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# The Transition to a Market Economy in Hungary

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IN HUNGARY, AS IN POLAND, the collapse of socialism was gradual and was caused by internal factors. Of course, without changes in the Soviet Union, particularly the abandonment of the Brezhnev doctrine, neither the Hungarian nor the Polish opposition could have brought down the system.

In Hungary the new, non-communist government committed itself to transforming the country's economy into a market economy based on private ownership. The question was: how to do it and at what pace? In substance all Central and East European countries adopted the same strategy, at the centre of which was a restrictive monetary policy. This strategy was applied in two versions: one gradual and the other the so-called shock treatment. (When economists talk about the two strategies mentioned, privatisation is usually not considered. This is the case here too.) Hungary opted for a gradual transformation. There, most economists took the position that Hungary did not need such extreme methods since the economic reforms had brought about quite an advance in the effort to change the economy into a market economy.[1] In addition, the Hungarians, in the course of the years, have got used to solving their problems gradually. A good example is a comparison of how Hungary and Poland tried to solve the problem of price distortions in the past. Unlike Poland, which resorted to a one-shot strategy—huge price increases—which turned out to be counterproductive, Hungary tried to change price relativities gradually.

The Hungarian programme of transformation, which was formerly called the Kupa programme (1991) after the former minister of finance, followed more or less the same objectives as the Polish and the former Czechoslovak (henceforth Czechoslovak or Czechoslovakia means the former combined country) programmes, but was supposed to be based on the idea of gradualism. When it was approved in 1991 it promised a turnaround in the declining economy in 1993, the reduction of inflation to a single-digit number in 1994 and the completion of trade liberalisation in 1992. The completion of the convertibility of the forint, which was to conclude the transformation process, was promised for 1994. No mention was made of prices, since they had been more or less freed in the meantime. Finally, the programme promised to complete the legal infrastructure soon.

The transformation package produced positive results at a very high social cost. In the five years since the collapse of the socialist system Hungary has made enormous

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progress in turning its economy into a market economy based on private ownership. However, despite its choice of a gradual transformation, it did not manage to avoid a deep recession, but with less drastic consequences for the standard of living than Poland or Czechoslovakia (see Table 1).

In this article I discuss first the macroeconomic and liberalisation measures which Hungary took. As is shown, these measures were in some respects different from those undertaken by Poland and Czechoslovakia, mainly because of the Hungarian option for gradualism. I then try to identify the factors which contributed to the recession in Hungary. Finally, I briefly discuss the new economic strategy of the new socialist-liberal government. To make the Hungarian transition to a market economy more understandable it is mostly compared with the Polish and Czechoslovak (or Czech) transitions.[2]

## *Monetary and fiscal policy*

In Hungary, as in Poland and Czechoslovakia, monetary and fiscal policies were at the centre of the transformation provisions. However, the government did not impose such a restrictive monetary policy as Poland and Czechoslovakia did. The money supply grew faster than the nominal GDP; in other words, in contrast to the situation in Poland and Czechoslovakia,[3] the real stock of money in Hungary increased in 1990 and 1991. In 1991 the money supply increased by 26–28%, whereas GDP in current prices went up by only 13–17% (*Reports*..., 1992, p.15.) As a result, the possibilities of borrowing by business were not as tight as in the other two countries (the term 'other two countries' or a similar term always refers to Poland and Czechoslovakia). In 1989 borrowing grew faster than the nominal GDP and in 1990 and 1991 proportionally (Valentinyi, 1992).

In 1989 interest rates were below the level of inflation. In 1990 they started to rise and reached their peak at the beginning of 1992. The real interest rate had become positive before this date and it remained so. In 1993–94 it was quite high and borrowing of capital became too expensive (*Figyelö*, 1992, 26, p. 7 and 1994, 45).

In Hungary under the old regime taxes on enterprises were quite high. In 1988 taxes were increased, but not on enterprises. In connection with the introduction of value added tax and income tax, the government shifted the burden of taxation to the population not only in relative but also in absolute terms. Taxes on the population, which made up 26.6% of state revenue in 1987, increased to 39.3% in 1992 (*Magyar Statisztikai Zsebkönyv*, 1989, p. 206 and 1993, p. 178 and Muraközy, 1992). In the first years of transformation (1990–92) it was not so much the monetary policy as the fiscal policy and other factors which caused the recession in Hungary. Later the monetary policy became a factor of great significance in the recession.

One of the objectives of fiscal policy was to bring about a balanced budget and thus contribute to the fight against inflation. This was to be achieved on the one hand by considerably reducing subsidies and government investment and on the other hand by increasing taxes.

Despite the measures mentioned, Hungary increasingly suffered from a budget deficit, in the past two years even more than Poland, let alone the Czech republic, which managed to balance its state budget. There are several reasons why Hungary

TABLE 1

MAJOR INDICATORS OF ECONOMIC PERFORMANCE

| | Hungary | | | | Poland | | | | Czechoslovakia | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *1990* | *1991* | *1992* | *1993* | *1990* | *1991* | *1992* | *1993* | *1990* | *1991* | *1992* | *1993* |
| GDP[a] | 96.5 | 88.1 | 95.7 | 97.7 | 88.4 | 92.4 | 101.5 | 103.8 | 98.4 | 85.1 | 91.3 | 99.7 |
| Industrial output[a] | 90.7 | 81.7 | 90.3 | 104.0 | 75.8 | 88.1 | 103.9 | 105.6 | 96.0 | 75.0 | 86.1 | 94.4 |
| Gross agr. output[a] | 95.3 | 93.8 | 80.0 | 93.1 | 97.8 | 98.4 | 87.2 | 102.2 | 96.0 | 91.7 | 87.5 | 97.5 |
| Investment[a] | 89.8 | 92.0 | 101.8 | 101.5 | 89.9 | 95.8 | 100.1 | 101.8 | 106.1 | 72.7 | 109.1 | 108.0 |
| Budget situation[b] | −0.0 | −2.1 | −6.8 | −5.7 | 0.4 | −3.8 | −6.0 | −2.8 | 0.0 | −1.7 | −1.6 | 0.0 |
| Balance of trade[c] | 101.2 | 89.3 | 96.0 | 70.5 | 150.3 | 96.0 | 82.7 | 75.1 | 91.5 | 103.2 | 88.7 | 100.6 |
| Rate of inflation[a] | 128.9 | 135.0 | 123.0 | 122.5 | 685.8 | 170.3 | 143.0 | 135.3 | 110.0 | 157.9 | 110.8 | 120.8 |
| Rate of unemployment[d] | 1.7 | 8.5 | 12.3 | 12.1 | 6.3 | 11.8 | 13.6 | 16.4 | 1.0 | 6.6 | 5.1 | 3.5 |
| Real wages[a] | 96.3 | 93.0 | 98.6 | 96.2 | 75.6 | 99.7 | 96.4 | 98.7 | 94.6 | 77.2 | 107.4 | 103.7 |

*Notes:*
[a]Previous year = 100.
[b]Deficit expressed as a % of GDP.
[c]Exports as % of imports; in Hungary and Czechoslovakia both are computed in domestic currency and in Poland in dollars.
[d]End of the year. In Hungary at the beginning of the next year.
*Sources:* Hungary: *Magyar Statisztikai Zsebkönyv*, 1993, *Bulletin* 1992, 4 and *Bulletin* 1994, 1. The two *Bulletins* are compiled by the Polish, Czech, Slovak and Hungarian Statistical Office and published in Budapest. Poland: *Zycie Gospodarcze* 1995, 5, p. 9 and *Maly Rocznik Statystyczny*, 1994, for investment and balance of trade. Czechoslovakia: *Statistical Yearbook of the Czech Republic* for 1993 and 1994; Hajek *et al.* (1993) and *Bulletin* 1994, 1. Czechoslovak figures for 1993 refer only to the Czech Republic.

has had difficulty balancing the state budget, the most important being the recession. Declining demand and production had substantially reduced the profits of enterprises and, as a result, government revenue from enterprises declined even in nominal terms. In 1990 the government collected 573.3 billion forints from enterprises; two years later, despite inflation, the revenue from enterprises declined to 498.7 billion. If one considers that in 1990 social security contributions made up 200.7 billion of the sum mentioned and in 1992 223.9 billion, the picture is even more depressing (*Magyar Statisztikai Zsebkönyv*, 1993, p. 178).[4] This development is also due to the fact that the private sector contributes little to the state budget, definitely less than its fair share should be.

Increasing unemployment, which entails growing amounts paid out for unemployment compensation benefits, was and is a significant drain on state expenditure, and the growing number of pensioners has a similar effect. Finally, the servicing of foreign and domestic debt has been the most important factor in the budget deficit.

### *Wage policy*

In Hungary the old quest continued for a wage regulation which would on the one hand prevent wages from becoming an inflationary factor and, on the other, give enterprises enough room for making wage decisions which would promote economic efficiency. In 1988 the socialist government had decided to transfer the decision making about wage regulation to representatives of government, the trade unions and representatives of employers, who were to work under the umbrella of the Interest Reconciliation Council. The new system was also characterised by limits on wage growth and the payment of taxes when the limits were exceeded. However, the limits were less restrictive and the penalty taxes were much more moderate than in Poland and Czechoslovakia. For 1989 the limit was set in terms of value added; only enterprises which increased wages by a higher percentage than the percentage increase in value added had to pay a wage growth tax (Herczog, 1989). Later the limit was linked to the wage bill, since the previous system had led to great interenterprise differentiation in wage growth, and in 1992 to average wages (Popper, 1991; *Munkaügyi Szemle*, 1992, 2, pp. 1–2). Commencing with 1993, there was no more wage control by tax penalties. Hungary felt that it could afford such relaxation since the trade unions were split and not very strong, and unemployment had been quite high.

### *Foreign trade*

In Poland and Czechoslovakia the transformation package was also intended to open the economy to the influence of the world economy by liberalising foreign trade and introducing internal convertibility of the national currencies. Poland went the furthest in its liberalisation; it removed almost all import restrictions and reduced customs tariffs. This policy damaged the economy and was soon corrected by increases in tariffs. Czechoslovakia was more careful in its liberalisation (Tóth, 1992).

Hungary started to liberalise its imports earlier than the other two countries, as early as January 1989 (with engineering products), a process which was to be finished in 1992, by which time tariffs were to be cut (Gács, 1991; Köves, 1992, p. 51). It seems that the process of liberalisation was completed.

Hungary followed a different policy on currency convertibility from Poland and Czechoslovakia. Because these two countries introduced internal currency convertibility and wanted to use the exchange rate as an instrument for expanding exports and curbing imports, they carried out a huge devaluation of their currencies, which contributed to the generation of inflation and, in the final analysis, to the recession. Hungary decided to achieve currency convertibility gradually. Because of its approach to convertibility, Hungary could afford to adjust the exchange rate slowly and moderately to the needs of the economy. The gradual adjustment of the exchange rate has prevented inflation from being fuelled from this source and perhaps has made the flight of capital more difficult (than from the other two countries, mainly Poland) at a time when the domestic economy needs it urgently. As will be shown later, the Hungarians were not able to use this advantage properly.

## *Reasons for the recession*

The transformation strategy adopted, mainly the restrictive monetary, fiscal and income policies, the liberalisation of prices and the massive elimination of state subsidies, necessarily led to a recession in Poland and Czechoslovakia. All these measures directly and indirectly restricted domestic demand for consumer goods and investment, and these in turn brought down output. The decline in output and resulting unemployment contributed to an even greater restriction on consumption and so on.

Since Hungary applied the transformation strategy gradually and in a more moderate form, and real wages declined less than in the other two countries, the restriction of demand in 1990–92 was milder than in Poland and Czechoslovakia.

There were also other factors which contributed to the recession. I first discuss the ones which have been common to all the three countries and then those which have been unique to Hungary.

### *General reasons*

Perhaps the most important factor was the collapse of trade with the former members of CMEA, primarily the USSR, in 1991. Simultaneously with the collapse of trade, Hungary and its neighbours lost access to cheap energy and raw materials, which was a great blow to their competitiveness. It seems that Hungary suffered more than the other two countries. The huge decline in industrial production in Hungary in 1991 and 1992 certainly was connected to a great extent with the collapse of trade with the USSR. Some economists, mainly the adherents of shock treatment, attach greater importance to this factor than it deserves. After all, it should not be forgotten that all three countries managed to offset to different degrees the loss of trade with the former CMEA countries by increasing trade with OECD countries.

The policy pursued *vis-à-vis* state enterprises, which Kołodko (1992) characterises as mismanagement of the state sector, no doubt played a very important role. It was correct for post-socialist countries to relinquish the policy of micromanagement of enterprises. But it was incorrect for this new policy to be combined with a large dose of indifference to what was going on in enterprises. The failure to devote proper care to enterprises, by, among other things, not introducing an effective system of management evaluation, by underestimating the need of quick demonopolisation, by introducing uncertainties with regard to the future of enterprises—whether or not they would be privatised and how—all these policies contributed to a decline in production. The uncertainty about privatisation had a negative effect on investment, and in some cases even led to disinvestment. On top of this the first non-communist government in Hungary, soon after taking power, ordered a reelection of managers of enterprises. It was expected that this action would bring about a purge of communist managers. This objective was not achieved (only a few managers were not reelected), but the uncertainties introduced by this action were damaging to the economy.

In Hungary as well as in Poland and Czechoslovakia under the old regime enterprises were indebted; but the indebtedness ballooned in the transitional period. There were several reasons for this phenomenon. Expecting price increases, many enterprises increased their inventories before the application of the transformation provisions without taking into proper consideration the impact of these provisions, including inflation, on demand. The decline in sales and consequent stockpiling in many enterprises in all three countries in order to avoid dismissing workers was another reason for the increase in indebtedness and insolvency. The huge debts of enterprises, most of which were in the portfolios of commercial banks, have been one of the main reasons why lending rates have been very high compared to deposit rates. Needless to say, this has made borrowing more expensive. Considering this and the fact that debt-ridden enterprises have difficult access to credit, it is not very exaggerated to talk about almost a credit crunch, more in one country and less in another, with all the consequences for the economy. Enterprise indebtedness has been a major headache for Hungary as well as for the other two countries since it endangers the solvency of banks (Bruno, 1992; Ehrlich & Révész, 1992, pp. 110–114; Groszek & Rak, 1992; Kouba, 1992). Recently the Hungarian government started to address this problem by a controversial action to recapitalise banks (see Mink, 1994).

The architects of the reforms based their strategy on the idea that the governments should undertake certain transformation measures, carry out privatisation and adopt proper legislation for a market economy and leave the rest to market forces. It was assumed that these provisions would set in motion forces which would generate economic growth. This approach was especially characteristic of Poland and also of Czechoslovakia, countries where neoliberals occupied the economic portfolios. This policy was supported by the IMF, which felt that interference might only hurt the economy.[5] The IMF also discouraged the application of an industrial policy, although there are many historical examples which show that the opposite was needed, mainly in the transitional period.[6]

Recently some economists who believed in the omnipotence of the market have changed their mind. Kornai, who belongs to this group, writes (1994) that the reason for '… this change is a recognition that simply to await a spontaneous, self-engendered movement in the present political and economic situation in Hungary could yield what is known in economics as a low level equilibrium trap'.

When designing the transformation strategy little attention was given to the old value system and how it might influence the behaviour of managers and workers in the transformation process. Most workers and managers hated the old system and wanted its demise, but nevertheless identified themselves with some of its values, mainly those connected with social programmes, full employment and more equal distribution of income. The decline in the standard of living and the threat of unemployment, which for many had already turned into reality, made the needed adjustment to the market economy and the internalisation of market culture difficult, and as result had a negative effect on the performance of the economy.

Certainly one of the reasons for the recession was what Kornai (1994) calls disruptions in coordination. In some countries, and this is less true of Hungary than of any of the others, the transformation started in an environment where market infrastructure and market institutions did not exist. Even in Hungary, the market institutions the build-up of which had already started under the old system (such as the establishment of commercial banks and the stock market, and the passing of some legislation relevant to the working of the market) cannot be regarded as complete. It takes time, experience and knowledge for the intricate linkages between individual institutions to be established, and a coherent and effective coordinating mechanism which sets in motion forces which speedily translate changes in macroeconomic policies into action in the market to be developed. Although the authorities use the same terminology and statistical data as in the West, behind the policies and actions different processes are often occurring. This is also because they do not yet have the proper tools to measure the targets set, *inter alia*, in monetary policy. In brief, the old planning system was eliminated, but market relations have not yet been fully established, and as a result macroeconomic policy cannot have the effect it has in developed market economies.[7]

A further factor in the recession was the policy of rapid large privatisation and neglect of privatisation from below. Among the architects of transformation the view was quite widespread and backed up by international financial institutions that fast privatisation might help to overcome the economic recession. No doubt, mixed ownership is beneficial for the economy, but the way to it (privatisation), at least for some time, contributes to recession by generating unemployment and curbing demand[8] (see Kornai, 1994; and Köves, 1994).

Last but not least, the huge indebtedness to the West, and this refers primarily to Hungary and Poland, has had a negative effect on the balance of payments and the state budget. It has also hampered imports of modern technology. Unlike Poland, which has managed to get debt relief, Hungary, though its debt per capita is the highest, has not been so lucky.

The Central and East European countries counted on Western financial help when they designed their programmes of transition to a market economy. The expectations of Western help, which were based on the promises of Western leaders, have been realised in reality to only a small degree. Nor did the West generously open its borders to the exports of post-socialist countries. Certainly an important reason for the Western attitude was the recession in the West. 'What the West'—writes Köves (1994)—'has effectively chosen is insistence on the maintenance of almost exclusively business-type financial relations with the former socialist countries and a marginal role for the "assistance" in the field of finance'.

*Particular reasons*

Now I will discuss reasons for the recession which are unique to Hungary, examining first the economic and then the political reasons.

*Economic reasons.* There have been three[9] principal economic policy measures which have negatively affected the performance of the Hungarian economy compared to the other countries and thus weakened the effect of the gradualist strategy. I have in mind the treatment of agriculture, the introduction of a strict bankruptcy law and the slow adjustment of the exchange rate to the needs of exports.

Hungarian agriculture was a success story. In 1989 agricultural output was almost twice as high as in 1938. Hungary made more progress in equipping agriculture with modern technology than other socialist countries. A considerable portion of output was exported, and the domestic market was well supplied. Average incomes of farmers were not much behind those of industrial workers. The transformation provisions have plunged agriculture into a deep crisis, from which it is slowly starting to recover. Gross output in 1993 was almost 42% lower than in 1989, a greater decrease than in the other countries. Besides the badly thought-out economic policy, the main reasons for this decline were drought and a fall in domestic consumption. Though many have left agriculture, unemployment in agriculture is high. Incomes of the agricultural sector have been the most affected; they are now no more than approximately three-quarters of those in the 'material sphere' (Mészáros, 1993).

By badly thought-out policy I mean primarily the compensation policy for the land taken for collective farms, privatisation and other agricultural policy.

Unlike Czechoslovakia, Hungary did not adopt a policy of restitution in kind (in Poland a restitution law has not yet been adopted); instead, compensation for property lost during the communist regime has been given in the form of vouchers. In agriculture, owing to the pressure of one of the coalition partners, the Peasant Party, compensation has in fact been given in kind. The Peasant Party hoped that with such a provision it would be possible to destroy the collective farms and create family farms on their ruins (see Köves 1994; Petschnig, 1994, p. 91). As a result of this policy a large proportion of the land has gone into private hands, but only a small percentage of the new owners are interested in cultivating the land.

The two policies have brought about extreme fragmentation of the land, created impediments to large-scale production and introduced a feeling of uncertainty into the reorganised collective farms which has manifested itself in a huge decline in arable land, a dramatic decline in the animal population (cattle numbers decreased by almost 50%) and lower economic efficiency. On top of this, and here I am already discussing the third factor, the government has dramatically reduced subsidies at a time when agricultural prices are depressed (Keserű, 1993; Mészáros, 1993; Ehrlich, Révész & Tamási, 1994, pp. 62–64; and Varga, 1994).

Poland had a minuscule cooperative sector in agriculture, and therefore privatisation was not a problem there. In the final analysis Czechoslovakia took a similar route to Hungary's with regard to privatisation. However, it seems that it was more generous with subsidies for agriculture (Divila & Sokol, 1993; Silař, 1993). Yet what makes the decisive difference between the situation in agriculture in the two countries is that agriculture plays a much greater role in the Hungarian economy and exports than in Czechoslovakia.

In 1992 a new bankruptcy law came into effect in Hungary. Briefly. the law consists of reorganisation and liquidation procedures. According to the original provisions a firm (banks are exempted) was obliged to file for reorganisation if it could not meet its due payments within 90 days. If the creditors unanimously agreed to approve the firm's solvency plan, the firm could get a maximum of 90 days moratorium for financial restructuring. If the creditors could not agree or the restructuring could not be achieved liquidation had to follow (see Kálal, 1993; Gray, 1993).

The law set in motion a mass of bankruptcy filings which overwhelmed the judiciary system. According to an official of the Ministry of Finance, firms which filed from April to the end of September 1992, when the filing fever was at its height, produced approximately a quarter of GDP, contributed 35% to exports and employed 18% of the total labour force (see *Figyelő*, 1992, 50, p. 25). Most of the firms filing for bankruptcy procedures in 1992 were organisations with limited liability (44.8%), but state enterprises were also well represented (12.8%). All sizes of firms were affected; of the total number of firms which employed more than 300 people, 11.85% filed for bankruptcy and in the case of firms employing 51–300 workers, the number was 11.1% (Kálal, 1993).

Needless to say, the bankruptcy law was too strict, which was also the view of foreign experts invited to a conference in Budapest in October 1992 in order to pass judgement on the law. The experts suggested several changes; some of them had already been approved by the government (Zsubori, 1993). But the damage to the economy was already done. According to Mizsei (1993), the consequences of the bankruptcy law might have been '…the most important single reason for the fall in GDP by 3–5% in 1992'. Needless to say employment was also negatively affected. What is no less important is that the Ministry of Finance official cited above expressed fears that reorganisation procedures would contribute little to the restructuring of the economy.[10]

It can be expected that in the long run the implementation of the bankruptcy law may have a positive effect. But in the short run, when the economy was anyhow in a recession, it made the recession worse. What is also important to emphasise is that the application of bankruptcy legislation has been contrary to the adopted principle of gradualism.

Neither Poland nor Czechoslovakia followed the Hungarian example. Both have bankruptcy laws, but they have strictly not enforced them. The Czechoslovak approach is interesting. The Czechoslovak parliament passed such a law in 1991, but the government has postponed putting it into effect several times. When the Czech Prime Minister was asked about it he maintained that there were better ways to restructure the economy than by bankruptcies (*Ekonom*, 1994, 1, p. 14).

It has already been mentioned that, unlike Poland and Czechoslovakia where huge devaluations of the exchange rates were an integral part of the shock treatment, Hungary devalued its exchange rate only a little. Despite this and the collapse of trade with the former CMEA countries, it managed to avoid a huge decline in exports. In the years 1991–92 there was even a revaluation of the forint in order to fight inflation.

Only in 1993 did the value of the forint start to decline faster, but still its revaluation continued, though at a slower pace than before. Only in 1994 was there a stronger devaluation of the forint.

The revaluation was one of the most important reasons why exports, which stagnated in 1992, declined in 1993, and why the balance of trade started to worsen in the second half of 1992 and continued in 1993, with a negative effect on GDP and employment. Of course, there were other reasons for the deficit in the balance of trade: a decline in agricultural exports owing to the general unsatisfactory situation in agriculture, drought and import barriers in the West, the embargo on Yugoslavia, the consequences of the bankruptcy law, etc. (Csermely & Oblath, 1993; Lányi, 1993 and Vértes, 1994).

Growing imports also affected the balance of trade adversely. In 1993, when exports, calculated in terms of volume, declined by 13%, imports increased by 12%. In 1994 there was an important improvement in the relationship between exports and imports. Still, imports are too high and are hurting some traditional industrial branches. In 1993 27% of imports were made up of industrial consumer goods and food. In the first seven months of 1994 43% of the increment in imports consisted of consumer goods (*Világgazdaság* ..., 1994). It is understandable that the demand for certain consumer goods increased substantially after the demise of the old system. Although the public was quite well supplied with consumer goods in socialist Hungary, still the selection and variety of goods lagged greatly behind the West, mainly with regard to luxury and electronic products. The satisfaction of the increased demand for foreign consumer goods was made possible by a gradual removal of impediments to imports. It seems, however, that the Hungarian government's liberalisation of imports went beyond what was needed in order to create an environment for competition.

There was also another reason for the increase in imports. During the so-called spontaneous privatisation some important retail networks (mainly shoes and clothing) were sold to foreigners, apparently without making provisions in the sales contract for the new owners to offer a certain amount (or percentage) of Hungarian products in their outlets.[11] As a result the Hungarian market was flooded by foreign goods.[12]

*Political reasons.* Political factors can also be blamed for the poor performance of the economy. In the political parties, headed by the Hungarian Democratic Forum, which came to power in 1990, there were few highly experienced politicians, economists and administrators. As a result the government was composed, to put it with some exaggeration, of second-class experts. This no doubt had a negative impact on the management of the economy. Many government members were learning on the job, and therefore it was no wonder that they had difficulty estimating correctly the state of the economy and what to do about it. The situation was compounded by the government's desire to have its adherents in positions of responsibility, often regardless of their qualities.

The government's reputation was also damaged by its desire to continue where the Horthy regime had left off before the war, mainly in giving a very important role in society to the countryside gentry (Antal, 1994). It did not want to accept that the 40 years of the communist regime had changed the country and that only a small segment of the population was still filled with nostalgia for the spirit of the Horthy regime.

Needless to say, such a policy did not have a favourable echo in the media. This was enough reason for the government to seek ways to get the electronic media under its control, and this effort brought about a conflict with the media and the president of the country. The excessive preoccupation with such political problems necessarily led to the neglect of the economy to some extent.

### *Social cost of transformation*

Several years have elapsed since shock treatment and gradualism respectively were applied, and prosperity is yet to come. True, a small segment of the population has made fortunes, legally and illegally; but the majority is much worse off; it must bear the burden of the transformation. The transformation has brought many freedoms which did not exist even in Hungary or only to a limited degree, such as greater freedom of expression, freedom to create political parties, freedom to practice entrepreneurship in various businesses, freedom to invest at home, and abroad with some limitations, freedom to travel abroad, etc.—freedoms which are of great importance for a small segment of the population, high income groups and highly qualified people, but are not of great importance for ordinary people (Antal, 1994). In none of the three countries have the ruling élites been much concerned about this development since they see the unequal distribution of the transformation burden as a way to create a prosperous property-owning middle class.

Labour shortages were one of the characteristic features of the old regime. With the start of the transformation to a market economy, labour shortages turned into unemployment. In 1990 the unemployment rate in Hungary was 1.7%, but in 1992 it was already 12.3%, to decline moderately to 12.1% in 1993[13] and even more in 1994. A government document predicts that in 1995 unemployment will grow again and reach the level of 1993 (*Népszabadság*, 5 January 1995). At the beginning of the transformation enterprises tried to avoid dismissals as much as possible and therefore unemployment grew much more slowly than output declined. As a result productivity declined. The government has an active, moderate employment policy, but the amount of money available for this purpose, considering the need for training and job creation, is minimal. In 1993 it amounted to 0.008% of government expenditure (Hámor, 1994; *Népszabadság*, 21 July 1994).

It is interesting that the decline in the number of the economically active population in Hungary was more than twice as great as the number of unemployed. By January 1994 the decline in the number of the active population was 1 362 000, whereas the number of unemployed was 608 000. The origin of this change is to be found primarily in a huge increase in the number of retired people (many people working beyond retirement age left voluntarily or were forced into retirement, and many people who were not in good health and feared dismissal opted for disabled status) and the return of many women to housework alone. Needless to say, the dramatic decline in the economically active population is not an economic advantage. It means *inter alia* that the state has less revenue and the economically active people must support a greater number of economically inactive people (see Timár, 1994).

As a result of the transformation process Hungary experienced a decline in the standard of living, though not to the same extent as Poland and Czechoslovakia. Figures on real wages give us a good indication of the impact of the transformation on the standard of living, though not by any means a complete one. In Poland and Czechoslovakia the decline in real wages in the year of the application of the shock treatment was quite similar, 24.4% and 22.8% respectively. In Hungary the decline was the smallest; in 1990 3.7% and in 1991 7% (see Table 1).

The standard of living was also affected by the interest rate paid on the population's bank deposits. In Czechoslovakia and Poland, in the years when shock treatment was applied, great losses in the purchasing power of savings occurred: in the former it was 40% (see Kohoutek, 1991) and in the latter at least 30%, but probably much more.[14] In Hungary the inflation rate and the difference between the inflation rate and the interest rate on deposits never achieved the level in Poland in 1989–91 or in Czechoslovakia in 1991; therefore there was not as great a loss in the purchasing power of savings in any of the years 1989–91 as in Poland in 1990 and in Czechoslovakia in 1991.

Unfortunately I do not have figures for Hungary on the impact of the recession on poverty. It can, however, be assumed that the number of people living below the poverty line has increased.

The increasing budget deficits in Hungary threaten health care and the education system and negatively affect the social security system.

### *The new government's strategy of economic growth*

The present Hungarian economy is not in good shape. The recession still continues and in some respects is worse than in preceding years. Though industrial production started to grow in 1993 and rose by 4%, and it seems likely to have exceeded the 1993 growth rate in 1994, the GDP in 1993 was still 2.3% below the level of 1992 and in 1994 at best 2% above 1993. According to the estimate of the Kopint Datorg research institute GDP will not grow in 1995 (*Világgazdaság* ..., 1994, p. 149). The growth forecasts of other institutes are not very different. The situation in agriculture has already been mentioned. Investment is still low. In 1993 imports grew much faster than exports, and as a result the deficit in the current account was very high and was expected to be more than US$3.5 billion in 1994, despite an improvement in the ratio of exports to imports. Foreign indebtedness is growing (Vértes, 1994). Perhaps one of the greatest problems is the growing deficit in the state budget. Inflation is still high and in 1992–93 was more or less on the same level (see Table 1).

The new socialist-liberal government would like to bring about a turnaround in the economy. The key to the turnaround is economic growth. To this end the coalition government's programme wants '... to curb consumption, which exceeds the performance of the economy and the realised incomes of the economy, while encouraging investment and saving' (see *Programme* ..., 1994, p. 5).

The government strategy of establishing conditions for economic growth was given a more concrete form by the budget approved for 1995 and the publication of the principles of the three-year draft stabilisation plan. According to the budget, the deficit should not exceed 5.5% of GDP. It is not clear whether this is already the compromise achieved with the IMF, but at any rate it is a concession to the IMF. According to an earlier budget draft the deficit was to amount to 7% of the GDP. Of course, the IMF, faithful to its policy of focusing on reducing the budget deficit as a tool of economic stabilisation, has been pushing for a 3% budget deficit (see the interview with the representative of the IMF in Hungary, *Népszabadság*, 17 September 1994). The government made it clear that it could not accept the IMFs demand because this would mean unacceptable social tensions.

The IMF attaches greater importance than is deserved to budget cutting and does not want to see the potential negative political and social consequences, which may be reflected in the performance of the economy. It is interesting that Sachs (1994) criticised this policy, arguing that, among other things, a low budget deficit does not guarantee low rates of inflation.

The approved budget envisages an increase in the share of investment in GDP at the expense of consumption, though, according to the authorities, only temporarily. It will also be necessary to increase exports and bring down the deficit on the current account (*Népszabadság*, 22 November 1994).

The objectives of the proposed budget will not be easy to achieve. The government will have great difficulty achieving a reduction in real wages, which it surely has in mind when it talks about restraining consumption.[15] It does not intend to meet this goal by introducing wage regulation; instead it is relying on an agreement achieved in tripartite bargaining (government, representatives of the employers and the unions). Understandably, the unions have not embraced the government's budget with enthusiasm. No doubt the fact that the leader of the strongest union is a member of the leadership of the socialist party helped to achieve a compromise, which includes certain concessions to the unions. Whether the rank and file of the unions will follow their leaders is not entirely certain. The recent strike by railway workers and their separation from the 'socialist' unions does not bode well for the future.

The job of the government would be easier if it could make the private sector contribute its fair share to government expenditure.[16] The government promises to intensify its effort to enforce the tax laws, but this will not be easy, in part because the government is reluctant to antagonise business. In addition, the draft stabilisation plan envisages an easing of the redistribution process (*Népszabadság,* 17 November 1994).

The government's policy of curbing consumption is criticised by many economists as an attempt to improve the performance of the economy at the expense of the workers. The government has, however, a powerful backer in the person of Kornai (1994(a)), who argues that real wages and the expenditure on social programmes are too high. He does not make suggestions about how much real wages should be reduced; he only shows that in Poland and Czechoslovakia real wages declined much more than in Hungary. In my opinion the smaller decline in real wages was an advantage which made it possible to proceed with the transformation in Hungary without any major political and social tensions. It is doubtful whether the Hungarians would have calmly accepted such a huge cut in real wages as happened in Poland in 1990 and Czechoslovakia in 1991. In addition, the moderate decline in real wages helped to restrain the fall in GDP. Finally, it should not be forgotten that the decline in real wages in the period 1988–93 affected low-income groups much more than high-income groups. There was a substantial widening of wage differentials. In 1988 the lowest decile made up 4.3% of the total wages, whereas in 1993 it made up only 3.5%; on the other hand the highest decile comprised 22.7% in 1988 and 26.8% in 1993. In 1993 half of manual workers earned less than 20 000 forints per month; to give an idea to the reader about what that meant let me mention that in December 1993 the subsistence minimum for a family of four (husband, wife and two children below the age of 15) was 47 858 forints (*Distribution of earnings*..., 1994, pp. 2–3 and *Statisztikai Havi Közlemények*, 1994, 7, p. 19).

A reduction in real wages can be expected to increase misery and may not help the economy. After all, the increase in the budget deficit was not caused by an increase in consumption, but, as the Kopint-Datorg institute study shows, mainly by the increase in interest rates, which brought about a hefty increase in debt servicing outlays. In 1993 they amounted to 157 billion forints but rose in 1994 to 295 billion, almost as much as the deficit. In other words, if Hungary had no debts there would not be a deficit. A reduction in consumption due to a decline in real wages may hamper economic growth and bring about a decline in saving at a time when the government is trying to encourage saving in order to give a boost to investment and to contribute to the effort to achieve financial equilibrium as much as possible by domestic means. On the other hand, increases in consumption, as far as they are combined with curbs on imports, boost employment and economic growth. And the Hungarian consumer goods industry can easily supply more goods provided there is a demand for them. The writers of the study also expressed doubts whether the risks of social tension were worth the possible slight benefits from restraining consumption (*Népszabadság*, 19 October 1994 and *Világgazdaság*..., 1994, pp. 101–102).

One way to curb imports and boost growth is to impose high taxes on luxury goods or restrain the wage growth of high-income groups, which are primarily the consumers of imported goods, and to allow increases in wages equal to inflation for low-income groups which are the consumers of domestic products. Such a policy, which would be natural for a socialist party, cannot be carried out in Hungary since many in the party would not agree with it, regarding it as contrary to capitalist principles. Even if there were a consensus in the leadership of the party for such a policy, it would not dare carry it out because of the fear that it would meet an unfavourable reaction in the West. In addition, such a policy would be vehemently opposed by the opposition and also by the coalition partner.

There has been some disagreement in the socialist party on the role of stabilisation. The previous Finance Minister, Békesi, who subsequently resigned, and the authors of the stabilisation draft, pushed the idea that stabilisation should precede growth and should create preconditions for growth, a strategy which is one of the articles of belief of the IMF. The Prime Minister, who is the leader of the Socialist Party, as well as many other members of the leadership, disagreed with this strategy for political reasons, but because the coalition partner supported the Finance Minister, the latter prevailed for a short time and the strategy became official government policy.

It is interesting that this government policy was criticised by Kornai (1994(a)), who argues that both should proceed simultaneously. To insist on the principle that stabilisation must be achieved before it is possible to put the economy on a growth path means postponing growth for many years since in practice it very often happens that after the elimination of one instability a new one appears. One must also agree with him that budget cutting should not be at the expense of output.

The appointment of a new Finance Minister has not brought about a substantial change in the strategy; in his 25 programmatic points (*Népszabadság*, 17 February 1995, p. 15) the new minister, like his predecessor, insists on the need to limit social programmes and redistribution of income through the budget. The difference between the two ministers is that the new one refrains from taking a clear position on the relationship of stabilisation and growth and uses a more soothing rhetoric.

## *Concluding remarks*

It has been shown that Hungary, despite its option for a gradual solution, did not fare much better than Poland and the Czech Republic. If we confine the discussion to output, Hungary is now in a worse position than Poland. As to unemployment, Hungary is worse off than the Czech Republic. Does this mean that the transformation strategy does not matter or that shock treatment is a better strategy? I have tried to answer this question in a previous article (1994(a)). Here I only discuss it briefly.

In my opinion it matters, but it is not the only factor which determines the performance of the economy. In other words, a gradual strategy may produce worse results if blunders are committed in economic policy, as has been shown in the case of Hungary with regard to agriculture, bankruptcy legislation and the exchange rate. These blunders, combined with a change to a more restrictive monetary policy, started to have an increased negative effect on the economy in 1992–93. Thus there is no wonder that Hungarian performance, which in the first years of transition was better than that of its two neighbours, later worsened. Sachs' & Woo's (1994) statement that 'Poland, the Czech Republic and the Baltic republics acted boldly, [meaning that they applied shock treatment] and growth has returned to their economies. Hungary, which stuck to its gradual reform strategy, may see its decline bottoming out only in 1994' and is an example of ignoring important forces which determine economic performance.

In comparing the two strategies one should not confine oneself to output and unemployment. Social costs other than unemployment should also be taken into account. It has already been shown that real wages and real savings declined less in Hungary than in the other two countries.

How the strategies contribute to political stability is also of great importance. In Poland the deep recession destabilised the political system to some extent and generated great social tension, and in Czechoslovakia contributed to the split of the federation. In Hungary the gradual strategy, even if it was not consistent, helped to avoid great social tensions.

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[1] When Kornai came up with the idea of a kind of shock treatment in his 1989 book he was criticised by many well known economists who showed the dangers hidden within such a policy.

[2] I have already discussed the Polish and Czechoslovak transitions (1993, 1993(a) 1994 and 1994(a)).

[3] For example Hrnčíř (1991) mentions that money supply in real terms declined by 27% in the first five months of the shock treatment in Czechoslovakia. In Poland money supply declined in nominal and real terms in the first two months of 1990 and in real terms in most months of 1990 (Dąbrowski, 1992).

[4] It is worth mentioning that at the same time the contribution of the population to revenue, which was 248.9 billion in 1990, increased to 403.0 in 1992.

[5] For example, the IMF representative discouraged the use of public works as a method of easing unemployment (see *Economic Transformation*, 1992, p. 80).

[6] A study sponsored by Oxford University (*Historical Precedents*, 1991, p. 32) warns: 'Yet past experience shows that even when the primary objective is the creation of a market economy, it is necessary for the state to play a substantial role for many years. Following the collapse of the command economies, euphoria among some advocates of free markets and deregulation may engender an exaggerated belief in the powers of market mechanism'. Bruno (1992) writes: '... hands off policy (by the government) during the transition from a centrally planned to a market economy would be most inappropriate'.

[7] I have used the comments of K. Kõvári-Csoór for this paragraph.

[8] Kornai emphasises that one should not mix up the long- and short-term effects of privatisation. To him privatisation in the long run is an instrument of economic efficiency, but in the short run is a source of recession.

[9] One could argue that the restitution can also be blamed for the difficulties in the economy. It is generally accepted that compensation was quite generous, certainly compared to the potential of the economy. It is estimated to amount to 250 billion forints (see Horn's speech, *Népszabadság*, 27 September 1994).

[10] It is important to emphasise that many Hungarian economists evaluate the bankruptcy law less critically.

[11] The sales contracts were designed sloppily partly because the sellers had little experience and partly because they wanted to be nice to the buyers. An economist who researched the sales told me that Salamander, an Austrian shoe chain, which bought the biggest retail shoe business in Budapest, committed itself to a large investment in Hungary. Since the investment was not specified, Salamander honoured its promise to a great extent by importing shoes from its outlets in Austria, among others, shoes which it could not sell at home.

[12] Some economists suspect that one of the reasons for the large imports is that they serve as an instrument for illegal capital exports.

[13] Some believe that the real figure is 15–16% since many of those who lost the hope of finding a job are no longer registered as unemployed (see Petschnig, 1944, p. 99).

[14] In a debate Rosati (1991) used the figure 80%.

[15] According to an earlier budget draft they were supposed to decline by 5%, the amount they were supposed to increase in 1994 (*Népszabadság*, 17 September 1994).

[16] A reliable economist told me that in 1993 the 700 000 private businesses reported on average earnings below the minimum income level.

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