of these might be interesting not only from a scientific point of view but equally for other socialist countries determined to embark on such a transition.

The volume of GDP-growth reached 0.5% at most which means a considerable slowing down of the growth process. This is the second lowest growth rate of the 'Eighties (after 1985) and is due mainly to **reasons of business conditions**. Unchanged business perspectives (mainly domestic demand) would have brought about an approximately 2% rate of growth because natural conditions were quite favourable with a mild winter and other beneficial climatic factors throughout 1988. The demand picture deteriorated above all because of restrictive policies hitting domestic demand in a very selective way. External demand increased in a

conspicuous manner (convertible-currency exports: 12%, rouble exports: 0.5%) but only owing to trade with market economies. Domestic use decreased by 2% in 1988 but this fall is even more shocking if inventory changes not directly linked to the 1988 demand situation are not considered. These changes consisted of the reconstruction of inventories that had been exhausted by the purchasing fever of the population in late 1987, due to inflationary expectations mainly because of the introduction of the new tax system. Without respect to inventory changes, aggregate domestic demand decreased by 3.5% in 1988 which also means a fall of 8.5 percentage points as compared to 1987 demand growth.

The population's demand diminished by almost 5% while that of enterprises fell by 4% (again if inventory changes originating in 1987 are left out) and public consumption by 3%. The volume of aggregate investment even dwindled by 6%. Strongly restrictive economic policy also had a very slow growth of supply, as a result gross output increased by less than 0.5% in 1988. This is confirmed by the fact that enterprise inventories from their own production increased - at current prices - by less than 1.5% of industrial GDP.

The almost dramatic deterioration of the demand and supply picture was **not simply a result of strong and wide-range macroeconomic restriction**. The fact of consequent restriction cannot be denied, of course, but this went

together with a conscious intention of creating elements of a "customers' type market" in general, as well as of hardening the domestic currency. This is why the **introduction of new macroeconomic regulators and of a new pricing system, changing demand patterns in foreign trade, novel elements in the spending and saving habits of the population and new monetary or other governmental policies** also had their impact on the performance of the Hungarian economy in 1988.

The reform of the pricing and regulatory system brought about **significant changes in the global cost structure**. The share of gross incomes from labour increased by approximately 6.5 percentage points, the balance of monetary flows between the state budget and the enterprise sphere increased from 7% to 10.5% of GDP, and the share of taxes decreased by 10 percentage points to 11.5%. Part of the tax burdens of the enterprise sphere was transferred to the population which had to contribute 6 percentage points more to budgetary incomes than in 1987. About one-half (8 percentage points) of consumer price increases occurred apparently due to the tax reform. Regulation of foreign trade also changed significantly in favour of enterprises mainly importing for rouble and exporting for convertible currency. Since convertible currency exports have a much higher degree of elasticity this was the main trade flow

influencing domestic supply and demand conditions (and having an apparently restrictive impact to a great extent.

These changes did not only influence primary cost structure but - due to not underestimable psychological effects - the whole set of spending, saving and investment habits of enterprises and the population. The population trying to preserve its welfare position realised additional purchases mainly of consumer durables at a value of at least 30 billion Forints, about 3% of GDP in the second half of 1987 and invested still more into real estate. This extra demand by the population was equal to approximately 7% of aggregate household demand in 1988, thus introducing an element of strong instability into the functioning of the markets of consumption goods. The financial stability of the enterprise sphere deteriorated to a great extent because many firms built up considerable inventory stocks even at a price of huge indebtedness and quickly worsening liquidity positions. Several investment projects were realised much earlier than planned. This sort of enterprise behaviour was a logical precursor of what followed in 1988; enterprises became "shy" and "modest" with spending less than they would have been able to. Their motives were twofold: 1. A cautious avoidance of performances and profits evidently better than the average because of fears of "tailored" changes of regulators or "case-by-case treatment" by state administration eager to improve budgetary positions at the

expense of well-off enterprises; 2. As members of a silent "cartel", all enterprises had the common interest of persuading the government that the regulatory changes of 1988 were strict enough and they did not make extraordinary performances possible. This did not prove true, but the government had to be cognizant of the fact that rules of the "regulation" game must be considered fixed unless the risk of a very passive behaviour (this is called the "performance-withholding attitude in Hungary) of enterprises is deliberately run by the government on a longer-term.

The population also stopped part of its legal economic activities due to the new income tax system. The population lost about 80 billion Forints in net taxes on a 1987 income basis. Real wages sunk by 5% while real incomes stagnated, but it was a serious sign of quickly growing monetary imbalances when the population started to withdraw its monetary savings. The most important part of these were channelled into illegal or semi-legal forms of savings but a portion was simply consumed (partly as a compensation for real wage losses).

The nominal purchasing power of the population grew by somewhat less than 10% which means a loss of real purchasing power of about 5%. This took place in an environment of strongly increased fiscal activity by the state. Payments from income and turnover taxes by the population amounted to

196 billion Forints in 1988 (the comparable 1987 figure was only 72 billion Forints). Payments to the population from the budget reached 217 billion Forints (social allotments and subventions of housing credits) which meant an increase of 47 billion Forints from 1987. It has to be stressed, however, that the state has in practice no autonomy in a significant part of the latter payments. This part always depends on the actual rate of interest, since the stock of housing credits to the population amounts to 255 billion Forints with 3% of annual interest. Given the fact that actual money market interest rates at which the government can borrow to finance budget deficit amount to 19 1/2 %, approximately 42 billion Forints (about twice the 1988 budget deficit) have to be spent on housing credit subventions on an annual basis.

Even if the income distribution pattern changed in favour of the budget and to the detriment of the population, the global (domestic and external) demand of the latter increased by altogether 50 billion Forints drawn from savings. This sum corresponded to 25% of the 1987 stock of savings books (but was only partly drawn from these) and was spent on **durables' purchases** advanced to late 1987 and **purchases of foreign currency** due to the 1988 introduction of "world passport" on a fifty-fifty basis. A significant part of legally purchased convertible currency as well as of payments from convertible-currency accounts were spent by

"shopping tourism".³ This was the main reason why the external balance did not improve as expected in 1988.

The trade balance improved in a more spectacular manner in 1988. The trade balance in convertible currencies ameliorated by not less than USD 820 million in one year reaching USD 495 million. This was due to a fast increase in exports (volume growth in 1988: 12%), a terms of trade improvement of 1.3% and to a 3% fall in the volume of imports. At the same time, however, the balance of tourism deteriorated by USD 300 million owing to the increased spending of Hungarian tourists abroad. Even thus, the current account balance improved by USD 255 million to - USD 592 million and - due to exchange rate fluctuations favourable for Hungary - net debt increased from USD 10,904 billion to only USD 11,069 billion. It is clear that customs or monetary measures taken simultaneously with the liberalization of travelling abroad could have significantly diminished the outflow of currency for "shopping tourism" and an even more spectacular improvement of the current account could have been reached.

The development of trade with Socialist countries corresponded roughly to expectations with 200 million

³ This can be considered, by the way, one of the most efficient forms of consumer goods imports.

roubles of trade and 300 million roubles of current account surplus.

External balances show an almost radical improvement of Hungarian economic performance in 1988 even in spite of the above-mentioned significant currency outflow. 1988 was thus a year favourable in external balances and rather unpromising in the growth field. Two other important aspects of macroeconomic performance are **structural changes and domestic balances**.

The structure of production changed to the detriment of industry whose production volume stagnated in 1988. The growth pattern of industry did not change at all as compared to 1980-1987 trends. Branches with a stronger than average dynamism remained the same as before (aluminium industry, instruments and lighting equipment, plastics, pharmaceutical industry, furniture industry, breweries) but none of them could manage to become a decisive leader of a structural transformation process. It is rather remarkable that export successes can be attributed to "depressed industries" (iron and steel, petrochemical industry, textile and clothing) to a great extent. These industries could make use of favourable world market developments. Their exceptionally good export performance created a **new dilemma** for the government: should priority be given to short-term conjunctural or longer-term structural policy as far as

these "mature" industries are concerned? The answer is neither yes or no, because the sets of tools of such economic policies are completely different, and they would belong - at least in a future governmental set-up with much more transparence than the present one - to different independent governmental bodies not necessarily called ministries (like, for instance, the National Economic Development Organization - NEDO - in Britain with responsibilities only in the structural policy field). This also means that the tools of these different policies could even be simultaneously applied and some contradictory effects for such industries could not be necessarily excluded.

The structure of the **increment** of Hungarian exports for convertible currencies in 1988 clearly shows the scope of the above-mentioned dilemma. If the incremental value of Hungarian convertible currency exports in 1988 is equal to 100, the share of **energy** is 2.9, the share of **materials and spare parts** is 47.4, the relative weight of **machinery** amounts to 12.0, **consumption goods** make out 10.1 and **food plus agricultural products** represent 27.6 (TGI 1989; p. 56). This means that approximately 78% of the export growth occurred due to sectors which were, in general, judged as depressed so that good export performance influenced export profitability in a clearly negative sense and it quite strongly hampered structural transformation. To be more

precise, rather, it only rather prolonged the start of this process, signs of which were still hardly observable in 1988. The value of exports for convertible currency increased by 30.0% in 1988. Higher than average export growth was observable in materials and spare parts (34.8%) and food (32.6%), while the value of machinery (27.7%), energy (25.5%) and consumer products (17.4%) exports increased less than the average.

The development of the "profitability structure" of the main industrial sectors shows that structural transformation was also hindered by sectoral changes of profitability in 1988. As a general trend, profitability decreased in rouble exports and domestic sales of all major industrial sectors (basic metal industries, machinery industry, chemicals, light industry) as well as on the industrial (-5.8 percentage points, -0.3 percentage points) as the national economy average (-5.4 percentage points, -0.6 percentage points). Macroeconomic demand management was transformed in 1988 with the purpose of increasing profitability in non-rouble exports at the expense of sales on the other two markets. Overall profitability of convertible currency sales in industry increased only by 0.2 percentage points and improvement took place only in basic metal industries (12.8 percentage points) and chemicals (3.2 percentage points). Profitability deteriorated even in the machinery industry's and the light industry's convertible currency exports(-9.4

percentage points, -8.0 percentage points). All this occurred when the profitability picture of industrial sales for convertible currency is far from favourable from a structural policy viewpoint: industry's average profitability is 1.7% in rouble exports, 6.7% in non-rouble exports, and as high as 8.6% on the domestic market. On the national economy average, corresponding profitability figures are 1.4%, 7.6% and 6.3% showing that profitability in convertible currency exports still comes mainly from agriculture and services.

The profitability pattern among the main industrial sectors also implies that the main lines of a structural transformation process are far from clear. For the machinery industry, for instance, only convertible currency sales were loss-generating (-3.1%), whereas domestic sales proved more lucrative for light industry than non-rouble exports (3.7%, 2.9%). In the case of the basic metal industries and chemicals, the profitability of convertible currency exports was much higher than the average (19.2%; 8.8%). All this shows that revealed Hungarian comparative advantages on Western markets are still linked to traditional capital and material intensive sectors and profitability reflects skill intensity only in domestic sales and rouble exports.

Domestic imbalances were created or strengthened in 1988 mainly by monetary policy based on an outspoken

restrictive and anti-inflationary philosophy. These imbalances were visible first of all in the monetary sphere. Commercial banks were forced by the central bank to apply strongly restrictive credit and refinancing policies in order to transfer a not insignificant part of enterprise-level liquidity into the banking sphere. Liquidity problems in the enterprise sphere have increased to a degree we can probably consider abnormal. The volume of outstanding debts within the enterprise sphere increased by more than 50% (120 billion Forints, more than 10% of GDP) only in 1988. "Queuing" due to lagged payments (i.e. payments not realised because of chain-like liquidity problems of enterprises which are unable to pay because their customers cannot pay) amounted to 45 billion Forints - an involuntary credit stock with zero interest - at the end of 1988⁴ as a result of a 250% growth in the stock of these promised but not realised payments. Serious liquidity problems nourishing inflationary expectations also emerged due to the growth of the stock of officially expired credits to more than 10 billion Forints. Banks had to pour a part of withdrawn liquidity back into the enterprise sphere in order to maintain a living from hand to mouth of a considerable number of enterprises: about 8 billion Forints of "emergency" credits were given to firms unable even to pay wages in 1988. This means a 300% increase from the previous year.

⁴ Unofficial estimates put this figure at 80 bn Ft at the end of 1988, and at 190 bt Ft at the end of April 1989.

The extent and the inflationary impact of these liquidity problems show the limits of monetary restrictions in a semi-monetised economy. It was an undeniable result of 1988 that the government really became aware of these limits.

2. Economic system: the thorny path towards a market economy

As it has been pointed out in the papers of the ongoing WIDER programme on Socialist countries (see, for example, Rosati-Mizsei, 1988) and by a number of other scholars, the economic systems of the East European region exhausted their growth potential at the end of the 1970's. The last rescue which could prolong the traditional growth path in the 1970's was Western credits. By the end of that decade, however, net inflow of Western money had to be stopped. From then on, in the last decade the two central themes of the economic policy efforts were debt servicing and institutional reforms. This was not different for Hungary. Hungary had been the pioneer of systemic changes from 1968 but the known shortcomings of the new economic mechanism (Török, 1989) resulted in that the macroeconomic situation was not fundamentally different here than elsewhere in the area.

In December, 1978 the Plenary Meeting of the Central Committee of the Hungarian Socialist Workers' Party (HSWP) marked a turning point in economic policy. Concerning the systemic dimension, it initiated the **double movement** which has been characteristic for the past decade. On the one hand, it opened up new thinking on the continuation of

market reforms which had been interrupted a few years earlier under the pressure of political forces in and outside the country. Liberalization steps have been virtually continuous in this period as the need for fundamental reforms was also there because of the poor and depressed economic situation and perspectives. Different sorts of decentralization drives have been present in the Hungarian economy in the last ten years. Some measures intended to streamline the system along the concept of the "Socialist market mechanism" or the market simulation model (Miszei, 1988) while others opened new opportunities for additional incomes for state employees, partly as a compensation for loosening up the former hierarchical structure in that sector. The real private sector could also expand its activities although this tendency has been far from a conscious reprivatization programme.

On the other hand, however, long-lasting and in periods like 1982, intensifying tensions in the economy as well as the need to service international debts, have facilitated economic centralization in as much as it helped to concentrate efforts on debt servicing and other unexpectedly occurring urgent problems. The Hungarian economic system has been shaped in the magnetic field of the double movement (the notion has been borrowed from Polányi, 1968 applied to a remote but analogical historical process of the formation of capitalism in the late 18th century). Similarly, with

respect to the administrative-business cycles, it is not easy to identify reformist and centralization periods in the 1980's in Hungary. The reason is the same for both changes: in this decade Hungary entered the period of ultimate crisis of the existing economic system: with respect to the business cycles, it has meant (compared with the earlier stages) unusually long periods of restrictive policies and in terms of the economic system it has given rise to steady need of economic reform. The picture is made even more confused because of the procedural time lag between decisions and implementations of reform measures often overlapping the business cycles' recent hectic stop-go oscillations.

In this chapter we will not try to give a clear periodization of the last decade from the point of view of systemic movements. Even in the time of the 1985-86 acceleration policy some clearly progressive steps were made (Szegevári, 1988), while in the most restrictive periods decentralising measures were matched by centralization minded ones (Csaba, 1988). In the first part of the chapter we will provide an overview and a brief evaluation of systemic changes in the 1980's until 1986. Thereafter we will focus on developments from 1987 until the recent time. The choice of 1987 as a landmark in reform history is due to the fact that at the time, the leadership realised that an acceleration in the old way cannot be feasible in the

circumstances of the 1980's. Partly this assessment led in the same year to personal changes in the leadership that ultimately concluded in the resignation of almost the whole Kádár team and, through this, in significant changes of the political framework and constraints of the economic reform process. Because of the considerable uncertainties of just these political developments, one cannot provide without trickery a reliable forecast for the future development of the economic system. It is possible, however, to present the recent intentions of the government about the necessary measures in the near future being aware of the volatility of the government itself and also of the number of elaborated and only partly fulfilled programmes in the last two years.

2.1 Systemic changes in 1980-1986

Looking at the events of the early 1980's, it seems very likely that the most important innovation of the period was that the ruling apparatus approached the reform economists for new ideas, and this initiated a new wave of public reform debates (Török, 1989). In the longer-run, renewed reformist thinking has elaborated much more sophisticated designs on how to change the system. These projects have also been much less compromising in the ideological sense and gradually have approached a model of a profoundly market economy instead of the 1968 reform concept with its market-simulation illusions. These discussions

revealed for the first time in Socialist Hungary that the main shortcomings of the 1968 reform were that they did not touch upon the problems of the state property as well as of the necessity to establish capital markets. In this key respect two fundamentally different approaches have been present: one group of economists suggested a reorganization of the structure of the agents in the economy, establishing large holding-like companies to replace branch ministries. These holdings would be interested in maximising the capital value of the subordinated units. They could operate on the capital market, the formation of which was also proposed by the reform economists. The opponents of this idea in the reform camp have pointed out that the advocates of the holding concept cannot prove or guarantee that the holdings would behave in a market-like way instead of reproducing roles similar to those of the old ministries (Bauer 1984).

It was a characteristic feature of the early 1980's that the central authorities were unwilling to accept the need of the "second wave" of reform (or, as was formulated then, the "reform of the reform") but were keen to pick up elements of different concepts. This happened with the idea of capital market as well. The first, very cautious steps on this road started in 1983, when a rather restricted **bond market** was established. The restrictions meant especially an isolation of this market for the population from that for the institutional investors through different interest rate

restrictions. Interest rates were fixed and guaranteed by the state on both markets. Even this kind of capital market seriously challenged the basic doctrines of the ruling ideology, but in real economic terms for the population it meant only a substitute for bank savings which promised very unfavourable interest rates in that time (As an important fringe benefit of the bond market, the absolute monopoly of the Hungarian Saving's Bank on the population's savings was lifted.) In 1985 the unification of the two markets started and in some cases only partial guarantees were given on the interest rates. By 1988 the administrative separation of the two bond markets was totally eliminated (Járay, 1988). No serious attempt was made, on the other hand, to implement the concept of holding companies which, in its early version (Tardos, 1982) was a far too rough and costly project.

The other wing of the reformist camp opted for an enterprise of self-management solution. The sense of this would have been that the companies' ties with the macroeconomic management (the right of the higher party organs to dominate directors as well as the informal influence of the branch ministries on the production profile) would be broken and the alienation of the workers from the final results of the company could also be eliminated this way. Some strongly compromised version of this idea could gain official approval since it seemed the more 'socialist' of the two property reform versions and

therefore was less vulnerable to ideological attacks. From a practical point of view, however, the self-management legislation of 1984 proved to be a blind alley and one of the most serious economic policy mistakes of the 1980's in that it diverted attention from the impossible solutions which could have contributed to real improvements in overall economic efficiency. As subsequent empirical investigations reveal (which could have been expected anyway) only a small minority of enterprise collectives organised themselves into a serious controlling body of the executive management and were strong enough to enforce their legal rights in the strategic decisions of the company.

The advocates of this idea did not even try to formulate the technical details of the self-management solutions so that it could strongly increase economic rationality. Now, as the country has entered the next chapter of reform efforts, the very existence of the enterprise councils poses a serious problem since transformation of the state enterprises into a corporation or reprivatized unit cannot take place without the approval of these bodies.⁵

Besides the mainstream reform wings another approach, the "socialist entrepreneurship" idea of Tibor Liska gained

⁵ See a more detailed presentation of this problem in 2.2.

considerable popularity as well (Bársony, 1981). Although it was a utopian scheme, some parts of it were worth application, even in the given economic system. The leasing of different estates, mainly of restaurants and shops, to private people in the form of bidding was quite widespread. Leasing was applied together with other forms of the so-called small-scale entrepreneurship in the early 1980's as an expression of compromise between state and private ownership. The state economy was no longer able to assure visible growth of living standards, which had been **common in the earlier periods of Socialist** economy, but the ruling elites were not yet willing to start with a programme of profound changes in the property structure of the economy.

In this situation a middle course was taken by permitting various forms of small-scale business. The most widespread form was enterprise working groups, a very dubious sort of group economic activity using the assets of the state enterprise. Practically this solution served to avoid the strict wage regulation in overtime work by offsetting the decreasing or stagnating real value of the wages. Working groups were organized outside the state enterprises on a semi-private basis as well. Here the legal constraint of at least two members served ideological purposes to hide the basically private businesses. (In fact, in many cases the working groups or other small-scale "cooperative" forms of entrepreneurship had to pay a heavy

price for this rule since in most cases small businesses with one owner, mostly on a family basis, could be the "natural" solution.)

Small businesses frequently mushroomed in the service sector where human skills rather than large-scale capital investment were needed. Also typically, these entrepreneurial activities were additionally applied (i.e. also in overtime) to state jobs since the economic agents evaluated the new opportunities as only temporary concessions as a result of the poor economic situation. Nevertheless, progress in this field has produced a quite numerous stratum of urban petty entrepreneurs, unusual in most of the other Socialist countries. In many cases the need to build up one's own home forced engagement in private businesses as the state has gradually withdrawn from the housing market, once regarded as a social function, because of the lack of sufficient budgetary resources. The presence of private firms in the industrial branches was, however, extremely marginal in the first half of the 1980's.

In order to create circumstances for market competition, the central authorities made several efforts aiming to **demonopolise the organizational structure of the economy** (Török, 1989; Vince, 1987). Since branch ministries had been regarded as strongholds of the obsolete centralistic macroeconomic management both by professionals

and by representatives of the financial authorities, a single industrial ministry was established in 1980 with the aim to use it for long-term forecasting and as an advisory organ for the industrial branches. Similarly, from the late 1970's the central authorities tried to split up some huge and artificial industrial units merged in the early 1960's. The results of this campaign were extremely modest since the overwhelming majority of the large Socialist companies could count on sufficient political support to evade division. Actually, the result of the campaign was strongly counter-selective as the politically weaker companies were usually financially less ailing while the real trouble-spots of the national economy were generally the companies in traditional, and therefore politically stronger, industries (Mizsei, 1986; Vince, 1986). The campaign for centralization of the size structure of Hungarian industry did not yield a more competitive situation, but as a side-effect contributed to the growing confidence-crisis between industrial managers and the higher decision-making bodies.

Behind the above-outlined systemic efforts lay the belief of the reform-minded scholars and ministerial staff as well as politicians that Socialist economies can ultimately be made efficient through the reforms which we described above as market-simulating. This belief was the strongest (and had the most devastating results) in the case of the 1980 "price reform" which wanted to imitate (instead

of creating a direct link to) world market price relations on the domestic field. The new price system, which forced many producer prices down, created a **liquidity crisis** among enterprises but, because of the absurdities of the system, the rules could not, of course, provide a framework for bankruptcy procedures. Therefore, it was doomed to failure from the very beginning of its existence (Török, 1989).

Another illusion of the price system was that it could lead in the foreseeable future to convertibility of the domestic currency. Undoubtedly, the planners paid much more attention to the problems of the foreign trade mechanism than in the late 1960's. Most notable was the organizational change in loosening and reformulating the state monopoly over foreign trade. In 1982 already 160 enterprises had the right to export autonomously while 180 firms had temporary licences to export certain commodities.

Nevertheless, foreign trade difficulties only added fuel to the strong anti-reform movements. In 1982 Hungary even formally temporarily suspended its obligations to GATT concerning import rules. In fact, imported items were distributed in the most bureaucratic way and the practice of informal interference of state authorities with the life of the enterprises through import allocation became a new and long-lasting tradition of the Hungarian economic system (Csaba, 1988).

Economic policy did not seriously try to influence demand for hard currency imports through exchange rate devaluation. With the entry of Hungary into the international financial institutions (IMF, World Bank) the exchange policy had to change towards a course of devaluation, although fear of inflation hindered a more serious real devaluation of the Forint. It is not clear either whether the cost sensitivity of the Hungarian enterprises was sufficiently high so that the more expensive imports resulted in decreasing demand.

It was a general practice in the early 1980's that the restrictive fiscal policy drastically decreased effective demand of the population and of the enterprises in order to increase supply on foreign markets. In the given economic system the tools of such an endeavour could increase overburdening of the enterprise funds. Secondary taxation of the bonus fund had already been a widespread practice. With worsening external imbalances and budget deficits the policy center introduced new practices to diminish enterprise demand. Reserve funds (formed according to central rules) were first frozen and then centralized into the budget; spending from accumulation funds became the target of secondary taxation similarly to the case of bonus funds; finally a seemingly more modern looking taxation of the enterprise resources (like an assets tax) was introduced.

The problem was not just the overburdening of enterprises with taxes, but also the way it was done. Regularly, the enterprises were able to avoid some payments because of too complicated rules; as a reaction, fiscal policy imposed new **ex post** financial burdens which created an unintended liquidity crisis for several economic agents. The fear of widespread bankruptcy caused the financial agents to give extra relief to companies in a difficult financial situation (Csaba, 1985).

This vicious circle, generated mostly by the budget's extraordinary redistribution activities, was another source of the earlier mentioned confidence crisis between enterprises and central management. Trying to overcome this, the financial authorities also wanted to "streamline" the regulation rules. After the "expropriation" acquisition of the enterprise reserve funds by the government, the obligatory character of the reserve fund formation was abolished; the centralised part of the amortization disappeared as well. The most important process has been, however, the gradual elimination since 1985 of the centrally regulated intro-enterprise fund-formation system. The integration of the wage fund and the bonus fund, as well as the easing of the burdens on accumulation were the main targets of this policy. In a peculiar way relaxation of external tensions on the economy contributed to liberalization. The problem was that it eased the financial

situation of the enterprises without establishing the conditions for market competition (or, in other words, for hard budget constraint) (Svegári, 1988).

Another crucial aspect of the growth-oriented policy in 1985-86 was that it favoured large enterprises with major shares of exports towards the Socialist countries (Szalia, 1988). Restrictions in the earlier period mainly between 1981-84 accumulated such pressure on these units that from 1985, as the emergency situation temporarily eased, policy-makers could not resist giving extra preferences to them. The suddenly relaxed application of regulatory rules weakened the interest of enterprises to export to the hard currency area at the same time. It would be an oversimplified approach, to say that a return or shift towards the traditional regulation practices characterized the 1985 turn in the economic policy. It would be more appropriate to emphasize that it was a policy of **liberalization without establishing market conditions** (property rights, liberalized rules, import-competition) which led quickly to a failure of the growth-oriented measures by the state.

The other important feature of the permanent reform of the 1980's was that its elements were implemented step by step instead of introducing them as a comprehensive package. One can doubt, however, whether the introduction of the

market-simulation model at one go would have been fundamentally more successful.

This visible and striking economic policy failure fundamentally shook the status quo. Already in 1986 an eminent group of reform economists decided to elaborate a reform package independently of a state or party initiative, as a first such act after 1956 in Hungary (Lengyel, 1988). From then on, political struggles have directly determined the fate of system reforms.

2.2 Reform efforts in 1987-88

2.2.1 The political background

It has been a prevailing view among scholars dealing with Socialism that for economic reforms a combination of a stable political situation and a fear of its disintegration were needed. It was undoubtedly true for Hungary in 1968 and also for the first part of the Czechoslovak reforms in the 1960's as well as for the Polish reform efforts in 1982. What we have been witnessing in Hungary for the last three years puts a question mark behind this statement. Destabilization of the old political status quo has continued simultaneously with some serious reform efforts, although the reform steps were lacking a comprehensive nature. The Hungarian social renewal has undoubtedly been

initiated by intellectuals, mainly by economists, political scientists, sociologists and progressive journalists. Growing dissatisfaction led in two stages to the removal of the Kádár team from the political scene after more than 30 years of apparent stability and political continuity. It is not the purpose of this paper to evaluate the Kádár era nor the reasons and consequences of the political changes which culminated at the party conference in May 1988 with major changes in the political leadership. It is sufficient to emphasize at this point that a major factor behind these political events was the growth of economic tensions and that the political status quo could not be re-established after the party conference. Conflicts in the ruling party have reflected growing discontent in the population (mainly in the intellectual circles with uncertain popular support) and led to recognition of the so-called **platform-freedom** (the right of the party members to express and defend opinions different from the ones formulated in official resolutions). Political destabilization has also led to the intensifying articulation of **political platforms outside the party**. This process has culminated in the establishment of oppositional political parties as well as party-like organizations while the ruling party, for **the first time in the history of any Socialist country**, recognised the right of these parties to exist. It is not clear, however, what will be the new political rules of the game and

consequently, what kind of political conditions of the unavoidable reform process will emerge.

Political struggles have shortened the time horizon of the politicians and of civil servants responsible for economic policy since after three decades of institutional stability, positions have become increasingly uncertain and temporary. In the short run this factor has undoubtedly worsened the changes of a durable reshaping of the economic rules and institutions. It is a question for the future if the price the Hungarian economy has to pay now for political changes will be provisional. (It is certain, however, that the price for lack of change would be huge.)

There is another dimension as well that in Hungary, unlike Poland or Yugoslavia, changes of the political structure have not (as yet at least) taken a trade unionist character but rather a more conventional political pluralization has developed. In spite of the growing external difficulties and political disintegration, the level of inflation is incomparably lower than in the two other Socialist reform economies. The official trade union structure has undergone only slow and modest changes and, as yet, there have not been massive industrial strikes which could have strengthened the wage-price spiral. This is not to say that Hungarian inflation is modest, but the damaging effects of the less than 20 per cent yearly price increases

are much less than those of Polish or Yugoslavian hyperinflation. New, independent trade unions have so far been established only in marginal branches and mostly only in intellectual professions (the first independent union was formed by scientists) and could not sufficiently alter the earlier mechanisms of price and wage formation.

2.2.2 Banking system

Banking reform was already discussed in the first half of the 1980's but a lack of political determination postponed its introduction until 1987. The idea of the reform was a logical extension of the market simulation institutions on the money markets. The authorities wanted to divide the functions of money emission and of crediting with the help of organizational separation of the central bank and the newly-formed commercial banks.

The separation was very cautious and several serious restrictions assured that the real monetary processes would not change dramatically at one stroke. First of all, even after decentralization, the structure of the banking system remained overcentralized. The Hungarian Credit Bank became the biggest of all and inherited the accounts and deposits of the great majority of the industrial enterprises. It was responsible for about half of the credit amount in the whole business sphere at the beginning of the existence of the new

bank structure. The banking sphere was deregulated in the sense that after a short transition period banks could theoretically compete for each other's clients. Interest rates, however, were centrally fixed and were far below equilibrium although they generally provided some real gains over inflation (Csaba, 1988).

The reason for higher market rates was shortage of the money market. Big central investment projects like the Nagymaros hydroelectric power plant or other investments in the energy sector including joint projects in the Soviet Union have absorbed huge resources and (partly because of this) the fast growing budget deficit has narrowed the money supply as well; budget deficit has been automatically refinanced by the central bank. Similarly, debts of the enterprises from earlier credits (sometimes from the 1970's) burdened the starting situation of the new bank system. The central authorities exerted informal pressure on the banks in order to save the enterprises while even the banks themselves were not especially interested in initiating bankruptcy procedures.

In the case of the biggest commercial bank, the **overwhelming majority of the initial resources** (70 per cent) **were refinancing credits of the central bank** and only a smaller part stemmed from deposits of the business sphere. Private savings were separated, and only the National

Savings Bank and the newly established Hungarian Postal Bank were entitled to deal with it. The main obstacle to integration of the enterprise and private savings and credits were the strong subsidies of housing investments of the population. Inflation has very strongly undervalued these investments and such an anachronistic situation has occurred that the budget (through the bank) has subsidised investments of the relatively better-off part of the population since only they have had the initial financial resources to start with new construction. (Housing construction for purposes of private renting is still practically forbidden.)

Integration of the banking system has started in 1989; although in a transitional period, the commercial banks have to create deposits for 100 per cent of the accounts from the population. The integration is also supported by an increasing equality of credit conditions developing neutrality of crediting for the different property forms as well as by measures allowing the commercial banks to hold foreign currency accounts of the enterprises (Szalkai, 1989).

To some extent, shortcomings of the banking deregulation have undoubtedly been a result of the coincidence of its start with the failure of the 1985 acceleration efforts. From 1987 the central authorities had

to apply strong restrictions on the whole economy which had implications on the banking sphere as well. The budget deficit had to be refinanced by the central bank; the bank is subordinated to the Ministry of Finance, therefore this refinancing is practically automatic. In this situation, the declared normality of the relationship between the central bank and commercial banks remained an illusion; the tools for restricting money supply have been typically bureaucratic. The central bank drastically severed its refinancing activity already in 1987; it modified the level of obligatory reserves for the commercial banks often and voluntarily. As a well-known expert of the monetary sphere summed up the results of the bank reform: "the role of the banks in the reallocation of capital, in the selection of capital withdrawals and investments is still secondary compared with that of the state budget" (Várhegyi, 1988).

It is important to mention here that besides the 5 newly-formed commercial banks some monetary institutions (small banks) have developed during the 1980's. However, their rights on the money markets are restricted even compared with the commercial banks. They are severely limited, for instance, in collecting deposits from companies (Várhegyi, 1988).

The balance-sheet of the bank reform is thus far from clear. On the one hand, it has been an important step on

the road to depoliticising the economy, on the other hand, however, the progress has not broken away from the market-simulation logic of the 1968 reform package. It has created, however, institutional frameworks for a possible future real marketization of the economy if concentrated efforts in that direction proceed.

2.2.3 Capital market

As we pointed out in 2.1, the bond market was a substitute for more simple methods of capital-raising on one hand and of normal private savings on the other. In circumstances of growing inflation and the unelastic interest rate policy of the state (or the Hungarian Savings' Bank), motivation of money savings weakened. In the early period of bond market history, demand was sluggish in the branch dealing with enterprises as firms were still more interested in investing money in themselves, while for better real savings perspectives, demand was strong on the market for private persons. In 1988 the two markets were integrated.

At the end of 1987, however, the tender bond market experienced its first major crisis. Preparations for the tax reform (see 2.2.4) increased inflationary expectations of the population. Because of this, people massively withdrew their bonds in order to spend their money on consumer items.

The buying fever caused severe shortages on the consumer markets of durable goods for a few decades - a very uncommon event in Hungary. Speculation that bond revenues would also be taxed from 1988 aggravated the crisis. The banking system tried to counteract this with some success, but as a consequence of the falling confidence in the bond system and of bleak profit prospects of the companies, no new bonds appeared on the market in 1988. **Treasury bonds** were a new phenomenon on the bond market, an expression of the will of the budget to shift deficit financing from the central bank to open market transactions. The commercial banks raised the stock of their resources by also issuing deposit slips in 1988 (Hardy, 1989).

Since neither commercial banks nor the bond market could sufficiently contribute to efficient reallocation of capital for the benefit of efficient activities in the period of severe monetary restrictions in 1987-88, the attention of the "reform-architects" increasingly turned towards creating the institution of the **stock market**. Preparations for inventing it have been relatively fast in the last two years but serious problems have also occurred concerning the question of how shareholders will be "created". (This problem is discussed in 2.3.) Up to the present private investors have been excluded from purchasing shares in the few already existing shareholders' companies. (These companies have also been predominantly "closed"

corporations i.e. shares have not been eligible for trading.) This ideological barrier was eliminated by the parliament approval of the corporation law at the end of 1988 which established neutral conditions for different property forms.

Some of the most ailing companies (with a high share of indebtedness towards commercial banks) tried to escape bankruptcy through transformation into shareholder companies in 1988. In particular, the case of the Medicor firm (producer of medical equipment) has provoked a public controversy since in this case (similarly to others) the majority of the shares remained in the possession of the formal enterprise center (Figyelő, May 4 1989). At the bottom of the controversy is the fact that in the Hungarian situation, where there are practically no private shareholders, property rights are very uncertain and mutual shareholding among enterprises is a real danger. In other words, it is not yet clear if this situation will increase the assets-maximising interest of the state institutions as shareholders. Another important feature of the Hungarian developments is that, unlike the Anglo-Saxon practice but similar to the Austrian and German solutions, the commercial banks have taken part in the shareholder companies and increased their influence as owners quite rapidly. Conversion of debts into the banks' shares is a widespread practice as well.

The first newly-formed shareholder company was NOVOTRADE Inc. founded by several banks and other shareholders in 1983. In 1989 this company has been innovative again by encouraging its top management staff to buy individual shares in the company. This has also been an alternative to bonuses since sharply progressive income taxes would have depreciated the real value of bonuses. Progress on the stock market is certain and one can expect that after the adoption of the stock market bill (expected by the autumn of 1989) its development will accelerate. It seems likely, however, that it can gain ground only if and when the final owners (private investors or institutional ones collecting private resources, such as insurance companies) will gain a high proportion of the shares.

2.2.4 Tax reform

The 1988 tax reform has been propagated by economic policy as a great leap forward on the road to a European-conform economic system. As all of the important government decisions in the last two years, it gave rise to considerable public controversy. Its opponents said that the new tax policy was nothing but a new tool in the hands of the "financial dictatorship". A balanced evaluation should start with the statement that the tax reform took place in the period of severe financial restrictions and therefore

reform also meant the introduction of modern taxing and tax collecting techniques. It was simultaneously a step forward and at the same time a means to channel enterprise profits into the state budget. The greatest shortcoming of the tax operation was, however, that it tried to centralize revenues by - deliberately or not - accelerating inflation. The basic rate of the newly-introduced value added tax (VAT) was established at 25 per cent while a quite large group of items had a lower, 15 per cent tax rate and some basic goods had a zero tax rate. While the shift from direct to indirect taxes was very progressive and eliminated much of the earlier case-by-case taxing practices, (Kollarik, 1988) a high VAT rate served to offset the elimination of earlier taxation forms through strongly inflationary budget revenues.

At the same time, several temporary rules and exemptions were built in the system. Due to budgetary considerations, investment items would only gradually be released from VAT coverage which makes this part of the reform somewhat useless. Agriculture, however, has received very generous tax exemptions as a consequence of strong lobbying and the authorities' fear of disturbances on the food markets. The smallest private enterprises were hard hit by the bookkeeping and administration needed by the new tax regime since earlier they had usually had a lump sum tax obligation.

The major problem with VAT was inflation. Paradoxically, although the main purpose of its high rate was increasing state revenues, inflation considerably increased budget expenditures such as subsidies to housing construction and interest rate obligations (Balázsy, 1989). While this negative effect was strong, the annual budget revenues of VAT in 1988 were much less than expected. This has had a very negative impact on the position of the state budget in 1989.

It is important to note that the high inflation rate has had very adverse implications on the state enterprises by depreciating the real value of the amortization fund. The real net profits of the companies, therefore, have been much lower than the nominal ones on the records. Lack of appreciation of the current assets have similar results. On final account, the tight budgetary income centralization, although justified in the recent stage of reforms and by the state of the national economy, has forced state companies to "use up" their resources since the average net profits have been much lower, compared with production costs, than interest rates on bank deposits. We think that in the given framework this has been almost unavoidable. More serious imbalances of the budget would have other negative consequences like shortage inflation (Kolodko, McMahon, 1987). What remained open to Hungary is escaping ahead by a much

more determined reprivatization programme and other elements of a profound market reform. (Reprivatization has a twofold anti-inflationary impact; it would increase state revenues at the moment of selling as well as later when higher taxes can be collected from more efficiently run enterprises.)

Personal income tax (PIT) was the other invention of the 1988 tax reform. It caused an even bigger controversy because of its politically more sensitive nature, though VAT's real significance was not less important. PIT formally introduced a very Western-type taxation technique. Its advocates have emphasized the benefits of its clarity (in contrast to the earlier hidden ways of taxing the population through low nominal wages and strict wage regulation) and the in-built progressivity as a tool of fair and just burden-bearing. PIT received extremely sharp criticism in the media, sometimes in an exaggerated and even demagogic way. The main shortcoming of the way it was introduced was that it created a strong bias against overtime work as its sharp progressivity started at a relatively low tax ratio. (The planners had adopted a mechanical way of counting the necessary budget incomes, deducting them from the pre-reform situation. There was a widespread and internationally well-known joke at that time that Hungarians had Ethiopian wages and Swedish taxes.) Many semi-private auxiliary units (see 2.1) had to stop their activities because of the strong

progressivity of PIT exactly at the income level which affected incomes at above average salary rates.

The other major problem with PIT was that it did not take into consideration social policy aspects such as (and especially) the number of children in a family, etc. Several participants of the national debate therefore advocated a family-based taxing principle (Török, 1989). In 1989 a renewed public debate has started on the modifications of the tax system which will most likely lead to decisions about maintaining the basic principle but with a stronger incorporation of family size considerations into the structure of tax reliefs.

The joint impact of the two major new taxes had very negative consequences, especially on the above-mentioned semi-private and private entrepreneurships (KIOSZ, 1988). Partly for this reason, more critical remarks dealt with the level of company profit (income) tax during 1988. The financial authorities promised its significant lowering as the next step on the road to tax and budget reform with a further shift from direct to indirect taxes. At the end of 1988, however, the authorities raised the planned level of the profit tax. For the first time in the history of Socialist Hungary, the parliament rejected this (big enterprises have a very strong direct or indirect representation in the highest legislative body). As a result

of intensive bargaining, however, the Minister of Finance was able to get an approval for a "50 plus 4" per cent tax level. (50 per cent as a rule and 4 per cent due to "temporary" budget difficulties.) The case of the profit tax seems to support our thesis that in the recent institutional framework (especially property structure) the possibility of appropriate solutions is almost excluded.

2.2.5 The "libero" programme

The post-Kádár leadership, partly under the pressure of the IMF and World Bank, elaborated a large-scale liberalization programme in 1988 with the intention of introducing it the following year. The package (which was given the nickname "libero" in the administration after the name of the popular baby's napkin) finally contained three elements: prices, wage deregulation and import liberalization. It has been a large-scale set of measures, but their basic trouble has remained the same: without establishing clear property relations in the economy, hard budget constraint could not be established (See Kornai). In the situation of "almost soft budget constraint" increasing inflationary and shortage pressure as well as a pressure on the external balances cannot be avoided because the enterprises could increase wages and transform their effects towards prices and the danger of bankruptcy could remain very weak; similarly, high import prices could also be

transformed into prices. (About the illusion of wage liberalization see Kóvári, Gábor R., 1988.)

Before we analyse the actual implementation of the liberalization programme, it should be stated that even in the event of an overwhelming role of state property, the monetary authorities can theoretically try to tighten the money supply. This has actually happened in Hungary during the last two years. In the given situation it has inevitably led to a cumulation of enterprise liquidity crises. The well-known phenomenon in Socialist reform economies has been repeated: the firms massively delay their payments in the way of a chain reaction in the hope that in lack of a bankruptcy solution, the central bank will ease their situation through a massive increase in the money supply. This is a certain type of collective blackmailing of the monetary authorities by the business sphere.

It is too early to evaluate the recent reaction of the central bank, but most likely it is a mixture of forcing out some bankruptcy cases while also pushing money into the system through tax allowances and other fiscal relief.

The main pillars of the price reform have been an abolishment of the 1980 rules on world market prices, a major shift of items from the state determined to the "free" price category and cutting subsidies on basic consumer goods

and energy. The formal elimination of the 1980 price system came in 1987 although the system has never worked in its theoretical form (in fact, it could never work because of its deep inherent logical weaknesses. From then on, the scope of the formally free prices has gradually broadened and will reach 70 per cent by 1990. Free prices, however, do not have the same connotation as in a Western market economy. They are subject to various forms of advance agreements and ex post consultations. Moreover, a bill, adopted in 1987, has introduced the category of unjust profits, meaning profits significantly higher than the average in the economy and/or price increases not justified with "objective" cost increases. Reductions of subsidies for consumer prices were very radical in 1988 and 1989. While one of the main reasons of the external successes in 1988 was a decline in real wages, this practice has its limits. The most important one is social resistance. The social situation was dramatic in January 1989 when official price increases were announced for basic consumer goods. It mobilised even the official trade unions and the danger of organised or spontaneous strikes was real. On that occasion a mutual effort of both parties as well as fear of the Polish example of the emergence of a price-wage inflation spiral helped to avoid major social unrest, however, this even showed the limits of step-by-step reduction of real wages. In the recent months there has been a race against time: if the performance of the economy does not improve

significantly in a few months, the authorities will have the same dilemma: whether to increase the basic consumer prices or the budget deficit.

Because of the changes in taxation, the wage system was very rigid in 1988 (Halmos, 1989). It also helped the authorities to maintain wages in manageable dimensions. In 1989 several changes have been introduced. In the place of the scattered and differentiated rules of the earlier years in the 1980's, the new regulation unified the formula of wage deduction from the enterprise level value added as the main indicator in this respect. The other change is less important but has been propagated as the main part of the liberalization package: the secondary taxation of wage increases above the quota allowed by the unified formula is not a result of government decision but of a negotiation between three parties, the government, the Economic Chamber and the trade unions. This mechanism is seemingly modelled on the Swedish formula, but in fact the underlying economic system makes, as yet, such a similarity very illusory. Namely, during circumstances of general labour shortage (as part of a general economy shortage) the interests and management (represented by the Economic Chamber) and the workers are about the same. A Swedish-like triangle, however, would suppose contradictory interests of labour and capital in which case the negotiator could be the government if the parties cannot agree. The system does not get rid of

the racket principle either: the point of reference for wage increases is still the wage sum of the previous year.

In 1988 the government improperly believed that as a consequence of its reform policy, larger-scale unemployment would occur. From the beginning of 1989 the legal framework of unemployment benefits has been in force (Vincze, 1989) but the lack of determination to use bankruptcy procedures due to fear of massive unemployment has proved unrealistic as well. However, a tighter monetary policy has encouraged managers to sack more employees than earlier. Unemployment occurred on a modest scale (official estimates state about 30,000 people) and mainly among the uneducated.

Recent developments in the economic and political field have necessitated a legal regulation of strikes as well. The strike bill was adopted at the beginning of 1989 under the strong control of the newly-born political organizations and small independent trade unions. The bill is therefore very liberal; it allows for solidarity strikes, for instance. Major strikes have not paralysed the Hungarian economy; the future will show if the benefits or drawbacks of the new strike law will prevail in the long-run.

There are two contradictory approaches among the Hungarian economists which both claim to be reformist. According to the more traditional one, wage formation rights

should be decentralized with the elimination of obligatory fund formation and double taxation. Another approach (Gábor R., 1989, Kóvári - Gábor R., 1988) points out that without strong capital representation in the enterprises, wage increases will never have strong institutional barriers. Therefore, a strict state policy in this respect appears to be necessary. A recent project on property transformation has also suggested that in state enterprises wage control should be strict (stricter than recently) while it should be sharply liberalised in companies which are already transformed according to the corporate law (Matolcsy, 1989).

2.2.5 Foreign trade regulation

In an organizational sense, demonopolization of exports has progressed in the last decade, the emphasis is recently on the questions of exchange rate and convertibility of the domestic currency as well as on liberalization of hard currency imports. As to the problem of import liberalization, two basic approaches have been discussed recently. Both agree on the necessity of a gradual approach. According to one reasoning a step-by-step liberalization may include the introduction and gradual extension of the retention quota system for hard currency earnings as well as a connecting hard currency exchange market for the domestic flow of the decentralized foreign revenues (Mizsei, 1987 and Szegvári, 1988).

In the practical solution of the import liberalization of 1989 another approach has prevailed. According to this a certain list of commodities are completely freed from central intervention. The scope of the list should be gradually broadened (Salgo, 1988, Gács, 1986). The major problems of this system are twofold: on the one hand, it is not possible to combine it with the hard currency exchange market as a liberalized institution of flow among enterprises, while on the other hand it is very difficult to build effective "market-friendly" barriers of import demand for these problems, the Hungarian foreign trade balance has already slightly deteriorated in the first few months of 1989. A possible and likely temporary solution is sharp devaluation of the domestic currency which probably could have been avoided by the other kind of import liberalization implemented. Under the recent circumstances the exchange rate devaluation has unusually sharp political limits as well. Arguments against the exchange rate changes based on possible inflationary effects were very strong in March and April 1989 when the government and the central bank respectively realized very modest devaluations.

However, increased private (tourist) imports have been the main source of external balance difficulties and not import liberalization. The so-called world passport (deregulated passport rules) were introduced in 1988 without

ascertaining that demand for hard currencies would not grow beyond manageable limits. Consequently, these demands skyrocketed in 1988 dramatically decreasing the country's net revenues from tourism. A sharpening of customs regulations also became unavoidable as Hungarian "high-tech" companies were not able to stand the competition from the private importation of deep-freezers, television and video sets, hi-fi equipment and the like. Customs quota increases actually unified the rules for private and company imports. However, a far from skillful introduction of the new quotas caused week-long invasions of Austria by Hungarian tourists and a billion dollar outflow of hard currency holdings of individuals.

This event has also focused on the problems of the Hungarian policy towards hard currency retail shops in the country. In the last decades a slow liberalization in this field has gone on. The dilemmas with a further sharp liberalization are, however, considerable. The Polish situation with double currencies and drastic devaluation of the domestic currency on the secondary markets is discouraging. On the other hand, a continuous extension of the network of hard currency shops is likely due to the extreme hard currency demand by the economy.

2.3 How to go on with reform?

In the 1980's the assessment became general in Hungary that the modernization strategy based on the dominance of state property and absolute state control over economic activities had failed. Under the pressure of the situation, the authorities of the country have introduced new institutional solutions which would have been unthinkable, even for the most radical economists, in the course of the 1968 reform. Nevertheless, the performance of the Hungarian economy has not yet fundamentally changed. Part of the explanation is that the individual elements of liberalization have not been cemented into a conceptual unit and have not been introduced with respect to their mutual effects. This is, however, only the tip of the iceberg. More important is that the reform acts have still not clarified property relations. State property is unclear and its practical concept has been obliterated in its history. A spontaneous and (in times of concentrated reform efforts) conscious decentralization of disposition rights to the enterprise managers has taken place but without the appropriate delegation of financial responsibility for their assets.

Theoretically, several solutions could have been found to the **property dilemma**. One of the prevailing concepts would realize the property reform in two basic steps.

Initially, they would, in a way, "re-centralize" the property rights. In other words, the suggestion of the advocates of this concept is that one should take seriously that state property and the disposition rights should be recentralized. In the second step it would be possible to transform these enterprises into shareholder companies (Matolcsy, 1989, Bársony, 1988). The main difficulty of this idea is that it is not clear whether demand for the shares of ex-state companies would be sufficient if transformation were relatively rapid and concentrated.

The official approach puts more rights in the hands of the managers. A so-called transformation bill is being prepared which is aimed at supporting the acceleration of the transformation of the state firms into shareholder companies. The bill does not envisage forcible solutions in the case of the firms run by enterprise councils or by the general assembly of the employees. It would create, however, strong financial incentives. In the case of state enterprises without workers' representation, transformation would be organized by the state organs. At the firms with enterprise councils, transformation should contain selling at least 20 per cent of the shares to external shareholders. However, after 3 years of working in shareholders' form the non-marketed shares would go to the assets' operating organ of the state. The above-mentioned organ (sometimes called State Assets' Fund, SAF) would be established in order to

operate the state's shares. It is not clear, however, why and how would SAF be interested in maximising the value of the assets.

Many participants of the recent property debate argued the necessity of establishing competing state holdings which could operate on the stock market; similarly, they conferred about legislation which would encourage institutional investors (mainly insurance companies, pension funds, universities, local councils and foundations) to operate in this market (Heti Világgazdaság 25.03.1989). As to the former, similar problems to those of the SAF may occur: the advocates cannot prove the guarantees for market-like behaviour in their case either. Undoubtedly there are significant reserves in utilizing the resources of the institutional investors.

The troubles of the latter case are similar to reprivatization through sales of enterprises to the public. In both cases, effective demand is doubtful. In Hungary many people are afraid of a cheap sale of state assets. This problem is very complicated, however, since with a lack of capital market we have no information about the real value of a firm's assets. One can try to find this out from the volume of profits but market distortions and a huge budget distribution distort the picture.

A similar controversy arose when the Hungarian Credit Bank recently sold 49.6 per cent of the shares of TUNGSRAM, the best-known Hungarian manufacturing firm to foreign investors (Magyar Nemzet 10.05.1989, Heti Világgazdaság 20.05.1989). According to the value of the firm shown by its balance sheets, the deal was very unfavourable. However, as compared with its realized profits in the last years, the sale was extremely profitable, although the appendixes to the deal imposed unusually severe conditions as guarantees on the Hungarian partners.

In the case of branches, where the "natural" size of the economic activity would be small (such as restaurants, shops, and some other services) and big companies run them only because of earlier bureaucratic actions, centralized sale to public entrepreneurs would be feasible. The first attempt of the Hungarian government has mainly failed due to the resistance of the attached huge organizations which have a strong representation in the recent legislation as well. It is not very likely, however, that bureaucratic resistance can prevail for very long in this field.

Another controversial attempt of the government in 1989 was an attempt to sell ailing enterprises to foreign investors. Here as well, lack of strict determination of property rights caused the vehement reaction of the firm managers (Figyelő 16.02.1989). In spite of the initial

difficulties, it seems likely that Hungary is now entering the phase of property reform in its long march towards the market economy. The Economic Reform Commission of the government as well as the Prime Minister in his latest speech on the occasion of personnel changes in the government have expressed the political will to carry out privatization (Figyelő 04.05.1989 and Magyar Hírlap 11.05.1989). The new political organizations are also advocating the property reform. (See for example Szabad Demokraták; March, 1989.)

Similar problems occur with the land property reform: lack of satisfactory estimation of the lands' value (simple marketization would endanger with unjust advantages the cooperatives' bureaucracy through corruption) as well as earlier investments adjusting to the huge sizes of the estates may hamper the reform. On the other hand, enormous subsidies to cooperative agricultural production call for effective solutions. Land reform is also a field of political struggle: particularly those new organizations which having strong provincial basis are very radical in their agricultural programme. The vested interests of the still powerful cooperative bureaucracies conflict heavily with ambitious reform programmes.

The future of other elements of the market reform (especially regulatory principles of the wage system and

import regime) depends considerably on the solutions of the property transformation. However, the price system project of the above-mentioned reform commission is very unsatisfactory: they argue that price liberalization has already been fulfilled and only small corrections are ahead. In fact, semi-liberalized prices might cause major market disturbances.

To sum up, in spite of all the shortcomings and potential dangers, Hungary is now entering an extremely important, interesting and pioneering phase in its reform history. It will also provide valuable experience for other Socialist countries, less advanced in their reforms.

3. **Opening and reorientation - towards a new model of international economic relations**

In addition to the economic system, the pattern of international integration has been the other fundamental source of the recent crisis in the Hungarian economy and society. The two factors are deeply interconnecting. The pattern of the CMEA economic relations has a system determining influence while the centralistic economy mechanisms do not allow for an equal participation in international cooperation (Koves, 1989).

The Stalinist economic system and integration model developed simultaneously at the beginning of the Socialist economic history of Hungary. Notwithstanding its inherent shortcomings, this integration model had some dynamism in the 1960's and 1970's. The dominant pattern of trade relations for Hungary was an exchange of Soviet energy and raw material deliveries for Hungarian manufactured goods. This trade model has also established institutional vested interests since the managers of major enterprises and government officials, having participated in the negotiations, have been the main beneficiaries.

Nevertheless, from the late 1970's the Socialist trade pattern led to a growing crisis, simultaneously and interconnecting with the mounting internal systemic

troubles. Growing production costs and world market prices of Soviet raw materials aggravated the conditions of trade and the extensive and ineffective growth of the Hungarian (and other East European) manufacturing industries could no longer be fed by increased Soviet deliveries.

Participation in remote and costly Soviet investments in the oil, natural gas and crude iron mining industries as well as in paper and cellulose manufacturing has also diverted investment resources from the domestic market during a period of decreasing development resources. Conversion of imports for scarce hard currencies, necessary to accomplish Soviet exports and common investments, into ruble revenues has been highly detrimental and has contributed substantially to Hungary's debt crisis.

Yet, comprehensive recognition of this situation has ripened very slowly in Hungary. For a long time the political attitude prevailed which regarded imports for transferable roubles at any cost more favourable than opening to the world markets for supply of the above-mentioned commodities. This kind of economic policy has, naturally, prevented major structural changes in industry since it has stiffened the commodity structure of Soviet exports at times when it has become increasingly difficult to obtain appropriate value and commodity range in exchange. Since, as we have pointed out, the economic system and

integration pattern are strongly interconnected, a full-fledged reorientation towards the world market would naturally have been unrealistic in the first half of the 1980's.

The acceleration policy in 1985-1986 strengthened the large organizations with strong Soviet exports as well. However, due to worsening external balances with the developed market economies, an export offensive in that direction seemed already in 1987 again inevitable. Memories of the consolidation pattern in the early 1980's also pushed the leadership towards an export-expansion; the consolidation through import cuts seemed unrepeatable because of its destructive influence on the domestic economy and on the longer-term competitiveness of the Hungarian industry.

The economic policy tried to shift Hungarian exports towards the world markets (hard currency areas) in 1988. For this purpose the exchange rate policy evaluated the dollar but devalued the rouble to the domestic currency and tightened the subsidies on Socialist exports. Due to a lack of lasting institutional solutions, however, one cannot hope to maintain this course because of the growing tensions at the enterprise level. Massive liquidity crises are partly due to financial conditions in Socialist exports. In this case it is very difficult to exercise a tight monetary

policy as extreme distortions in Socialist trade always provide an excuse for enterprises. In fact, at the beginning of 1989 the government devalued the domestic currency to the rouble in order to ease the financial crisis of the firms. Central authorities informed the enterprises about the devaluation already in the autumn of 1988 with the purpose of avoiding a major conflict between themselves and the large, politically strong enterprises (Antalóczy, 1989.) For this dilemma as well, a harder application of the bankruptcy procedures could contribute to a reduction of Socialist exports.⁶

Theoretically, the reform of the CMEA trade mechanism could ease the situation. However, as we stated in our earlier analysis (Rosati, Mizsei, 1988) the perspectives of a significant reform in the integration are bleak.

Marketization of trade among the Socialist countries depends on their internal reforms. As we envisaged in the same study, the reform of the dominant economic partner, the Soviet Union, will meet with great difficulties. In fact, no real reform initiative has been introduced in the Soviet economy which would seriously influence the micro processes. In the meantime, the equilibrium situation of the Soviet

⁶ In the given mechanism of Socialist trade, export surplus is very unfavourable as it can be offset only by deliveries of soft goods. In the recent period even this has become increasingly difficult.

Union has markedly changed for the worse. This will further impede the implementation of meaningful modifications of the economic system.

However, the course of political reform in the Soviet Union has drawn the two countries nearer in political terms. Such a contradictory situation has emerged that closer political cooperation would be a favourable background for reforms in the economic field while no reform in the Soviet domestic economy and very sluggish reform plus heavy equilibrium problems in Hungary have not provided a favourable ground from the economic point of view. In 1988 a decrease in the mutual exchange became necessary. In earlier periods great political emphasis was put on the necessity of uninterrupted quantitative growth of mutual trade. In 1988, however, a large surplus on the Hungarian side would have further endangered Hungary's position on the convertible markets. So, for the first time in 40 years, the Hungarian political leadership officially supported the temporary curtailment of Hungarian exports to the Soviet Union.

The efforts of reform-searching have concentrated on the Soviet relation as well. A few different reform formulas have been discussed in the reform commission on opening towards the world market. The participants of the debate have agreed on the necessity of reaching a hard currency trade in the future (Figyelő 16.02.1989). They differed very

much, however, in the way of how it could be achieved. In the spring of 1989 it appeared that the seemingly most radical solution, the immediate transformation of mutual accountings on the dollar basis would have the upper hand. The Soviet Union could agree to such a solution, especially as in the current commodity structure it would have immediate gains for business. The Hungarian advocates of the idea argue that the hard currency basis would initiate a rapid adjustment of the trade structure, the mutual exchange of low value soft goods would disappear and it would also help clarify what is efficient export and import and what is not (Figyeló 27.05.1989). Another favorite argument for this solution is that it would appeal to Hungary's potential foreign investors since dollar-trade could eliminate contingency constraints in the CMEA trade.

The opponents of such radical changes point out that the Hungarian economy could not bear the immediate financial losses (estimated at about 1.5 billion dollars in the first years, Figyeló 22.06.1989) that this change would bring about. At the same time, neither country's domestic economic mechanisms are prepared for a dollar trade. Therefore, the most likely outcome would be a return to the old contingent system instead of supporting gradual reforms (Figyeló 20.05.1989). Therefore, being aware of the dangers of a gradualist approach, one can argue for more radical solutions in the domestic field and only on the grounds of

this (though simultaneously in time) can one hope for efficient modifications of the mutual trade mechanism.

A gradualist approach would contain a separation of the so-called 'strategic' items (approximately 50 per cent of the recent trade volume) where centralized decision-making would prevail, and of the rest. In this second part of the Soviet trade, national currencies could be used. The Hungarian state would not guarantee the exchange of the rouble at the official (highly artificial) rate. It would be the responsibility and risk of the enterprises to find appropriate imports or other domestic firms willing to spend those revenues in Soviet currency, for Soviet commodities. Currency transactions ought to take place with the technical assistance of the commercial banks, without central interference in the market rate. This way the exchange rate would mirror existing demand for and supply of the Soviet rouble (or in the case of trade with other Socialist countries, of their currency).

In this half of the mutual trade other solutions, such as dollar or dollar-based barter, are also being discussed. In terms of the organizational field, an establishment of a special, 'buffer' trade organization is being considered. It would behave towards the Soviet partners in a more traditional way, but on the domestic market it would operate in a normal, business-like way.

The situation might be slightly different in reforming the trade relations with Poland, the only other reform economy besides Hungary in Eastern Europe. In this country the autonomy of the enterprises has already reached a higher level than elsewhere. Still, a gradualist approach seems to be necessary here as well, perhaps on the basis of step-by-step extension of decentralized trade in national currencies. The biggest problem of this option might be the weakness of the monetary systems of the two countries (especially of Poland with strongly negative real interest rates and hyperinflation) and still prevailing restrictions in the domestic and foreign trade sector. The solutions of mutual trade in national currencies, which need to be supported by an institutional innovation giving the enterprises a chance to trade with the other country's currency since official exchange rates do not reflect supply and demand relations.

While a reduction of Hungary's trade volume with the Socialist countries seems to be unavoidable if one would like to diminish barter trade in soft manufactured goods, slow change in Hungary's economic system hampers the country's more rapid integration in the world markets. This negative effect can be moderately neutralized by active economic diplomacy. Hungary achieved a relatively favourable trade agreement with the European Economic Community in

1988. However, the situation is rapidly changing, and the EEC's agreement with Poland is more advanced in some respect than its counterpart with Hungary (Világgazdaság 11.07.1989.)

The real significance of the Hungarian trade agreement with the EEC in terms of the Hungarian export quota is almost negligible, at least for the period until the year 1985 (Figyelő 29.06.1989.) Predominantly because of the rapid political democratization in the country, some West European governments have expressed their willingness to renegotiate the Hungarian agreement for a more liberal quota. The Polish agreement envisages deeper financial cooperation. It could also be a pattern for Hungary to follow (Világgazdaság 11.07-1989.)

A debate is going on in the country about the feasibility of Hungary's future membership in EFTA. The answer depends on the future of EFTA as well as on the depth of the Hungarian economic reforms, including the foreign trade pattern. Political factors are also a consideration: the reception of such a step by the Soviet Union as well as by the EEC. Recent changes in foreign policy (diplomatic relations with the Republic of Korea, forthcoming diplomatic relations with Israel) are also intended to facilitate deeper international economic integration.

In summation, Hungary's foreign economic policy has undergone very significant changes in the last two years. Its efficiency will, however, depend on the strength of the economic reform, meaning reprivatization, a business-friendly deregulated central administration, and an appropriate handling of politically strong large economic organizations.

Hungary has arrived at a debt spiral in which traditional methods of debt servicing in themselves are not sufficient.

By 1991-1992, as debt service obligations peak, a partly non-traditional solution should be found. It might contain a combination of traditional means (increasing exports, new credits) more aggressive export incentives, more direct foreign capital investment, debt-equity schemes and hopefully some voluntary relief from the creditor countries as an expression of international interest in the success of the Hungarian experiment.

The corporate law in 1988 further liberalized the rules for direct foreign investment. 1988 already witnessed an acceleration of growth in the number of partly or entirely foreign-owned firms as well as in the sum of foreign investment. In the first four months of 1989, this trend accelerated. The invested capital is, however, in most cases

relatively small and is usually directed to different kinds of services rather than manufacturing industries.

There are as well some more ambitious ventures. The selling of 49.6 per cent of TUNGSRAM or part of the ailing GANZ MAVAG, 50 per cent shares to the ex-owner in the once nationalized UNICUM (Zwack) liquor company are the most encouraging recent example of foreign direct investment in the industry. There are signs that the direct engagement of foreign banks on the Hungarian money market might become significant in the foreseeable future as well.

4. Factors and constraints of economic development until 2000

Long-term projections for the Hungarian economy must have a quantification of the external balances constraint for departure. This constraint has reached a point where it is the most important variable of any verbal or formalised forecasting model for Hungary. Interest payments amount to 5% of GDP, to 19% of convertible currency exports, and the debt service ratio is higher than 50% of these exports. The Hungarian economy has to be able to produce a USD 1.2-1.4 billion current account surplus on an annual average in the Nineties. This fact has a strong dependence on international monetary trends for the consequences. Every fall of 1 percentage point in the international level of interest rates would have a 0.2% of GDP volume growth and a 1.0 increase in domestic use as a result. If the growth of Hungarian indebtedness can be stopped until the end of 1990, the yearly burden of interest and principal payments would not go higher than USD 1.5 billion during the Nineties.

The fulfilment of this constraint depends on the external side mainly on the semi-exogenous factor of the terms of trade. According to computations by the Long-Term Planning Department of the Department of the National Planning Office a 1% improvement in terms of trade in non-

rouble exports and imports makes a 0.5% growth of GDP and a 0.8% increase of domestic use possible **ceteris paribus**.

A key factor for the long-term scenario is also the import elasticity of GDP growth. The results of such calculations are somewhat controversial even if they don't differ much from each other. It can be shown that a 1% decrease of the share of imports in domestic output increases GDP and domestic use by about 0.6%. It deserves to be mentioned, however, that Hungary's increasing integration into the world economy makes such considerations somewhat pointless. The import/gross output ratio can significantly be diminished only if export push effort prove unsuccessful and current account targets can be met only by cutting imports thereby running the risk of growing structural and technical backwardness with a further worsening current account and debt reimbursement perspective.

Hungarian grounds for action in international economic relations is strongly influenced by trade with Socialist countries. Present information does not allow the forecasting of any significant change in this field even if news of a possible switch to a convertible currency payments system are quite widespread. The most probable path is one close to stagnation in the volume of this trade with exports and imports nearly balanced. But even this cautious projection is subject to brusque turns or changes.

Domestic constraints of the long-term growth process are mainly linked to the supply of resources. The diminishing yield of capital is a key element of our scenario partly due to a limited supply of capital and thus a growing obsolescence of capital stock, partly for structural reasons. Growth will mainly go in an "infrastructure-oriented" direction with increasing physical capital intensity on a national economic level. The physical capital stock/gross output ratio amounted to 1.8 in 1988 and it will predictably show a slow but permanent increase reaching 2.0-2.1 in the year 2000.

It is a **conditio sine qua non** for the country to stay on the above outlined growth path to generate a savings surplus equivalent at least to interest payments each year. This could be reached either by a relatively high savings propensity of the population and the enterprise sphere or - and this is a rather unlikely option - a continuous surplus in the state budget. Both options make active real interest rates policies, conscious and well-prepared reprivatization as well as radical subventions cuts an utmost necessity.

The forecasting framework till 2000 must be based on a distinction between a "recovery" and a "dynamization" period. The first one should last approximately until 1995 with the primordial task of stopping debt growth. GDP growth

can therefore reach only 2-2.5% even in the optimal case with the lag between developed industrial countries (for which an average of 3-3.5% is forecast by most experts) widening further. Domestic use will increase more slowly by about 0.4-0.5 percentage points. Even these modest rates of growth could probably be reached only from 1992-1993 as the initial steps of import liberalization and export push would require very cautious and eventually rigorous demand management in 1990-1991. A slow acceleration of growth from 1992 could take place only based on one component of aggregate demand which could be nothing else than investment in order to speed up structural change in production. The profitability patterns described in Chapter 1 make an additional loss of aggregate income due to these structural changes highly probable. These losses could then be financed only at the expense of consumption.

The 1995-2000 period would make a GDP growth approach a yearly growth of net convertible currency exports of at least 4% necessary with a not worsening services balances position. Higher export growth would generate faster GDP growth only if its rate surpasses 6% as GDP/export elasticity ratios usually diminish somewhat in the Hungarian economy when exports suddenly soar. This phenomenon is linked to decreasing profitability of as well as to

increasing financial preference for exports. The existence of the latter cannot be excluded even in a "reformed" but still strongly export-dependent Hungarian economy.

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