TITLE: THE HUNGARIAN EXPERIMENT: The Political Economy of Change in a Communist-Led Country

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EXECUTIVE SUMMARY

The study assesses Hungary’s 25-year experience (1965-1989) with economic and political reforms; analyzes the country’s early experience (April 1990-April 1991) with political and economic transformation; attempts to predict how further transformation will proceed to the year 2000; draws lessons from Hungary’s systemic changes; and notes the implications of the research findings for public policy.

Despite more than 20 years of reforms, in the late 1980s Hungary found itself on the brink of an economic and political crisis. What factors explain this?

Although reforms yielded certain positive achievements, the fundamental and mutually reinforcing problems that remained were these: Ill-defined ownership, no market for the factors of production, weak financial discipline on enterprises and for the state budget, no clear criteria for investment decisions other than the interests of the lobbies (partly a consequence of the ill-defined ownership structure), exceedingly heavy taxation, and an incredibly complex and continually changing system of administrative and financial regulation that tried, unsuccessfylly, to reconcile a series of incompatible objectives, strategies, and system features.

These unsolved systemic problems in large part explain the Hungarian economy’s unsatisfactory performance. They were compounded by a number of major mistakes in economic policy. The most significant policy mistake was allowing foreign credits to rise much too rapidly.
At the same time, however, the reforms did yield significant results, especially in agriculture and in the second economy, i.e., the private sector. Living standards improved considerably in the 1960s and 1970s (thereafter the improvement was based on foreign credits). Hungary was able to move away from the classical shortage economy. The supply, assortment, and quality of food and many other consumer and industrial products became significantly better than in most other CPEs. Queuing in retail stores was eliminated (but continued for a segment of the housing market, cars, and major repairs). For tourist purposes within the CMEA, the forint became practically a convertible currency. Many of these improvements could not be captured readily in standard economic statistics, such as the growth rate. Also, since 1968, Hungary's economic statistics are considered by experts to be much more reliable, much less subject to exaggerations and distortions, than those of a number of East European countries against which its performance is often juxtaposed.

Nevertheless, a more fundamental economic change became essential because by the late 1970s and early 1980s, Hungary could count on none of the growth support mechanisms it enjoyed during the previous decades: rapid mobilization and deployment of inputs (in the 1950s), integration with the USSR (in the 1960s), and Western credits (in the 1970s).

During the early 1980s, Hungary suddenly found itself unable to borrow further large sums from the West with which to finance a net inflow of resources from abroad and was saddled with interest on a large outstanding debt, whose payment required a substantial net resource outflow. This could be realized only by a drastic cut of imports from the West, which in turn had all kinds of adverse short- and long-term economic consequences. The sustained stagnation of the economy, in turn, helped to undermine the relative political
stability that characterized the regime of Kádár for about 15 years (1964-1978). And as soon as Gorbachev repudiated the "Brezhnev doctrine" because it stood in the way of detente with the West which Gorbachev needed in order to enlist the West in helping him implement economic reforms in the USSR, the repudiation set in motion forces throughout Eastern Europe that the region’s communist leaders became unable to control. The communist leaders who succeeded Kádár in 1988 introduced a series of political liberalization measures, intended as lightening rods for the pent-up tensions of the population. In 1989, they granted the ultimate concession: the promise of free elections. It soon became clear that only parties that pledged a sharp break with the communist economic and political system could hope to win sufficient votes to form a government. In free and fair elections that were held in the spring of 1990, a center-right coalition government was formed. The main pillars of its economic program are to establish a social market economy based on private property, to arrest the growth of foreign debt, and to maintain the country’s external creditworthiness.

Taking stock one year after elections, the government gets rather poor marks. The main mistakes were that the Prime Minister made unrealistic promises, appointed not always the best - in some cases even qualified - persons for key government posts, and the new government initially has shown no sense of urgency in attacking the major economic problems. To be sure, in all fairness one must also point out that the new leadership was up against daunting difficulties: it had to, simultaneously, give birth and extend democracy, restructure a bankrupt economy, and find a way out of a crisis situation.

The main economic and political difficulties of system transformation include:
(1) The accumulated legacies of several decades of command economy, such as:

- a neglected infrastructure whose increasingly frequent breakdowns are causing severe problems;
- environmental pollution that is much worse than in the western part of Europe;
- trade excessively oriented toward East Europe’s uncompetitive markets;
- a large and growing volume of non-performing loans to enterprises are held by banks, whose ability to support the healthy sectors of the economy is thereby limited;
- a large foreign debt.

(2) New external shocks, such as the deepening crisis in the Soviet Union and other east European countries means disruptions in the supply of energy, raw materials and access to their markets;

(3) Unrealistic expectations by the population that regime change will bring about an immediate and sustained improvement in living standards.

(4) The fundamental dilemmas of economic transformation, such as the difficulty of controlling the strong pressures for open inflation; how to substantially lower the level of spending, and then to reduce the tax burden on producers and households, commensurate with a balanced budget; how to ascertain and politically agree upon the full complement of laws and policies that set out clearly the scope, the speed, and the strategies of privatization; and how to revamp Hungary’s relations with the countries of the CMEA.

Hungary’s main opposition parties as well as the international community are pushing the government to speed up marketization. A comprehensive government program is
beginning to take shape in 1991 whose implementation is slated to get fully under way in 1992. Its main elements are: maintaining relatively tight monetary and fiscal policies; assuring by law the independence of the central bank; accelerating privatization; cutting unproductive expenditures from the budget; restructuring or closing a large number of state enterprises; further freeing of prices and imports from government control; a comprehensive reform of the banking system that will lead to regulations conforming to international standards to govern lending, capital adequacy, loan-loss provisions, and annual audits; the introduction of currency convertibility for current transactions; and strengthening the social safety net via improved unemployment compensation, retraining, and job-placement assistance,

Looking ahead to the year 2000, my prediction is that the political and intellectual difficulties of economic transformation will slow but not derail Hungary’s transition to a market economy. Hungary has several major assets that make it likely that economic transformation will by and large remain on course: Twenty-five years of experience with partial reforms; that the country does not face, within its own borders, severe ethnic tensions; and that economically, politically and even culturally Hungary is extremely dependent on the West and will become even more so in the future, which gives the West important leverage on Hungary’s economic policies. The biggest danger is no longer that Russia will intervene in the country’s internal affairs, but that the main political parties will be tempted to take too short a view, to agree to too many unworkable compromises, or to follow populist policies.
The main lessons of Hungary’s experiences since the mid-1960s are that system transformation is very complex and faces many constraints; that the economy operates as an organic whole, not as an unrelated collection of bits and pieces; and that transformation is an intensively political process.

The key implications for public policy are that the interest of the West lies in seeing that a country like Hungary moves, with all deliberate speed, toward a market economy in which democracy and human rights are respected and international obligations are observed.

The West is in a position to offer Hungary (and to the other countries in the region) a powerful package of economic incentives - technical assistance, a dismantling of trade barriers, foreign investment, debt restructuring, subsidized credits (via mainly the international financial institutions), improved access to commercial credits, and eventual membership in the EC. The delivery of this package of economic benefits should be tied, partly explicitly and partly implicitly, to Hungary remaining a democratic country and its economic transformation persevering on course. The United States should lead Western efforts toward such "coordinated conditionality."
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I. INTRODUCTION AND BACKGROUND

The Original Proposal

On October 31, 1988, I submitted a research proposal to the National Council to prepare, between August 1, 1989 and December 31, 1990, a major study, "The Hungarian Experiment: The Political Economy of Change in a Communist-Led Country." The competitive proposal was awarded a National Council grant in January 1989.

The study was to focus on three sets of issues:

1. Assess Hungary's 25-year experience (1965-1989) with economic and political reforms;
2. Analyze the prospective political and economic transformation of the country during the next decade; and
3. Draw the lessons of the Hungarian experiment for an improved understanding of reform prospects and outcomes in the USSR and the countries of Eastern Europe.

Research Proposed And Completed

Shortly after the research proposal was approved, dramatic political changes swept through the region. In Hungary as well as in several other countries in the region the communist political system collapsed and was replaced by democratic governments; Soviet influence in the region rapidly declined. In Hungary, the new government formed after democratic elections in March-April 1990 pledged to transform the country's "modified" centrally planned economic system into a market economy.
These developments led me to give greater weight in the research to the second set of issues (the political economy of transforming the country into a market economy), but the other issues were also covered.

The Research Context

To carry out the research, I took a two-year leave from Indiana University (January 1989 - December 1990). Approximately half of my time was spent in Hungary; the other half mostly at my home base in Indiana and attending conferences and workshops involving Hungary, held at various locations around the world.

One of the two years (the summer of 1989 until the summer of 1990) was spent conceiving, organizing, and co-directing the work of the joint Hungarian-International Blue Ribbon Commission (BRC, for short). The purpose of the BRC was to prepare a comprehensive economic transformation program for the (then still future) democratic government of Hungary to chart the heretofore unexplored route from a centrally directed to a market economy.

"Blue ribbon" connotes a "first place prize" or "best performance" standard; a blue ribbon commission, therefore, is a panel of experts and individuals of other distinctive achievements in a given field. Nine distinguished citizens of Hungary and 12 individuals of distinction from 10 other countries made up the BRC. This group was assisted by about 100 experts from Hungary and other countries, who prepared issue papers and participated in a series of workshops and conferences. The activities of the BRC were sponsored by the Hungarian Academy of Sciences, the Hungarian Chamber of Commerce, and the Budapest
University of Economics (in Hungary), Hudson Institute, the East-West Forum, and Indiana University (in the U.S.), and Nomura Research Institute (in Japan).

The activities of the BRC were analogous to that of a research laboratory on Hungary's economic transformation. It played an important educative role for the participants, which may have been as important a contribution as the value of its recommendations was to policymakers.

The summary findings and recommendations of the BRC were published first in Hungarian and then in English, *Hungary in Transformation to Freedom and Prosperity: Economic Program Proposals of the Joint Hungarian-International Blue Ribbon Commission* (Indianapolis: Hudson Institute, 1990).


Funding

The approximate total direct and indirect cost of my two years of research was $200,000. This was funded by:*  

1. Sabbatical pay by Indiana University (January-June 1989);  
2. Grant by the NCSEER;  
3. Grant by the Smith-Richardson Foundation;  
4. Short-term consulting with the World Bank and the OECD on projects relating to Hungary and the other countries of Central and East Europe.  
5. Travel and related expenses were covered by the Joint Hungarian-International Blue Ribbon Commission; no salary was paid to me by the BRC.  

*Sources 1 + 2 + 3 below jointly covered the opportunity cost of my released time, August 1989-December 1990.
II. RESEARCH FINDINGS, INTERPRETATIONS, CONCLUSIONS

Introduction

The findings, interpretations, and conclusions of my research are organized into four parts. The first three correspond to the main questions stated in the proposal. Part A is a retrospective assessment of the political economy of Hungary's reform experience from the mid-1960s until the end of the 1980s. Part B lays out the main problems and policy choices of economic transformation, reports on what the new government of Hungary has accomplished by early 1991, and looks at the country's economic prospects to the year 2000. Part C states some preliminary lessons one may draw from Hungary's reform and transformation experiences to date for systemic changes in the other countries of Central and Eastern Europe. The last section (Part D) notes the implications of his research for Western public policy toward Hungary and the other transforming countries in the region.

A. Economic Reforms (1965-1990)\(^1\)

Despite more than 20 years of reforms, in the late 1980s Hungary found itself on the brink of an economic and political crisis. Why is it that even though the New Economic Mechanism (NEM) was introduced in Hungary in 1968, the country was in such a precarious situation a generation later?

To attempt to answer this question, it is useful to have a framework that organizes the facts and our interpretations concerning developments in Hungary from the mid-1960s to the end of the 1980s.

The conceptual framework I propose attempts to highlight the basic features of the political economy model of a traditional (pre-Gorbachev) Soviet-type centrally planned
economy (CPE) and its transformation through various stages. The issue is; how much did Hungary deviate from or remained the same as the CPE model?

The Conceptual Framework

The political economy model of a Communist-led country is defined by three interrelated components: (1) Key objectives of the political "influentials," including their tradeoffs, (2) the strategies pursued by the influentials, and (3) the system. Associated with but not strictly a part of the model are policies.²

*Key objectives* are those goals that superimpose design upon the myriad activities that take place in a country, that deliberately choose the direction in which the country should be moving. In brief, the "grand design."

"Political influentials" are those who "operate" the model. They vary in number depending on the style of leadership, ranging from the nearly unlimited power of a single despot to a large number of party or party-affiliated individuals sharing in the exercise of power as well as competing for influence. The population is passive; its independent interest accumulation and articulation are not permitted.³

*Strategies* are those basic policies that implement the grand design. They are concerned with long-term developments that endure over relatively long periods. Actions that are customarily labeled policies are divided into two categories: strategies, which are fundamental, long-term policies and are considered basic building blocks in the model; and policies proper, which are of shorter duration, more easily reversible, and are not considered separate building blocks in the model.⁴
System refers to the institutional framework and the instruments available to implement goals, strategies, and policies. It is defined by six components: (1) Basic institutional arrangements (ex: the political and economic bureaucracy, ownership); (2) location of the authority to make specific decisions (e.g., the sphere of authority of the party bureaucracy, central planning agencies, ministries, enterprises, workers, households); (3) the information system (ex: plan directives, prices); (4) the incentive system (ex: bonus maximum, profit sharing); (5) the instruments available to implement decisions (ex: mandatory plan targets, the nomenklatura); and (6) the formal and informal "rules of the game" (ex: laws and regulations and routine behavioral patterns that enforce, hinder, or complement the formal structure).

This conceptualization of the political economy model of a Communist-led country is believed to be useful because it

- integrates economic and political variables;
- allows ideology, historical experience, the internal and external environment, and the leadership's personal values to influence basic objectives, strategies, system features, and policies, and thus to determine significant, country-specific deviations from the standard model;
- explicitly includes key objectives and strategies; trying to infer them from outcomes can be misleading because outcomes are often quite different from those that the influentials intended;
- suggests a definition of reform: qualitatively significant modifications in key elements in the model. If only one or a few elements are modified, the change is called partial
Reform; if a significant number of elements are modified, the reform is comprehensive.

Reform is Almost Synonymous with the Kádár Era

During practically all of the period we wish to analyze, from the mid-1960s until the late 1980s, János Kádár was Hungary's preeminent political leader. He assumed power in 1956, resigned in 1988, and died in 1989. This period can thus, not inappropriately, be called the Kádár reform era. To be sure, from 1957 through 1962, Kádár ruled through repression, whose severity and methods were reminiscent of the worst of the Stalin era.  

KEY OBJECTIVES

Kádár and his group of influentials had two fundamental and unchanging objectives: (1) To maintain their monopoly of political power and (2) to build and consolidate a socialist economic system.

Monopoly of Political Power

Although around 1963 Kádár made significant changes in the strategy of exercising political power, power remained firmly the monopoly of the party or, more accurately, those self-selected to exercise it. The goals and tasks of state organizations were defined outside the organizations; their interests were in carrying them out. Power flowed from top to bottom. Those who wanted it had to gain support from above rather than mobilize a constituency from below. In this respect, Hungary remained a traditional CPE.

Socialist Economic System

In a Soviet-type system, a socialist economic system is defined by the following subgoals of its influentials: (1) Predominantly socialist ownership of the means of
production; (2) a forced rate of economic growth; (3) full employment; (4) a quasi-welfare state; (5) eliminating extreme disparities in income and wealth; and (6) consumer price stability.

1. **Socialist Ownership.** The authorities view ownership hierarchically: state ownership is preferred over cooperative ownership, which in turn is superior to private property. Private enterprise is tolerated as a transitory concession, prompted by economic necessity. Under Kádár, the hierarchy of ownership was maintained. More accurately, sometime during the 1960s large cooperatives were declared to be of equal rank with state ownership. But "socialist" was consistently considered superior to private property. Although the scope of second-economy activities was expanded, no constitutional protection was granted to private ownership, ambivalent and frequently changing stop-and-go policies were pursued toward the sector, and the preferential allocation of capital, inputs, and subsidies to state-owned firms and large cooperatives continued. Thus, this objective of a CPE was not really altered. This created great hardship and uncertainties for private activities, which limited greatly their scope and effectiveness. Furthermore, the predominance of socialist ownership prevented the establishment of markets for factors of production, especially for that of capital. That, in turn, impaired greatly the efficient operation of the economic system.

2. **Forced Economic Growth.** This means pushing the tempo of growth beyond the capacity of the economy to achieve it without disruptions. The influentials were motivated by a desire for their economy to catch up with those of the advanced countries and to demonstrate the system's claimed advantage over market economies. Forced growth means emphasis on quantity over quality, expanding capacity rather than its efficient use, and (for
the heavily trade-dependent countries of East Europe) tensions in the convertible balance of payments. In Hungary, Party resolutions announced repeatedly that growth must be accelerated; the latest such Party declaration was in April 1984. While the push for growth under Kádár was not as extreme as under his predecessor, or that taking place, say, in Romania, this feature of a Soviet-type model was not eliminated. Similar, too, were the consequences.

3. **Full Employment.** The preservation of full employment is both a short-term and a long-term goal in the Soviet-type model, for ideological as well as political reasons. It is not the goal itself, which after all is a worthwhile objective of political leaders in any country, that is problematic, but the way it is interpreted in practice. In the interest of full employment, the authorities allow labor to be hoarded by enterprises, and provide that practically all jobs become permanent entitlements to their holders, largely irrespective of need or the individual’s performance. This, of course, limits structural change and weakens labor discipline. The preservation of full employment remained a basic objective and direct state responsibility under Kádár. Thus, in this respect too, Hungary remained a Soviet-type economy.

4. **Quasi-Welfare State.** The CPE system may be called quasi-welfare states because access to most of the benefits the state provides (e.g., health care, housing, social security, subsidized basic foods and services) is tied to employment, not country of residence or citizenship. These entitlements were preserved under Kádár. To be sure, the rapid deterioration in Hungary’s medical, social, educational, and cultural infrastructure during the
1980s suggests that making good on this aspect of socialism had become, in recent years, a lower priority than implementing other goals and objectives.

5. *Overcoming Extreme Income and Wealth Inequalities.* The CPE's goal is to eliminate extreme inequalities as well as incomes based on returns on property and entrepreneurship. However, earnings differentials among workers and employees (but not between them and the nomenklatura) are kept small, not as a matter of principle but arising out of the logic of the system and from social pressures. The systemic reforms introduced under Kádár were associated with an increase in the inequalities of income and wealth. But much of it was due not to marketization per se, but to the glaring imperfections in the market mechanism (taking the form, for example, of niche monopolies for a significant number of participants in the second economy, who thereby reaped large unearned incomes). The authorities' response was periodically to clamp down on all private activities rather than to strengthen market forces. Thus, in this area, too, the goals and behavior of the authorities had much in common with those of Soviet-type economies.

6. *Consumer Price Stability.* This objective was pursued in Hungary vigorously until 1979, that is, even after the introduction of the NEM. Its main instrument was administered price determination or rules enterprises had to follow that achieved the same thing. This made it all the more difficult both to adjust relative prices to scarcities, to allow market forces to operate, and to let enterprise profits serve as true indicators of their performance. That, in turn, contributed to the maintenance of paternalistic relations between enterprises and the authorities. After 1979, the authorities in Hungary were compelled to give up price stability, for a time being, in order to hold down domestic consumption and thereby improve
the balance of payments. As a byproduct, relative prices did improve, but the practice of cost-plus pricing had continued through the 1980s.

**STRATEGIES**

The following strategies are identified: (1) On exercising political power; (2) on the standard of living; (3) on resource mobilization; (4) on resource allocation; (5) on foreign economic relations with the CMEA; (6) on foreign economic relations with the West; (7) on foreign borrowing and debt management; and (8) on economic reform design and implementation.

1. **Exercising Political Power.** Approximately seven years after the ruthless suppression of the Revolution of 1956, Kádár changed his strategy of exercising political power. Around 1963 he instituted, gradually, a set of policies, often referred to in the West as political liberalization (but would be called more accurately enlightened absolutism) that increased the personal security of the citizenry and made life in Hungary much more tolerable than in all other Soviet-type systems, with the possible exception of Poland. This strategy (together with that on the standard of living) was, in Kádár's judgment, the best way to ensure that 1956 would not be repeated.

   Kádár, in effect, told the Hungarian people: "The Soviet Union and its basic policies are here to stay. Cooperate with me by not challenging the political system and I'll make life as tolerable for you as it can possibly be under our geopolitical circumstances." At the same time, Kádár said to the Soviet leaders: "Hungarians are unhappy with your rule, as you saw in 1956. If you give me a free hand in domestic affairs, I can calm this explosive situation and my management will thus be to your advantage."
Kádár's great historical merit is his skill in designing and managing this grand compromise. But its successful implementation ultimately rested on two pillars: steady improvements in the standard of living and the Brezhnev Doctrine. The combination of a carrot and a stick made the Hungarian people willing to tolerate a situation that, fundamentally, was not acceptable to them. Once the two pillars collapsed, more or less simultaneously in the late 1980s, so did the great Kádár compromise and the regime's stability.

2. Standard of Living. As mentioned, Kádár gave high priority to steady improvements in the citizenry's material well-being. When this could no longer be assured from domestic resources (after 1972), Kádár resorted to large foreign borrowing to maintain the expansion of both consumption and investment. After 1980 this strategy could no longer be implemented, owing to the large inefficiencies of Hungary's economy and the huge debt-service burden. That, in turn, gradually eroded the implicit compromise between the regime and the population (the social contract, as it is often called), helping to undermine political stability.

3. Resource Mobilization. A hallmark of a Soviet-type economy is that resource mobilization is forced and highly centralized. By and large this continued after the introduction of the NEM, but with one (not very important) difference: Whereas before the NEM was introduced, resources were mobilized through mandatory directives and campaigns, after the NEM was put in place, resources were mobilized by manipulating a variety of "regulators." During the first half of the 1980s, taxes and other levies still
centralized, on average, more than 80 percent of enterprise incomes and about 60 percent of GNP. Thus, there did not seem to be a fundamental difference in this area between Kádár's Hungary and the more traditional CPEs.

4. Resource Use. This strategy refers to decisions on investments and to the size and purposes of state budget expenditures. The NEM envisioned giving enterprises substantial autonomy only regarding replacement investment plus "small" new investment, and to retain for the center the strategic decisions on expansion. Even when enterprises could, formally, initiate a project, since they were left with meager resources after taxation, and were also limited as to the purposes for which after-tax incomes could be spent, they had to rely on the authorities for grants, subsidies, and imports; on the monobank for credits; and on the state budget for grants. Investment projects of significance were determined by the preferences of top policymakers and by the interests of powerful lobbies, not by market forces. Their revealed preferences show that the strategy of investment did not depart very far from those of the more traditional CPEs: basic and heavy industries (e.g., coal, steel, petrochemicals), selected branches of manufacturing, projects to increase exports to the CMEA or to replace convertible imports, and projects that were huge. The revealed dispreferences included infrastructure, the services, light industry, projects to increase exports to the West (except for periodic campaigns), environmental protection, and projects in the second economy.

5. Foreign Economic Relations: CMEA. The foreign economic strategy of a typical East European country after about 1950 was to maximize the growth of imports of energy, basic materials, and intermediate products ("hard goods") and to pay for them by shipping (mostly or increasingly) "soft" manufactured products. Each East European country could,
of course, realize such a strategy only vis-a-vis the USSR. The strategy's rationale was that it facilitates rapid economic growth, provides economies of scale and full employment, and makes possible the production of intermediates that are nonexpendable hard-currency earners. However, the long-term consequence of pursuing such a strategy was to build, expand, and maintain an industrial structure not in accordance with comparative advantage. It made the East European economies extremely vulnerable to Soviet ability and willingness to continue this pattern of trade, and contributed to continued loss of export-competitiveness on the world market. In all these respects, Hungary did not appear to have pursued a fundamentally different strategy than the other, less reform-minded countries of Eastern Europe.

6. *Foreign Economic Relations: West.* A typical Soviet-type economy’s foreign economic strategy vis-a-vis the West is one of extreme inward orientation: incentives biased in favor of production for the domestic or CMEA market and against both export and import trade with the world market. If the purpose of convertible imports - and this is where strategy comes into play - is (1) to purchase technology and inputs to produce exports to the CMEA, where payment is not in convertible currency; (2) to alleviate bottlenecks created by overambitious investment drives, poor investment projects, planning mistakes, and inefficiencies at the micro level; and (3) to sustain, with the help of foreign loans, domestic absorption above the level of production, then the resulting increase in convertible imports cannot be taken as evidence of "openness." By contrast, if the strategy of imports from the West is to lower the cost of production and to generate competition, then one can speak of an economy opening up to foreign markets. On the export side: if too much of the wrong kinds of imports, plus debt-service, is paid for by exports that are generated with large
subsidies (much greater than needed to offset the protection on inputs) and with short-term export incentives that undermine the sustained expansion of exports, then such trade, too, does not evidence "openness."

Hungary's strategy was essentially that just indicated and it had two main consequences. One, paradoxically, was a very substantial increase in dependence on the West for essential imports (there were also other contributing causes), making the economy highly vulnerable to import-supply disruptions. The other consequence is that a significant part of Hungary's trade was not in accordance with the country's long-term comparative advantage. Therefore, its gains from trade remained much smaller than the volume and relative importance of exports and imports in its economy would suggest. Two modestly significant differences between Hungary and the other East European countries: it was the first to liberalize - half heartedly to be sure - joint ventures with Western partners, and it was one of the first to undertake a reorientation of trade from the CMEA to the West. As a consequence, Hungary today is in a relatively more favorable position to absorb the shocks caused by the collapse of the CMEA economies and trade.

7. **Foreign Borrowing and Debt Management.** During the last two decades, Hungary's debts to the West increased rapidly not because of a strategic decision to tap the long-term inflow of foreign resources for development (as Poland and Romania did during the 1970s), but to finance time and time again the unplanned excess of imports and shortfalls in exports. But Hungary did make a strategic decision in the late 1970s not to reschedule. This was a factor in the decade-long austerity program during the 1980s. In the 1970s, Kádár borrowed to increase the standard of living, to pay for the import costs of misguided investments, and
to buffer the country from the effects of a large deterioration in its terms of trade. In the 1980s, Kádár borrowed to refinance the payment of principal and a portion of the interest on the foreign debt. Since there is no CPE strategy on foreign borrowing and debt management, the analogy here is best made with countries, not necessarily CPEs, where the authorities and foreign lenders bear joint responsibility for taking and providing excessive amounts of credits.

8. **Economic Reform.** Strategic issues on reform involve decisions on when to initiate it, what kind of reform should be introduced, whether to put it in place experimentally or broadly, and how to sequence its implementation.

As background for discussing the kinds of reforms Kádár supported, let us divide the economy into two sectors: (1) State firms and large cooperatives (the first economy) and (2) private and semi-private firms and activities (the second economy). The two sectors have different relationships with the authorities. Reform strategy during the Kádár era can be divided into four periods: 1956-64, 1965-72, 1973-78, and 1979-88.

**1956-64:** Immediately after 1956 a reform commission prepared a blueprint that was very close to that of the NEM of 1968, but the reform was not introduced. Instead, a series of politically motivated, ad hoc concessions were made to the second economy, which turned out to be significant building blocks for subsequent reforms.

**1965-72:** Prompted by growing tensions in the first economy and by the success of reforms in the second economy, the NEM was introduced to improve the first economy. Central planning was retained, but mandatory plan targets to enterprises and central resource allocation were replaced by financial and administrative regulators, i.e., by indirect planning.
The NEM did not plan to enlarge the second economy. But the combination of allowing workers to change jobs and giving greater autonomy to cooperatives actually brought about that result. Agricultural and retail trade cooperatives established subsidiaries in industry and construction. Those ventures became the first important forms of semiprivate activity, characterized by strong profit orientation and de facto independence from the authorities. Because many aspects of the NEM were introduced at once, it is called a comprehensive reform. This is not a fully accurate term because a great deal was not touched (ex: economic institutions and the political superstructure). Nevertheless, on balance, the reforms implemented through the NEM were sufficiently wide ranging, in terms of changes in the economic system, to warrant the conclusion that it transformed Hungary from a Soviet-type economy into a modified CPE.

1973-78: The reform was "frozen" for about 6 years because of a domestic backlash by union leaders and managers of powerful enterprises, antireform trends in the USSR and to protect Hungary from the adverse impacts of the world energy crisis.

1979-88: Increasingly acute tensions, especially in the convertible balance of payments, prompted Kádár once again to turn to reform. But the suggestion of economists to create a real market mechanism was rejected. Instead, a series of partial reforms were implemented over a period of a decade, both in the first and in the second economies (summarized below). However, owing to lack of a clear concept of what model was desired, and the many constraints imposed by the simultaneous pursuit of a CPE's fundamental objectives as well as strategies that were enumerated, the reform steps were full of contradictions. The constraints were partly domestic and partly external (Soviet) in origin.
THE SYSTEM: INSTITUTIONS AND INSTRUMENTS

A great deal has been written about systemic reforms in Hungary.6

Political System. There was no significant change in the political system. The fact that many actions and activities were permitted, not as constitutionally guaranteed rights but as an aspect of exercising political power (ex: publishing articles critical of some aspects of the regime or its policies; travel to the West; tolerance of second-economy activities) brought about an improvement in the quality of life. But, at the same time, such privileges became a corrupting influence in society. This was so because many of those who enjoyed its benefits became regime supporters to protect their "privileges." Just like many activities in the second economy (i.e., the privileged money-making opportunities through bribery, monopoly, access to information, connections), it created supporters of the prevailing undemocratic political and corrupt economic arrangements.

Economic System. The most important reform measures were the following:

1. Reduced the scope and rigidity of the central plan.

2. Changed the plan instruments: plan directives and material allocation through the system of material balances were replaced with indirect regulators.

3. Increased, in a limited way, the autonomy of enterprises (for certain categories more than for others), in most cases creating dual dependence for them: vertically on the authorities and horizontally on suppliers and customers. This established, in Bauer's phrase, an economy that was neither fully centrally planned nor anywhere near fully a market system.
4. Enlarged the second economy, but in a way that simultaneously promoted and constrained it. On the one hand, the austerity program that was in place in the 1980s put great pressure on the work force to have two jobs (one in the first economy, for the sake of security and its entitlements; and one in the second economy, for money, and in some cases for creative satisfaction). It also gave opportunities, selectively, to engage in them. (Selectively because one had to have the right marketable skills or access to a plot of land.) But, at the same time, the expansion of the second economy contravened with many other objectives (ex: social ownership of the means of production, price stability, and successfully competed for the first economy's most productive labor). For this reason, actions toward the second economy were schizophrenic and of Rube-Goldbergian complexity, with the design changing frequently as the authorities attempted to reconcile many contradictory objectives. As a consequence, the efficiency of the second economy remained low and the cost to its participants high. About half of the work force had to have two jobs, so that Hungarians, on average, were reported to have worked longer hours than any other nation's work force, leading to stress and to a significant deterioration in health and demographic indicators. The relationship between the first and second economies was full of bureaucratic irrationalities (less so in agriculture). This contributed greatly to the corruption that mushroomed. That, in turn, was a factor in the growing cynicism on the part of the population against a "model" that not only tolerated but seemingly encouraged all kinds of inefficiencies. But in spite of all these negatives, reforms in the second economy were sufficiently important to generate all of the economy's modest growth in the 1980s.
5. A series of reforms during the 1980s created some of the institutional preconditions of a market system. Specifically: the authorities began to break up some of the large trusts in production and distribution and introduced legal provisions for establishing subsidiaries and new ventures (1979); combined three industrial sector ministries into a single ministry, putting it in charge of industrial policy (1980); decentralized more and more of foreign trade decision making (since 1980); eased and then eliminated production profile restrictions (1982-85); introduced a system of tenders for managerial positions (1983); introduced the right of enterprises to issue bonds (1983) and established a "stock market," where the bonds could be traded for an hour or so once a week; set up enterprise councils to elect and "supervise" the director (1985); enacted a (weak) bankruptcy law (1986); created a two-tier banking system, without, however, all the conditions that would make it possible for commercial banks to be largely profit driven (1987); and because the first CMEA country formally to propose a fundamental revamping of the CMEA's trade and financing system (1988-89).

Reforms and Economic Performance

While one should not minimize the importance of the many reform steps taken between the mid-1960s and the end of the 1980s, they did create an exaggerated impression in the West of what was taking place: "Hungary's reforms always going further and further." (It is only fair to admit that the author himself, in his previous writings, was much more taken by the apparently significant extensions of the reforms than he is today, in 1991.) One useful purpose of the conceptual framework is that it provides a perspective not only on what changed during the reform period but also on what remained unchanged. At the same
time, one must not go too far in the other extreme and dismiss as insignificant the reform steps taken and what they accomplished.

The institutional and policy changes improved somewhat the economy’s performance. Equally if not more importantly, they laid the ground for a more fundamental transformation in the future.

The fundamental and mutually reinforcing problems that remained were these: Ill-defined ownership, no market for the factors of production, weak financial discipline on enterprises and for the state budget, no clear criteria for investment decisions other than the interests of the lobbies (partly a consequence of the ill-defined ownership structure), exceedingly heavy taxation, and an incredibly complex and continually changing system of administrative and financial regulation that tried, unsuccessfully, to reconcile a series of incompatible objectives, strategies, and system features.

None of the reforms introduced until the end of the 1980s solved the fundamental question of ownership. The reforms did not succeed in designating an individual or an institution to have full property rights, that is, with full responsibility for an the right to appropriate the returns on productive assets. In the final analysis, the authorities remained owners and regulators of state enterprises. Regulation was often enterprise specific to achieve economic and social objectives, e.g., domestic supply, exports, employment, and price stability.

These unsolved systemic problems in large part explain the Hungarian economy's unsatisfactory performance. They were compounded by a number of major mistakes in
economic policy. The most significant policy mistake was allowing foreign credits to rise much too rapidly.

At the same time, however, the reforms did yield significant results, especially in agriculture and in the second economy, i.e., the private sector. Living standards improved considerably in the 1960s and 1970s (thereafter the improvement was based on foreign credits). Hungary was able to move away from the classical shortage economy. The supply, assortment, and quality of food and many other consumer and industrial products became significantly better than in most other CPEs. Queuing in retail stores was eliminated (but continued for a segment of the housing market, cars, and major repairs). For tourist purposes within the CMEA, the forint became practically a convertible currency. Many of these improvements could not be captured readily in standard economic statistics, such as the growth rate. Also, since 1968, Hungary’s economic statistics are considered by experts to be much more reliable, much less subject to exaggerations and distortions, than those of a number of East European countries against which its performance is often juxtaposed.


Why Is Transformation Essential?

Political Aspects

The transformation of Hungary’s economic system is a must for two sets of interrelated reasons: economics and politics.

Certainly the traditional, and even Hungary’s modified CPE system had exhausted itself by the 1980s. It was increasingly realized by the experts as well as by the population
that mere tinkering with the system will be unable to halt Hungary's economic decline relative to Western Europe and the newly industrialized countries.

The political imperative of transformation arose from the fact that the Soviet-type economic and political system was alien to the country, and so it could be preserved essentially only by force. As soon as Gorbachev repudiated the "Brezhnev doctrine" because it stood in the way of detente with the West which Gorbachev needed in order to enlist the West in helping him implement economic reforms in the USSR, the repudiation set in motion forces throughout Eastern Europe that the region's communist leaders became unable to control.

The repudiation of the Brezhnev doctrine made it possible for Hungary's politically attuned population to express long-suppressed views and desires. The communist leaders who succeeded Kádár in 1988 introduced a series of political liberalization measures, intended as lightning rods for the pent-up tensions of the population. As concession after concession was made, the leadership faced increased opposition from the conservative wing of the Party. The attempt of Party Secretary Grosz to pacify the conservatives while making concessions to the reformers and the opposition caused him "to speak from both sides of his mouth." This, in turn, diminished his credibility and became a key factor in the Party's disintegration, which the Soviet Union could not halt without the use of force. In 1989, Hungary's communist party granted the ultimate concession to the opposition: the promise of free elections. It soon became clear that only parties that pledged a sharp break with the communist economic and political system could hope to win sufficient votes to form a
government. In free and fair elections that were held in the spring of 1990, the communist party (i.e., the reform wing of the old party, now called the Socialist Party) came in fourth.

Economic Aspects

Let us return briefly to the statement that by the 1980s the CPE system had "exhausted itself," became a spent force, in Hungary and in most if not all of the other countries in the region. What factors explain this?

In brief, during the postwar period, Hungary (as well as its neighbors) was able to rely upon a series of temporary factors that supported a credible rate of economic growth.

During the 1950s, the authorities mobilized unemployed and underemployed labor and other resources, increased investment in human and physical capital at a rapid pace, and got the resources needed to finance these activities by imposing a high rate of forced savings on the population and by neglecting infrastructure. The authorities deployed the large increases in inputs into sectors of relatively high productivity, such as industry and construction, and thereby quickly achieved impressively high rates of growth of output. Eventually, however, the rapid forced mobilization of the economy had to be moderated as the growth of inputs slowed, more and more bottlenecks appeared, and the population expressed its resentment about these policies in the Revolution of 1956.

During the 1960s and early 1970s, Hungary's emerging problems (which a growing number of their own experts began to attribute, some as early as the second half of the 1950s, to the shortcomings of the CPE system) were held in check by two factors. One was the temporarily improved performance brought about by limited economic reforms, prompted by the current economic and earlier political crisis and by the example of the Liberman-
Kosygin reforms in the USSR. The other was the benefit that Hungary (and the other East European countries) derived from bilateral economic "integration" of a special kind with the USSR. This took the form of a rapid expansion of trade. Hungary obtained growing quantities of cheap energy, raw materials, and energy- and material-intensive semimanufactures in exchange for products of the light industries, foodstuffs, machinery and equipment, and other manufactures. Moreover, cheap Soviet energy and raw materials facilitated the development of metallurgical and standard manufactured products, some of which were exported to the West, where they earned convertible currency. This made it possible for Hungary to put aside worries about obtaining crucial supplies of inputs or finding markets for its rapidly growing and often poor quality output.

But this was only temporary. The USSR became less and less able and willing to continue integration along these lines. Hungary began to realize that the short-term benefits of this type of integration were offset by their long-term costs. Integration with the USSR helped create and sustain an outdated industrial structure and mode of production that were excessively wasteful of inputs.

Also during this decade, Hungary found a new source of growth: the rapid expansion of trade with the West, a significant part of it supported by large Western credits.

By the late 1970s and early 1980s, Hungary could count on none of the three growth support mechanisms it enjoyed during the previous decades: rapid mobilization and deployment of inputs, integration with the USSR, and Western credits. The rate of growth of complementary domestic inputs (capital and labor) came to a complete halt. The share of investment in national income could not be increased any longer at the expense of
consumption. Practically all who could be employed were already in the labor force, and all who could be shifted from less to more productive sectors were transferred. At the same time, more and more serious bottlenecks appeared in agriculture, material supplies and intermediate goods, components and spare parts, modern technology - generally convertible-currency imports - and in infrastructure and the service sectors. These bottlenecks precluded the earlier possibility of redeploying increasingly scarce resources into sectors with quick payoffs in terms of growth of output. They also revealed that something was fundamentally amiss with the country’s economic policies and system.

During the early 1980s, Hungary suddenly found itself unable to borrow further large sums from the West with which to finance a net inflow of resources from abroad and was saddled with interest on a large outstanding debt, whose payment required a substantial net resource outflow. This could be realized only by a drastic cut of imports from the West, which in turn had all kinds of adverse short- and long-term economic consequences. The tension in Hungary’s convertible-currency balances of payments, which used to occur periodically, now became chronic. The sustained stagnation of the economy, in turn, helped to undermine the relative political stability that characterized the regime of Kádár for about 15 years (1964-1978).

More far-reaching reforms - fundamental systemic transformation - were thus needed. Why Is the Early Stage of Transformation So Difficult?

Three sets of reasons explain why the environment is exceedingly difficult during the early years of systemic transformation: the legacies of the system, new external economic shocks, and unrealistic economic expectations of the electorate.
Legacies

The accumulated legacies of several decades of traditional or modified command economy include:

- A neglected infrastructure whose increasingly frequent breakdowns are causing severe problems;
- Environmental pollution that is much worse than in the western part of Europe and can no longer be neglected;
- Trade excessively oriented toward one another's uncompetitive markets;
- A large and growing volume of non-performing loans to enterprises are held by banks, whose ability to support the healthy sectors of the economy is thereby limited;
- A large foreign debt, the servicing of which requires the transfer of 3-5% of GNP to the West at a time when Hungary itself requires large net resource inflows to help rebuild its economy. Much of the money was borrowed by the previous regime to keep the economy, including consumption, afloat in the face of deteriorating economic performance, and to avoid having to make fundamental systemic changes.

New External Shocks

The first of these shocks is trade-related. The deepening crisis in the Soviet Union, Hungary's largest trading partner, means disruptions for all the central and eastern European countries in the supply of energy, raw materials and other essential imports. To the extent that such goods are available, they now have to be paid for in convertible currency. Moreover, Hungary has accumulated surpluses with the USSR which it cannot readily convert into the kinds of goods or currencies it requires.
Given the difficulty of reorienting trade to the world market, and improving quality, the decline in trade is severely disruptive, with multiplier effects. Trade with the eastern part of Germany has also been disrupted as suppliers from the western part are replacing earlier sources from the CMEA countries. In 1990, however, Hungary proved able to increase rapidly its exports to the West.

As of 1 January 1991 all of intra-CMEA trade has been conducted at current world market prices and settled in dollars or other convertible currencies. The move to world prices will have large adverse impacts on Hungary’s current-account balances, although this change in the system of trade is essential.

Having to reorient trade to the West comes at a time when world energy prices are very uncertain. This increases the pressure to restructure Hungary’s energy-intensive industries. In addition, the Gulf crisis has more severe economic implications for Hungary than for the Western European countries because it depends much more on energy imports and because Iraq and Kuwait were important trading partners.

As the external payment surpluses of Germany and Japan decline while world-wide demand for capital increases, a global shortage of capital may emerge. This does not bode well for the countries of central and eastern Europe, either in terms of attracting new foreign investment or easing the burden of servicing their outstanding debts.

Unrealistic Expectations

The euphoria triggered by the demise of the communist political system was accompanied by unrealistic expectations by the population that regime change will bring about an immediate and sustained improvement in living standards. In Hungary, unrealistic
expectations were reinforced by the unrealistic campaign promises made by all of the main parties. For example, of the parties that became coalition partners in the new government, the Democratic Forum pledged a calm and relatively painless transition to a market economy while the Smallholders promised to return agricultural land to former owners. The first promise was a mistake because it raised unrealistic expectations among the population and because it led to the new government showing no sense of urgency in attacking major economic problems. The promise to return the land was a mistake because it took a year of fierce debate to convince much of the country that there was no practical way of doing it without disrupting agriculture and plunging the country into years of litigation about all nationalized assets.

Fundamental Dilemmas of Economic Transformation

In addition to the obvious and costly legacies of a CPE that were mentioned and the new external economic shocks that were enumerated, there are certain less visible but equally fundamental and difficult problems that make the path of transition to a market economy such an arduous and economically and politically painful one. Some of the main difficulties and dilemmas are discussed below in some detail.

Inflation and Monetary Policy

One of the legacies of all the countries of Central and Eastern Europe is pervasive shortages. Shortages can be caused by two distinct phenomena. One is the unavailability of goods and services in the right quantities or assortment, or at the time and the places needed, i.e., the poor matching of demand and supply at micro levels, even though the economy's total supply at prevailing prices and total purchasing power may be in balance. All CPEs,
even those like Hungary that have undertaken significant reforms, face this problem to a greater or lesser extent.

The second - and more traditional - source of shortage is repressed inflation, the result of excess money and credit creation, together with price controls. This causes the involuntary accumulation of financial claims (the so-called "monetary overhang"). Excess money and credit creation is a policy decision whose roots can be traced to politics or to the unforeseen consequences of certain reforms, such as devolving greater authority to enterprises before they become subject to market discipline ("autonomy without responsibility").

Political leaders in Hungary had tried, at various times during the 1970s and 1980s, to "buy" political support from the population and from vested interests by distributing more than could be produced, and then resorted to printing money and large foreign borrowing.

The fundamental problem with repressed inflation is that it leads to further price distortions, so that prices or profits can be relied upon even less than before as guides to resource allocation. Repressed inflation also forces enterprises and households into time-consuming search for supplies through queuing, connections and barter. For the economy as a whole, this represents a huge and avoidable economic waste. The spillover effects of repressed inflation generate a peculiar distribution of enterprise and household incomes and wealth, and a great deal of social tension. Repressed inflation perpetuates the sellers' market and reinforces just those dysfunctional aspects of behavior that are characteristic of producers under central planning, namely, paying scant attention to costs, product quality, modernity, and service. For all these reasons, large repressed inflation must be eliminated.
The main policy options are some combination of a significant jump in imports that is paid for by drawing down foreign exchange reserves or borrowing; a currency reform that confiscates financial balances above certain levels; the sale of state assets to the public; and letting prices find market-clearing levels, i.e., corrective but hopefully temporary open inflation.

Large foreign borrowing is not an option for Hungary that already has a large foreign debt.

Confiscating private financial claims would not be an auspicious start for a government in a transition economy that faces the urgent task of making private property legally and politically secure.

Selling public assets, especially housing and small-scale business, has much to recommend it, except for the argument that many of those who have the money to buy belong to the old "nomenklatura," who used their privileged positions to accumulate private wealth.

Allowing prices to find market-clearing levels is a measure that will eliminate the macroeconomic imbalance and its accompanying ills, provided that the high rate of inflation can be stopped or reduced significantly and quickly, which is exceedingly difficult, for the reasons that will be stated.

Even countries that do not inherit a large repressed inflation must contend with the fact that significant inflationary pressures will be generated by the policies that are necessary during the transition to deal with certain undesirable legacies of the old economic order. Specifically:
Reduction of subsidies to producers and freeing prices in an economy where producers face little competition and weak financial discipline will generate inflationary pressures.

Strong new pressures for increased wages will emerge as subsidies on consumer goods and services are reduced and as firms in the socialist sector obtain greater autonomy. Two factors are at work. One is that more than one quarter of the average wage-earner's total compensation has been paid by the state - the main employer - in the form of free or subsidized goods and services, e.g., on bread, dairy products, children's clothing, housing, transportation, medical care, education, and culture. If consumer subsidies are to be reduced without a precipitous decline in real incomes, wages and salaries must be adjusted. In any event, the actual or perceived decline in the living standard that accompanies open inflation (together with the inflation-induced changes in the distribution of income and wealth) will generate strong pressures for wage increases.

Upward pressures on wages is reinforced by another legacy of the system: the absence of real owners of capital to resist the push for unjustified wage increases. Hungary's earlier reforms had devolved business decisions from the state bureaucracy to newly-formed enterprise councils that are run jointly by managers and workers. Arrangement under which workers "control" managers is a recipe for wage-push inflation.

Policymakers face a difficult dilemma during transition: should wages be allowed to be "market" determined and then live with its inflationary consequences, or should restrictions on wages be continued, its rigidities notwithstanding? And if wages remain controlled in the socialist sector while they are uncontrolled in the private sphere on the
grounds that the private sector has real owners, would that impede the effective restructuring of state-owned enterprises and large cooperatives?

A depreciation of the exchange rate, in real terms, will almost certainly occur during the transition toward a market economy, which will generate price pressures.

Moving to world market prices and convertible-currency settlement in intra-CMEA trade: Hungary, as of 1991, trades at world prices and settles in dollars when it does business with the USSR. As the prices of energy imports from the USSR increase and the prices of Hungary's manufactures exports decline, Hungary's terms of trade deteriorates and this, too has inflationary consequences.

Servicing the large foreign debt requires large net transfers abroad. Domestic absorption will have to stay below production, generating inflationary pressures.

Rising inflationary expectations, as open inflation accelerates, becomes a problem. Expectations trigger actions that feed inflation, such as precautionary and speculative purchases of consumer goods; flight from more into less productive assets, such as gold and land; and capital flight.

Controlling inflation is notably difficult during transition. Although the policy dilemmas are somewhat different in the countries where open or repressed inflation is very large vs. those where inflation is more moderate, the fundamental policy options are the same in both cases. One option is to try to get inflation "out of the way" rapidly by bunching together many of the factors that account for it, and then trying to wring out inflation quickly, through some type of a shock treatment. The other option is to handle the matter more gradually and opting for less drastic ways to try to control inflation. In either
case, inflation is more difficult to control in a post-Soviet-type economy than in developed market economies, and for several reasons:

Wage push inflation is difficult to halt without government intervention, as long as much of the workforce is employed by enterprises that are state-owned, partly worker-controlled, and largely non-competitive. The government’s choice seems to be either to follow such tight monetary and fiscal policies that many enterprises will have no choice but to lay off workers, or to control wage increases administratively by imposing prohibitive taxes on wage increases above certain levels, as did Poland in 1990. In a transition economy, state controls on wages probably distribute the burden of stabilization more equitably than would exclusive reliance on tight monetary and fiscal policies.

Commercial banks do not respond to tight monetary policy the way banks do in a market economy. One legacy of the system is that banks do not, as a rule, push enterprises with "nonperforming" loans into bankruptcy. When the commercial banks were established in Hungary in 1987 by sloughing off a part of the former monobank that performed both central and commercial banking functions, they were given an arbitrary portfolio of assets (outstanding loans to enterprises and government entities) and liabilities (enterprise and household deposits), without sufficient reserves to write off the bad loans. Therefore, insisting that banks try to collect all bad loans would mean bankruptcy for the banks also, which the authorities cannot allow.

Enterprise behavior is different. Even in Hungary, the country that over the years has progressed further with reforms than the other countries now entering transition, enterprises have found ways around tight monetary policies (that the authorities have pursued
for several years) by "credit queuing," by selling off real estate and other assets, and by using a part of the cash flow generated by depreciation to pay wages rather than to maintain the capital stock fully.

Queuing comes about when state-owned firms cannot obtain grants from the state or financing from the banks and the firms respond by delaying payment to their suppliers. Suppliers will typically grant involuntary credits because in these highly concentrated and protected economies they will not readily find alternative buyers. Also, suppliers have no ways of knowing the true financial condition of a buyer. Perhaps most important, suppliers expect, based on past experience, that any socialist enterprise in financial difficulty will somehow be bailed out by the authorities. The buyer may be unable to pay because it is de facto illiquid or bankrupt or because it, too, has felt compelled to extend involuntary credits to other enterprises, and so on down the line (or "queue"). In a market economy, where enterprises have real owners, there are economic incentives for creditors, at some point, to force non-paying debtors into bankruptcy, or for the debtor to voluntarily declare itself bankrupt. No one seems to have an economic interest in bankruptcy because no one cares if unsound business practices further dissipate the value of an enterprise’s assets. Thus, until the practice of bankruptcy takes hold and becomes an effective threat for enterprises that perform poorly, monetary policy cannot be fully effective and the behavior of enterprise managers is unlikely to be fundamentally altered.

The only way around these problems - before real owners are found and market institutions are created, which will take time - is for the authorities to institute draconian measures, something like the program in Poland. But enterprises - not being accustomed to
such pressures and not having much experience in how to be flexible, how to cut costs, how to find new markets and adapt to their requirements - tend to move slowly; their "supply responses" are weak. In the meantime, production may decline precipitously and cumulatively and unemployment jump.

Considering the role of the banking sector in making monetary policy more effective, it is a truism that the financial status of the commercial banking system is basically determined by the financial conditions of enterprises in the economy’s real sector. If the banks’ equity is zero or negative and their budget constraints are hardened by the central bank without the banks’ portfolios having first been restructured, then the banks will attempt to cover their nonperforming loans by raising charges to those who can afford to pay them. As a result, healthy firms could face extremely high costs of credit and could be crowded out.

Weakness of the financial sector can thus be an important reason for weak supply responses in the real sector, and thus of the high cost and political unsustainability of tight monetary policy during the transition. Consequently, early during the transformation, high priority should be given to the restructuring of bank portfolios and to the recapitalization of assets that are nonperforming and for absorbing the future losses that will be generated by changes in factor and product prices, induced by reductions in subsidies, changes in taxation, enhanced competition, and the restructuring of state firms before their sale. As to who might cover the losses, one possibility is absorption by the budget; another, distribution to all producers as a special charge or surtax. 9
Fiscal Policy and Taxation

One legacy Hungary and the other economies face is the very large share of the GDP that is channeled through public coffers: more than 60%, which of course has to be covered by taxes. Extensive redistribution in the form of transfers and subsidies to and from enterprises and households is a widespread practice.

The main objective of fiscal policy during the transition should be, first, to substantially lower the level of spending, and then to reduce the tax burden on producers and households, commensurate with a balanced budget, which is necessary to control inflation. How to go about these tasks, economically and politically, is one of transition's main strategic issues.

Several systematic factors add to the usual difficulties of streamlining the budget during the transition. By "usual difficulties," I mean the kinds of political problems that have been brought into sharp relief by the seeming inability, for years, of politicians in the U.S. to agree on a responsible budget.

Fear of Domino Effects. As long as production remains highly concentrated and competition is weak or absent, policies on subsidy reduction have to be mindful of the danger of large domino effects. There is concern that the bankruptcy of one or a group of enterprises would trigger the unintended bankruptcies of large numbers of other firms, owing to the extremely high concentration of production in a small number of monopolistic or oligopolistic firms. Therefore, widespread and deep cuts of subsidies to producers may have to be preceded by a program of deconcentration of production and other measures to strengthen competition.
Absorbing the Losses of the Banking System and the Presale Cost of Restructuring.

It is difficult to envision how the government budget could remain adversely unaffected by the cost of cleansing commercial bank portfolios of nonperforming assets and by the probable large cost of restructuring state enterprises before they are privatized. These facts, and the logic of a sound tax system, suggest the urgent need to broaden the tax base.

Privatization and Taxation. The rapid expansion of the private sector through increased entrepreneurship and privatization is likely to reduce tax revenues (absolutely or as share of profits) in the short run. It will take time for new private ventures to become profitable. Firms in the private sector (especially the smaller new firms) are likely to understate revenues and find tax loopholes. Also, it will take time for the tax authorities to get organized and to monitor the tax returns of, and enforce collections from, the mushrooming number of new private ventures.

A Social Safety Net Must be Created. One legacy of the old system is the almost complete absence of a social safety net, most importantly, unemployment compensation to workers. Until now, the social safety net consisted of the state guaranteeing a job for everyone in the socialist sector, together with tying benefits of all kinds (e.g., health care, subsidized food or meals, vacations, and in some cases, housing) to such employment. One reason it has proved difficult to impose financial discipline on enterprises is the concern about what would happen to a bankrupt firm’s workers. Establishing and funding a social safety net - whose main pillars should be unemployment compensation and a guaranteed minimum annual income - will place a large burden on the state budget, especially during the early phases of the transition, when unemployment can be expected to rise significantly.
Loss of Revenue on Trade with the CMEA. Up until now, Hungary’s state budget obtained substantial revenues by taxing the difference between the low price of energy and certain raw material imports from the USSR and the higher domestic price charged to users, based on the prevailing world price. With the conversion of intra-CMEA prices to world prices in 1991, state budget revenues will drop sharply. More generally, conversion of intra-CMEA prices to world prices and settlement to dollars will trigger losses of enterprise revenues and thus cause a reduction of their tax payments.

Infrastructure. Investment in building new and maintaining the old infrastructure has generally been neglected, as testified to by the quality and modernity of these countries’ housing, transportation, telephone, telecommunication, and medical facilities. One reason that economic performance has declined in all of the countries in recent years is the increased number of bottlenecks created by the neglect of infrastructure. Overcoming this bottleneck is one of the best ways to attract private domestic and foreign investment.

Environment. The extent of environmental degradation is immeasurably worse in the Eastern than in the Western parts of Europe. This is explained partly by the East’s priority to develop mining, metallurgy, the chemical sector, and other heavy industries; and partly by simple inattention. It is urgent that environmental regulations be tightened and enforced and that a long-term program of clean-up be adopted and financed, from domestic and perhaps partly from external sources.

Privatization

Many experts believe that there are no proven means for efficient and fully competitive markets to develop and for producers to be motivated toward efficiency,
customer satisfaction, and innovative behavior if most of the means of production are owned or controlled by the state or by the workers. Therefore, privatization is a cornerstone of successful economic transformation.

The state is in a very poor position to effectively exercise ownership functions, that is, to protect the value of its assets and to insure their efficient use. In trying to exercise its ownership functions, the state is hampered by the arbitrariness of factor and product prices (that in part is inevitable when the state is both the dominant buyer and seller), by the "distance" (in an informational sense) that exists between itself and individual enterprises, by the sheer scale of the tasks of coordination, and by the immense difficulty of establishing incentives for the efficient use of capital.

If enterprises, especially the large ones, are controlled by workers, their interests are likely to center on job security and pay rather than on the rate of return on the assets invested.

As yet, neither Hungary nor any of the other transforming European countries has put in place the full complement of laws and policies that set out clearly the scope, the speed, and the strategies of privatization. Privatization's major dilemmas include:

Workers Have Ownership Rights. In Hungary (as in Poland and Yugoslavia), earlier reforms have transferred some of the (not always clearly defined) ownership rights to workers or their elected representatives, in the mistaken belief that this would improve efficiency. Workers with a say may oppose privatization or object to terms of the sale that would be acceptable to a private owner. The two main policy options are to continue to allow workers a say in privatization or to "re-nationalize" such enterprises, returning to the
government all rights of ownership. The latter appears to be the preferred solution on economic grounds but it is politically exceedingly difficult because individuals do not wish to give up the rights they have acquired and because renationalization appears to be a step backward.

**Who Should Restructure?** Most businesses will require considerable restructuring before or after privatization because they are typically overstaffed, lack modern production and marketing expertise, and cannot raise sufficient capital in their present state. Restructuring the work force and management in large firms is perhaps best handled by the state prior to the sale because leaving this task to the new private owners would create immense political difficulties. But physical, technical, and financial restructuring is perhaps best handled by the new owner. All this is easy to state as a general principle but is very difficult, politically and practically, to implement in practice.

**Insufficient Domestic Purchasing Power.** There is insufficient accumulated domestic private wealth to find buyers for more than a small fraction of the enterprises to be privatized. And those who possess significant capital often have acquired it in ways the public does not consider legitimate. The main options are (1) to gear the scope and speed of privatization to the availability of private domestic and foreign capital; (2) to give every citizen a share in every enterprise, via holding companies; (3) to finance a portion of the equity acquired by nationals of the country with a special line of credits; and (4) to make large sales and/or placements to workers, pension funds, mutual funds, local governments, insurance companies, non-profit foundations, and like organizations. Each solution has advantages and disadvantages. Some combination of (1), (3) and (4) would seem to be the
best strategy. Option (2), distributing the assets free of charge, appears to have the least economic merit, except for the political support that it could generate for the process, which may be essential. Economists argue that if everybody owns everything then, in effect, no one owns anything and the managers in place would retain an inordinate amount of power. Another proposed solution, transferring firms to their employees, is problematic. Property has been accumulated at the expense of all of society, so why should one favored group get something for nothing. To be sure, granting partial ownership to workers on preferential terms certainly has political and perhaps also some economic merit.

Impact on Income and Wealth. Even though successful privatization will eventually make all of society better off, during implementation it increases the inequality of income and wealth, and it does so at the very time when the public faces accelerating inflation, unemployment, and stagnating or declining living standards. Therefore, unless strong political forces can be mobilized in support of privatization, the political tensions that privatization is likely to generate can become an obstacle to successful transformation.

Impact on Competition. Many sectors of production and distribution are dominated by monopolies or oligopolies. Therefore, it is necessary to consider the effects of each privatization on competition.

Valuation. How should state property offered for sale be valued? One problem is that costs, prices, and the accounting system are arbitrary; a more fundamental one, that private investors are typically willing to pay only the price warranted by the firm’s existing level of efficiency and earnings, while the population, the press, and most local politicians would like the investor to pay for future earnings that are expected after the improvements.
This is as much a political as an economic debate. Many who are against privatization, whether because of ideology or envy, use economic arguments against privatization to support their point of view. It should be recognized that no legislation can be devised that would insure a "fair" transaction price other than what a buyer and a seller voluntarily agree upon, under a well-functioning market system. Privatization is such a difficult problem because the seller is the state and not a private individual and because the markets in these economies are as yet so imperfect. For both reasons, the public will inevitably be suspicious - often justifiably so - that private individuals are obtaining advantages, at the public's expense.

Privatization Procedures. Some experts recommend that to assure a fair price, the state or its agent should establish, publicize, and enforce fully competitive and transparent privatization procedures, encourage the largest possible number of domestic and foreign individuals, groups, and organizations to participate, and then let the market determine value. Others point out that having to announce the intention to buy or to sell a state-owned enterprise, and being forced to compete with other bidders, is time-consuming and can deter prospective domestic and foreign buyers. Also, competitive bidding can drive the acquisition price not only higher but also lower.

There are many additional difficult issues, such as the handling of the financial and environmental liabilities of an enterprise when only some of its assets are sold; the issue of compensation to the previous owners who were expropriated; and the special problems of privatizing land and housing.
In sum, all privatization issues are extremely sensitive politically. It is worth noting that while the privatization experiences of market economies can offer helpful insights, in Hungary and the other economies in transition it has to take place on a much larger scale and in an environment in which much of the capital and many of the essential supporting institutions are missing or as yet underdeveloped.

**Foreign Economic Liberalization**

Foreign economic relations that must be liberalized encompass relations among the seven European members of the CMEA, imports from convertible-currency sources, exports to the same group, foreign direct investment, and financial links with the rest of the world, i.e., moving toward currency convertibility.

**Revamping the CMEA.** The essence of the CMEA is a common set of rules for coordinating production and investment plans, implementing bilateral trade agreements, and settling commercial balances among the members.

Intra-CMEA arrangements have always mirrored the basic features of the members' domestic economic systems. Thus, as long as governments owned most productive assets and economic activities were centrally planned, it was natural to plan in detail also the size and composition of intra-CMEA trade flows. As long as domestic prices were arbitrary and not generally relied upon for resources allocation and thus signal comparative advantage, prices in intra-CMEA trade also had to be decided and remained largely irrelevant for trade decisions. (Various averages of world market prices were periodically agreed upon, from which departures were bilaterally bargained.) And as long as the members' currencies could not be converted domestically into either usable currencies or into goods, neither could the
national currencies or the so-called transferable ruble become a convertible means of payment. Intra-CMEA trade had to remain bilaterally balanced, since accumulating a surplus was disadvantageous to the creditor country.

Intra-CMEA relations have always been characterized by large tensions. One source of conflict has been the growing divergence in the economic systems of the member countries. For decades, each country has been proposing institutional reforms for the CMEA that would be the most compatible with its domestic economic system. But, over the years, nothing much has changed in the CMEA as long as the economic system of the dominant partner, the USSR, has remained basically unaltered.

Another source of tension arose over the ability and willingness of the Soviet Union to export to its partners growing quantities of "hard goods" (energy and raw materials that are readily exportable to the rest of the world) in exchange for "soft goods" (manufacturers that are uncompetitive on the world market). The Soviet Union has maintained with Eastern Europe what would appear to be a disadvantageous pattern of trade, partly for political reasons (to hold together its alliance system) and partly for economic reasons (its producers became accustomed to technology and goods from Eastern Europe, even though many East European products were not up to world standards). For Eastern Europe, the result of this seemingly advantageous pattern of trade was an ever-deepening structural dependence on the USSR, making their economies ever more vulnerable to adverse developments or decisions by the dominant partner.

During 1989-91, all these tensions have intensified and new ones have emerged. Directions of economic systems change among the countries have begun to diverge more
fully. The political rationale for maintaining the existing structure and arrangements of intra-CMEA trade have been disappearing. And the Soviet economy’s growing crisis and uncertain future are prompting a hurried scramble on all sides for alternatives to intra-CMEA trade and the prevailing institutional arrangements.

Change is a must because the CMEAs long-standing arrangements are not compatible with a decentralized, market-driven, open economy towards which Hungary and the other Central and East European nations wish to progress.

The most essential step is discontinuation of the state-trading system (with the possible exception of trade in energy and certain primary products). Maintaining state trading would mean the preservation of a major role for governments in enterprise decisions.

Eliminating state trading is not the same as changing the system of intra-CMEA pricing and currency of settlement, which can be modified independently. In June 1990, the Soviet Union abrogated its long-standing bilateral agreements to settle intra-CMEA transactions in transferable rubles (TR). With the GDR having been united with the Federal Republic, switching to convertible-currency trade has already occurred. Uncertain is whether the states’ obligations to deliver and purchase specified products will remain in force, explicitly or (perhaps under a new name) in substance, in which case, economic liberalization will remain constrained, for the reasons discussed in [Kőves].

**Liberalizing Imports from Market Economies.** Central planning means, by definition, the full protection of domestic producers against foreign competition. Import liberalization is important to promote exports, to help control inflation, and to foster competition (especially necessary in a small economy like Hungary’s. There are important differences in the ways
in which protection is practiced in market economies (including developing countries) and in CPEs. In market economies, domestic producers are protected via tariffs (or their equivalents, such as import deposits and differential exchange rates) or explicit quotas; all these measures raise the domestic prices of the protected imports and import substitutes.

In CPEs, where domestic prices are administratively controlled, tariffs do not exist, or if they do, they serve only as an instrument of commercial policy to bargain tariff cuts with market economies. Protection is provided through implicit import quotas, set at zero for all goods whose import would compete with domestic production. Implicit quotas have no impact on the domestic prices of those imports or import substitutes as long as prices are administratively controlled [Oblath]; imports are "managed" through queues and administrative allocations. Import substitution, though pervasive, is not in response to price signals but to their unavailability due to foreign-currency shortage. (One consequence of this is that the pattern of import substitution is inefficient.) These features of the system - which have survived even in countries that had introduced reforms, like Hungary, have implications for the modality of import liberalization during the transition.

The main policy issue is the pace and strategy of liberalization, that is, the import of which goods should be liberalized first, and to what degree?

Import liberalization will be easier to implement in Hungary because over the years the country has introduced significant reforms in foreign trade by weakening and eventually disbanding the monopoly of foreign trade, by granting foreign trading rights to a growing number of business entities, and by abandoning the monopolization of production and trade
of various economic activities. (For details, see the chapters on Hungary in [Köves and Marer].)

Decontrolling Exports. The control of exports is as much a basic feature of a CPE as is the control of imports. Who can and should produce for export, who is authorized to make what deals, the terms and conditions of foreign trade transactions, the channels of sourcing and the disposition of output are all controlled. Other system features also represent an anti-export export bias: discrimination against small producers by the system generally and by the foreign trade organizations specifically that typically opt for large-volume transactions and therefore prefer dealing only with large firms. Export competition among domestic producers has until now been discouraged. Supply responsibilities on the domestic or CMEA markets that are assigned to specific firms also hinder exports, as do "profile" restrictions that prohibit producers from engaging in new activities. The greatest source of systemic anti-export bias is, of course, pervasive administrative controls on imports. In sum, decontrolling exports is as important as the liberalization of imports.

Promoting Foreign Direct Investment. International experience has shown that, at some stage of development, a relatively open system of foreign direct investment (FDI) becomes an essential part of increased openness and integration into the world economy. FDI promotes the cross-border flow of technology, know-how, marketing, management, foreign trade, and finance. Although since 1972 Hungary has permitted FDI reluctantly, under certain circumstances, the participation of foreign capital has been marginal until now. This contrasts with countries of similar size and level of development in Western Europe and
in many other parts of the world, where foreign capital has played an important role in post-
war development.

The two key issues for policymakers are: what role do they wish to assign to foreign
capital at various stages during the transition and, if an increased role is desired, what
policies would promote this?

The attractiveness of a country for foreign investors is determined largely by the
domestic business climate. This is largely a function of economic conditions (including the
adequacy of the infrastructure) and the government’s economic policies; the prospects for
political stability; and the complex of laws and regulations that affect business generally,
including currency convertibility.

Also significant is current and prospective access through foreign investment to other
markets in the region. This is why the prospects of how the CMEA countries will
reorganize themselves, and the kind of access that Hungary is expected to enjoy to the
European Community, are important strategic considerations for prospective investors.

Currency Convertibility. There are many different kinds of convertibility. The
alternatives are defined by answers to these questions: (1) convertibility for whom and for
what kinds of transactions; and (2) what other limitations are there on cross-border
transactions?

"Convertibility for whom" distinguishes between residents and nonresidents, further
divided into the enterprise and household sectors.

"For what kinds of transactions," the basic distinction is between the current account
and the capital account in the balance of payments. Within the capital account, convertibility
may be granted only on certain items, for example, the amortization of loans, depreciation on
direct investment, or the repatriation of capital.

Beside the outright prohibition of exchanging a given currency at all or for certain
purposes, governments can impose

-- selective limitations on the use of currency, which can take the form of taxes,
special deposits, nominal ceilings (such as for travel allowances), and
procedures for allocating foreign exchange; and

-- limitations on the underlying transactions, such as prohibitions or impediments
to trade (such as tariffs, quotas, and special licensing procedures) and foreign
investment.

Any liberalization of the use of foreign currency is a move toward financial
convertibility. Any easing of controls on the underlying transactions, especially on trade, is
a move toward commodity convertibility. To liberalize one without the other is to effectively
limit the use of a given currency in a practical sense, by reducing the extent to which it can
be used to carry out transactions and make purchases [Gilman]. Full convertibility is a
financial concept, strictly speaking. But in a practical sense, it also entails commodity
convertibility.

Although transition to achieve it is not without costs, convertibility is highly
desirable, for several reasons.

It enhances efficiency through the elimination of price distortions. In countries where
resource allocation has been distorted through the use of price controls, as in Hungary, the
largely unhindered use of an appropriate exchange rate, together with domestic price
liberalization and import competition, will facilitate the determination of appropriate domestic factor and product prices. And the closer the country is to full convertibility, under an appropriate exchange rate regime, the greater the freedom of choice between foreign and domestic goods, services, and assets, which in turn promotes exports, assures import competition, and enhances consumer satisfaction. But certain of these freedoms may be in conflict with certain other economic or political objectives. Convertibility also attracts foreign investors.

Preconditions to convertibility and exchange rate stability include:

Eliminating price controls. Introducing convertibility while maintaining controls on prices would trigger arbitrage that would quickly cause unsustainable damage. For example, if at prevailing domestic prices and exchange rates a commodity is cheaper than its world market price, all domestic supply will be exported; if the domestic price is higher, domestic production will be eliminated by imports.

Setting realistic exchange rate. The rate must be set and maintained at the appropriate level. This generally means a rate that is compatible with a sustainable balance of payments position over the medium term.

Adequate foreign exchange reserves, perhaps backed by an external line of credit (e.g., the $1 billion stabilization fund that was made available to Poland), is necessary if convertibility is to be introduced with a fixed exchange rate or if the nominal rate is to be maintained within a range. Reserves are necessary to bolster market confidence, especially during the initial period of adjustment, and to be in a position to respond to short-term pressures on the exchange rate.
To date, Hungary has pursued a more gradual road to convertibility and stabilization than Poland and Yugoslavia, for a complex of economic and political reasons. In 1989, it introduced a three-year program of trade liberalization, under which about 80% of imports from market economies will be fully liberalized by 1991. In 1989, its central bank also guaranteed for nonresidents the repatriation of profits on FDI and also the currency invested, with some restrictions. Thus, the Hungarian forint is largely convertible for the enterprise sector, but there are limits on the amount of foreign currency that households can purchase from official sources. Largely for this reason, a parallel market is also operating, with a different exchange rate. Hungary has a fixed exchange rate regime, periodically devalued to compensate for inflation differentials between Hungary and its main trade partners.

Among the reasons that Hungary's policies are not identical to those of Yugoslavia or Poland are large differences in their initial economic and political conditions. Although facing major problems, Hungary's economy did not suffer from hyperinflation, immense shortages, or loss of external creditworthiness. Therefore, there was much less economic justification for putting up with the concentrated pain and social tension that has followed the introduction of a Polish- or Yugoslav-type program; similarly, the gains from a shock therapy would also be smaller.

Political System and the Elections

Hungary's institutions of political democracy, destroyed by the communists between 1948 and 1950, have been practically rebuilt during the last two years.

Under the constitution adopted in 1989, Hungary is a republic. The constitution declares that the National Assembly (Parliament) is the supreme legislative authority. Its
responsibilities include the election of the Council of Ministers, the establishment and
dissolution of ministries, the appointment of the chief justice of the Supreme Court, the
approval of the state budget, and the ratification of international treaties. The Parliament is a
unicameral body, and its members are elected for a term of five years. Executive power is
vested in the Council of Ministers, which functions as the government.

The outcome of the March-April 1990 elections was as follows:

<table>
<thead>
<tr>
<th>Party</th>
<th>Seats in Parliament</th>
<th>% of votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Democratic Forum</td>
<td>164</td>
<td>42.3</td>
</tr>
<tr>
<td>Alliance of Free Democrats</td>
<td>92</td>
<td>23.8</td>
</tr>
<tr>
<td>Independent Smallholders</td>
<td>44</td>
<td>11.4</td>
</tr>
<tr>
<td>Socialists</td>
<td>33</td>
<td>8.6</td>
</tr>
<tr>
<td>Alliance of Young Democrats</td>
<td>21</td>
<td>5.4</td>
</tr>
<tr>
<td>Christian Democrats</td>
<td>21</td>
<td>5.4</td>
</tr>
<tr>
<td>Other</td>
<td>11</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>386</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

The government formed after the elections is a center-right coalition of the
Democratic Forum, the Smallholders, and the Christian Democrats, jointly controlling 60% of the seats in the unicameral National Assembly. To be sure, the term "center right" is more an assessment of the cultural and social views of these parties than their economic philosophy. Nonetheless, they are united in pledging their commitment to transform Hungary into a market economy, and in this they are supported by the main opposition party, the Free Democrats, as well as by the Young Democrats. The only fundamental issue is what type of a market economy and over what period of time should the transformation be accomplished.
One of the most significant aspects of Hungary’s political transformation is that it was accomplished peacefully. By 1989, the old regime became sufficiently liberal - and mindful of the national interest - to engineer a consensual and legal method of political transformation (not, however, without considerable political and social pressure to do so). A great deal of the credit for this goes to Hungary’s able last (reform) Communist Prime Minister, Miklós Németh. Although his party suffered a major defeat in the elections because the electorate wanted to reject any version of communism in any guise, one year later (April 1991) opinion polls identify Németh as the country’s most respected politician!

During March and April 1990, Hungary held its first democratic elections in forty years. They resulted in the formation of a coalition government, led by the Democratic Forum, whose chairman, József Antall, became prime minister. The Forum is a party that, on the surface, resembles the Christian Democratic Party of Germany, an image its leader cultivates deliberately. Even so, its largest constituency, in terms of voters and party functionaries, believes more in romantic nationalism and populism, which carry the seeds of possible future dangers.

Assessing the First Year of the Government

The new government is legitimate, which is very important, but it is also quite weak. Its weakness can be traced first of all to politics: it did not win the majority of the votes cast; there is no real consensus on policies within the party; and the promise to return land to those who owned it more than forty years ago is fraught with political and economic difficulties and dangers. As important as politics, however, is the economic situation: the new government has inherited many problems, and it must also deal with a host of new ones.
Compounding these difficulties is the government's lack of an experienced cadre of people ready to assume the mantle. Nonetheless, initially the new government did not wish to depend on experts who "served" the old regime because it considered them politically "tainted."

The Antall government came into office on May 23rd 1990 and announced a short-term economic program that broadly spelled out the new administration's policy direction. The Prime Minister said all the right things in general terms but was short on specifics. The government's primary objective was - and remains - to establish a strong social market economy based on private ownership and private enterprise, to arrest the growth of external indebtedness and to meet all debt-service obligations on time, and thus to maintain the country's creditworthiness.

Taking stock one year after Hungary's first democratic elections, the government gets rather poor marks. The main mistakes the Prime Minister made were, first, that he and his coalition partners made unrealistic promises during the elections. Second, all the opposition parties, and the new government also, stressed complete discontinuity with the past (by implication, also with past reform efforts and accomplishments). Although the voters did want a change of regime and system, complete disassociation with any and all aspects of the past may well have been a mistake, first and foremost psychologically. Discontinuity, by implications, rejected the accomplishments of reformers, who over the years did their best to change the system from within. It also, in effect, dismissed the life work of even ordinary citizens. And it tied the hands of the Prime Minister in terms of policies and appointments.
Promising a relatively painless transition to a market economy was a mistake because it raised unrealistic expectations by the population and because it was a factor in the new government showing no sense of urgency in attacking major economic problems. The promise to return the land was a mistake because it took a year of fierce debate to convince much of the country that there was no practical way of doing it without disrupting agriculture and plunging the country into years of litigation about all nationalized assets. One reason (besides the century’s worst drought) that agricultural production declined in 1990 was the uncertainty created by the strident political debate on this issue. This is doubly unfortunate because agriculture has been, for some time, one of the few relatively well-performing sectors.

Seeking complete disassociation with the past resulted in appointing not always the best - in some cases even qualified - persons for key government posts, although there were notable exceptions. While after the election the Prime Minister declared his intention to avail himself of the services of the best experts, during the first eight months it appeared that party affiliation and political background counted for more than expertise and competence. During the last few years of communist rule, many of the best experts in the economic and other fields were brought into or advised the government. They made more positive than negative decisions, given the political constraints they had labored under. Instead of the new regime harnessing their expertise, the coalition partners went on an all-out attack against former office holders. It was not surprising, therefore, that in such a key organization as the Ministry of Finance, not only the able Minister (Mr. Békesy) but all five of his deputy ministers and nine of eleven department heads resigned. This exodus of key personnel
contributed to the confusion, mismanagement and loss of precious time to get up speed during the crucial "honeymoon" period of the new administration.

The third criticism is that the new government lacked a sense of vision and priorities about how to tackle the most fundamental economic issues. Endless debates and a great deal of political capital was used up to address issues of minor or symbolic importance, while the legal aspects of ownership, problems of the banking system, the fiscal mess (urgently needing to reduce the excessive "redistributive" role of the state via subsidies, and to reform the health, education, pensions, and welfare systems), economic restructuring, and privatization policies - and the creation of appropriate administrative structures - received insufficient attention. Cabinet members and advisors with economic and social responsibilities were given no clear sense of direction and publicly debated and lobbied for the economic policies they favored.

In all fairness, one must also point out that the new leadership was up against some daunting difficulties: it had to, simultaneously, give birth and extend democracy, restructure a bankrupt economy, and find a way out of a crisis situation.

From the Prime Minister on down, most new leaders and government administrators assumed their posts with little or no background in the issues and no time to prepare. And they were immediately subjected to an onslaught of problems and pressures.

Perhaps the most important positive is that the new administration did not make any large mistakes, it simply proceeded much too slowly. Whereas the rest of the world had a sense that Poland was quickly and courageously attacking its problems (whether what its government did was right or not is another issue), Hungary appeared to be coasting on the
favorable image that the country already had at the time when the new democratic
government took office.

Recent Developments

**Government Reorganization**

By year end 1990, considerable pressure had built up on the Prime Minister to put his
government’s economic house in order. Around the turn of the year, the cabinet was
reshuffled and some key ministers were replaced. Most notable is the appointment of a new
finance minister, Mihály Kupa, a former deputy minister in the old regime who
masterminded the major tax reform of 1988, which made Hungary the first country in the
region to have a market-economy-type system of taxation. Kupa accepted the post with the
understanding that he will be in charge of economic policy. During his first few months in
office, Kupa appears to have gotten a firm hold on his ministry and on the issues; he is also
very good in public relations. It remains to be seen whether his leadership on economic
issues will, in retrospect, be likened to sterling silver or just simple costume jewelry that
shines but has no lasting value.

**New Defense Policy**

Hungary is rapidly cutting its links with the Warsaw Pact. The essence of its new
policy is that the country has no enemies or adversaries. Its practical implications are that it
is cutting the size of its armed forces and offensive weapons and is dispersing its troops,
formerly concentrated on its Western borders.

By the end of 1990, 80% of Soviet troops, stationed in Hungary since World War II,
left the country. Soviet pullout is to be completed by the end of June 1991.
According to Hungary's new defense doctrine, the size of its armed forces will be cut from 106,000 to 75,000 by the middle of 1992; the period of service reduced from 18 to 12 months; and the quality of training and the modernity of the equipment is to be improved. Accordingly, a great deal of out-of-date or poorly functioning equipment was scrapped (ex: 677 of 1,528 tanks), along with missiles and launching frames.

Much of Hungary's equipment is Soviet-made. As of 1991, the Soviet Union is supplying parts and components only for dollars. This, together with the more intensive training of the armed forces, are the main reason that Hungary's 1990 defense budget of about HUF 40 billion ($600 million) is expected to rise to HUF 55 billion ($800 million).

Hungary sent about 40 medics to the Gulf to support the Allied troops stationed in the Persian Gulf. The Hungarian army doctors served under British command.

**Foreign Economic Reorientation**

The decline in Hungary's Eastern and overall terms of trade, and corresponding losses, are going to be considerably less than forecast earlier. This is due to the significant decline in world energy prices during the early months of 1991. This will moderate inflationary pressures (30% in 1990; forecast to be 40% in 1991). But this "gain" is offset by the deeper than expected collapse of intra-CMEA trade. This means that the pain will be heavily concentrated among firms (and their suppliers and the employees affected) that are heavy exporters to the East.

During the last several years, there was a dramatic reorientation of Hungary's trade from East to West. Owing to inconsistent cross exchange rates, it is not possible to bring accurately to a common denominator Hungary's trade with the East and the West before
1991. Nevertheless, as a ballpark estimate, while in the mid-1980s about 60 percent of Hungary's total trade was with the Eastern-bloc countries, and about half of that total with the USSR, by the end of 1990, the total was down to about 30 percent and is still declining. In 1991 Germany is expected to be a larger trade partner than the USSR.

**Debt and the Balance of Payments**

Hungary's gross foreign debt is around $21 billion. During the early 1990s, servicing it will require $1.5 - $1.7 billion in interest and $2.1 - $2.3 billion in principal payments, totaling $3.6 - $4 billion. This represents 12.5 to 14 percent of 1989 GDP, which is very high in international comparison. Although Hungary still has some capacity to borrow from Western commercial banks and private bondholders, since 1990 strains have been evident and the market's appetite for (East European debts generally and) lending to Hungary specifically has been shrinking. This means that Hungary will have to count on some combination of the following to manage its external debt:

1. Large surpluses on the goods and services account in the balance of payments have to be generated. In 1990, Hungary achieved a record surplus of $1.2 billion in convertible currency trade, thanks to a 14 percent increase in the volume of exports and improvement in the tourism account. This required that GDP domestically utilized stay about 5 percent below GDP produced, which itself declined by more than 4 percent in 1990. Similar declines and production/utilization ratios are forecast for 1991.

2. A substantial inflow of foreign investment is needed. Preliminary figures show that in 1990 close to $600 million was invested in Hungary. At least this rate will have to be maintained during 1991. This underscores the need for accelerated privatization.
3. Hungary has to maintain access to private-sector borrowing. So far the country has managed to do this; continued access requires a large trade surplus, an inflow of foreign investment, as well as significant participation by international financial institutions, most notably the IMF.

4. The IMF and the World Bank have stepped into the breach and increased significantly their lending to Hungary (and to the other Central and East European countries). Hungary, too, became eligible to participate in the IMF's latest emergency financial relief program for countries that were hit by the Persian Gulf crisis. It is under this umbrella that the Fund is helping Hungary to parry the adverse impact of developments in its trade and settlement with the former CMEA countries. The assistance to Hungary over three years could total as much as $2.5 billion, in addition to its outstanding financial obligations to the Fund of $655 million. The main conditions are that in 1991 Hungary must keep the current deficit under $1.2 billion, the budget deficit under HUF 78 billion (1.5 percent of GDP), and monetary policy reasonably tight.

   What about debt forgiveness? In the wake of Poland obtaining a 50 percent cancellation of its official debts from the Paris Club (70 percent from the U.S.), should Hungary receive a similar treatment? There are several reasons why comparable treatment for Hungary is far from assured. One is that while for many years Poland has not been servicing most of its debts and declared repeatedly its inability to do so, Hungary has officially maintained that it will service its debts fully. (To be sure, privately, the government and the people would be delighted if some of the debt burden would be lifted. But the costs of officially requesting it would be forced rescheduling, whose costs are judged
by experts in Hungary to be prohibitively high, both in the short- and in the long run.) Very important is the fact that while two-thirds of Poland’s debt was owed to official creditors, more than two-thirds of Hungary’s is owed to private lenders. Debt relief is easier for the former to grant. The political importance of Poland, the need to persuade its new government to continue its tough economic policies, and the inclination of Western governments to reward Poland for actions taken are further factors why Hungary may not obtain a similar treatment.

**Economic Growth**

The economy has stagnated for about a decade (1979-89). In 1990 production declined by 4%. Economic forecasts predict that the recession will continue during 1991. The government’s own forecast is that GDP produced will decline between 3 and 4 percent, GDP domestically utilized by about 5 percent. (The difference is net service of foreign debt). The main causes of the economy’s continuing decline is the collapse of trade with the East, its multiplier effects in the domestic economy, and increased import competition. Their effects are being partly offset by increased exports to the West, forecast to grow in real terms by 3 to 4 percent, after a 14 percent increase in 1990.

**Unemployment**

At year end 1990, there were about 85,000 registered unemployed, just under 2 percent of the labor force. Although many Western countries would be pleased to have such a figure, there are reasons while unemployment is of concern.

One is the rapid rate of its increase: during the last month of 1990, unemployment rose by 17 percent; projection of the jobless by year end 1991 range from 200,000 to
400,000 (4 to 8 percent of the labor force). Budapest has the lowest rate of unemployment (0.2 percent at year end 1990). In general, unemployment is lower in the country’s Western and central parts and higher in the East and the South.

Another reason for concern is that neither the individual nor the state is well equipped to parry unemployment’s adverse consequences. Since until recently the state was responsible for the financial and health care of individuals, long-term financial planning (saving for rainy days) and learning new skills partly could not and partly would not be practiced. Most people, therefore, are not well prepared to cope with the new economic and social situation.

Only in 1989 did the state introduce a system of unemployment compensation (paid at 70% of the last wage during the initial phase and 50% thereafter), but only those qualify who have been consecutively employed for a year. The unemployment "fund" has 9 billion HUF ($130 million), which could be depleted in six months if unemployment rose sharply. To replenish the fund, Parliament is considering a law to impose an extra wage levy of 1.5 percent on employers and 0.5 percent on employees.

To be sure, not everyone who is unemployed is captured in official statistics. At the same time, some who are registered as jobless are working in the unregistered economy. Whether these biases are fully offsetting is not easy to determine.

The Financial System

The banking system is notoriously in poor shape in Hungary, as in all the "historically planned economies." The main reason is that under the old system all that the
single "mono-bank" (combining the functions of a central bank and the commercial banking system) had to do was to help finance and administer the "plan."

In 1987, three new commercial banks were established. To them the National Bank distributed its commercial assets (loans outstanding to enterprises) and liabilities (business deposits). The state carefully allocated among the new banks all the economy’s ailing sectors, each with a large volume nonperforming loans outstanding. The commercial banks thus became repositories of decades of accumulated mistakes and losses by state firms. But they were not given sufficient capital or reserves against which to write off their nonperforming loans. The banks have capitalized the accrued but unpaid interest on nonperforming loans, reporting it as income. Consequently, the published financial statements of the banks - all showing large profits - are not in accord with generally accepted accounting practices (GAAP) in the West.11

Such banks cannot play a proper role in allocating capital as financial intermediaries because when they extend new loans, they are not putting their own capital at risk. Any potential loss will be commingled with the nonperforming loans the bank already has and, one way or another, end up as the accumulated contingent liability of the government, which sooner or later has to cover it from the fiscal budget.

In the meantime, the banks have limited leverage over enterprises. If the firm does not have the money, it simply refuses to pay. The bank is forced to extend a new loan to recognize the nonpayment. Unless the government is willing to throw a firm into bankruptcy - so far a very rare occurrence - the banks cannot pursue an active credit policy. The
existing banking structure, therefore, is acting like a fiscal "black whole," misallocating capital to cover the losses of the state-owned enterprises.

In such a situation, tight credit policies by the central bank typically triggers the accumulation of payment arrears between firms, which has now reached huge dimensions in Hungary. Thus, "increased financial discipline" on firms fails to yield the desired results because it does not address the balance sheet losses which lie at the heart of the problem. Therefore, actions must be taken to cleanse unrealized losses from the balance sheets of enterprises and banks, more or less simultaneously. This is one of the fundamental issues that the government has failed to address so far.

For enterprises, the balance sheets can be cleaned up through some combination of bankruptcy, forced restructuring, and privatization. To put the banks back on their feet, the government must assume their bad loans. One way to do this, as recommended by Brainard, is to "purchase" these "assets" with long-term bonds that pay sufficient interest over the banks' cost of capital to generate a net income flow. The cost of paying the interest on these bonds could be funded by, for example, some combination of the proceeds of privatization, general tax revenues, and foreign financial assistance.

Enterprise Management

Managers of many state-owned enterprises feel that they are in a systemic limbo, facing many uncertainties. Managers do not receive the guidance they did under the old system. But there are still no clear objectives being laid down for them by the new owners.

To begin with, it is not always clear who are the real owners. Is it the government bureaucracy (e.g., the ministry or industry, the ministry of finance, or the State Privatization
Agency (SPA)) or is it the enterprise council, partly elected by the workers? To the extent that it is the state bureaucracy, so far it has not demanded that, within a reasonable time, enterprises be required to produce an acceptable rate of return on the capital invested. There is little pressure, such as would be exerted by real owners, to maintain the value of assets, in part because other considerations, such as maintaining employment, are still a factor. This means that depreciation and selling the firm’s assets (e.g., real estate) may be used to cover operating expenses.

As long as the balance sheets of enterprises, and the banks that finance them, are not cleansed so as to draw a clear line of demarcation between the cumulative effects of past mistakes and current ones, such a managerial behavior cannot be faulted.

Managers also face more than the usual business uncertainties in the financial, legal and regulatory environments, and in government policy. There are many questions still about what new laws will regulate the granting and collection of inter-enterprise credits. Who can, or will, decide on which enterprises to privatize, and what ways will be found acceptable to the SPA, are not yet fully certain. The laws on compensating former owners and on clarifying the full rights and duties of the owners of land and other real estate have not yet been agreed upon. There is uncertainty also about the government’s longer-term policies on subsidies and taxes. For example, which exports to the USSR should be subsidized temporarily, on the expectation that the economy of the USSR will recover, and which exporters to that country should be allowed to go bankrupt if they cannot find new customers domestically or in the West?
A New Economic Program

Much of the political opposition as well as the international community is pushing the government to speed up marketization. In early 1991, Prime Minister Antall seems to have concluded that complying with these pressures is its only political alternative.

A comprehensive government program is beginning to take shape in 1991 whose implementation is slated to get fully under way in 1992. Its main elements are: maintaining relatively tight monetary and fiscal policies; assuring by law the independence of the central bank; accelerating privatization; cutting unproductive expenditures from the budget; restructuring or closing a large number of state enterprises; further freeing of prices and imports from government control; a comprehensive reform of the banking system that will lead to regulations conforming to international standards to govern lending, capital adequacy, loan-loss provisions, and annual audits; the introduction of currency convertibility for current transactions; and strengthening the social safety net via improved unemployment compensation, retraining, and job-placement assistance.

Economic Prospects to the Year 2000

Experts in Hungary and in the West know pretty well the fundamental principles and many of the technical details of economic transformation, although there are unresolved questions still about appropriate sequencing and the costs and benefits of alternative approaches on certain policy issues.

The key issue that shapes prediction about Hungary’s future is one’s assessment on whether the transformation process can be sustained, politically, in the country. Can Hungary’s current and future, democratically-elected governments stick to a program that
will seem to initially (for several years) cause a significant decline in production and increased inflation, unemployment, and inequality of income and wealth?

My prediction is that the political difficulties of economic transformation will slow but not derail Hungary's transition to a market economy. Whereas if politics were no obstacle, and if successive political leaderships were strong and decisive, transformation could be accomplished in five to seven years, the inevitable mistakes that will occur and the political compromises that will be necessary will cause the process in Hungary to take 10 to 15 years. Thus, the most likely scenario is that Hungary will complete the transition by around the year 2000.

Successful transformation is defined here as establishing the essential institutional preconditions, and putting in place sound economic policies and giving them time to take effect that, jointly, are the bases of a well-functioning market economy. What I mean by these, concretely, are summarized in the next section, under "Lessons from Hungary's Reform and Transformation Experience."

Domestic politics is the key to the transition. The issue is this: how will contending political parties and successive governments propose to manage the tradeoff between, on the one hand, the strong central leadership needed to push through difficult reforms and, on the other, the broad political participation and compromise needed to secure support for a transformation program that is inevitably painful?

Hungary has several major assets that, in my view, make it likely that economic transformation will by and large remain on course. These assets are:
1. Twenty-five years of experience with partial reforms. The reforms introduced between the mid-1960s and the late 1980s can be thought of as an innovative but ultimately unsuccessful search process for a "third road", that is, an economic and political system that combines elements of the market mechanism with strong central direction and other aspects of "socialist economics." Hungary’s generation-long experience with economic reforms helps economic transformation in two ways. During this period Hungary made significant headway in establishing many of the institutions, instruments, policies and (not least important) developing the "mindset" that are essential for a well-functioning market economy. By "mindset" I mean enterprise managers, economists, policymakers, bureaucrats and even workers beginning to understand what a market economy really means, and beginning to develop the patterns of behavior that such a system requires. This puts Hungary further ahead on the road to transition than any other country. Second, perhaps the major lesson of Hungary’s 25 years of experience with reforms is that the search for a "third road" type of an economic system is not likely to be successful. Countries, just as individuals, are more likely to learn from their own mistakes than those made by others. To be sure, a key question is how broadly has this lesson been learned? The fact that the opinions and writings of many of the country’s leading economists reflects this is no assurance that the politicians and the general public will necessarily accept it. To be sure, the results of the first democratic elections in forty years show that so far the electorate has rejected the experience under both right-wing (1944) and left-wing (1949-88) dictatorships. This bodes well for the future.
2. Hungary does not face, within its own borders, the kinds of tensions - based on ethnic, national, or religious conflicts - that can easily derail systemic transformation in some of the other countries. The tensions that the situation and treatment of the Hungarian minorities living in the neighboring countries will certainly impart to Hungary’s domestic politics do not have the same potential for derailing transformation than if ethnic-based tensions were to prevail within the country’s borders.

3. Economically, politically and even culturally Hungary is extremely dependent on the West and will become even more so in the future. Based on the Soviet Union’s current and prospective medium-term economic and political situation, and taking into account Hungary’s historical traditions and orientation, the country has no place and no inclination to turn anywhere else but to the West. Given Hungary’s critical dependence on Western trade, technology, credits, and direct investment, and given Hungary’s strong desire to become associated with the European community, the West - defined here as the main industrial countries, the European community, and international economic institutions such as the IMF, the World Bank, and the GATT - has important leverage on Hungary’s economic policies and, indirectly, also on domestic politics. It is likely that the West will use its leverage to do what it can to keep Hungary’s economic and political transformation "on course."

Juxtaposed against these assets are some potential pitfalls. The biggest short- and medium-term danger in Hungary is no longer that Russia will intervene in the country’s internal affairs. Even if Gorbachev is replaced or changes course, leaders of the Soviet Union will have too many domestic crises to deal with to have much energy or many resources left to try to shape Hungary’s economic and political future. The real concern is,
instead, that the main political parties and the new governments will be tempted to take too short a view, to agree to too many unworkable compromises, or to follow populist policies. Such policies might include imposing price controls, soaking the rich, and blaming foreign lenders and investors for economic problems.

C. The Lessons of Reform and Transformation

Lessons from Reform

The experience of Hungary through 1989 reveals both the possibilities and limitations of economic reforms in a "traditional" Communist-led country. Such a political system forces the architects of the reform to try to reconcile design variables that have not proven to be reconcilable: on the one hand, pervasive and unchecked control of the party of the political and economic life, which was synonymous with the preservation of a series of ideologically and politically driven economic objectives, strategies, and system features; and, on the other, rapid progress in improving economic efficiency, export competitiveness, and the standard of living.

Although many countries, irrespective of their economic and political system, pursue fundamental objectives that are not fully compatible, pay little attention to feasible tradeoffs, make major errors in economic strategy and policy, and face daunting problems of system inefficiency, the main difference between many of them and a monolithic Communist country like Hungary is the unchecked power of the authorities. Often absent is any meaningful debate, checks and balances, political accountability, and professionalism in decisionmaking. These probably mean that the mistakes are likely to be greater and persist longer than in societies where the ruling party does not have unlimited power.
Hungary's experience suggests, further, that simulating how a market would work if it existed will not do. Unless the frequency and intensity of intervention by the authorities into market processes falls below a certain critical level, the market never "takes hold," remains emasculated, as Kornai noted. During Kádár, intervention had remained considerably above the critical level. Hungary had (and still has) an economy that an enterprise manager has characterized as a "jungle of regulators, most of them inconsistent."

Further concerning the reform design, another lesson of Hungary is that if increased autonomy is given to enterprises before imposing on them financial discipline and exposing them to competition, then rapid increases in wages and prices are much more likely than the expected supply improvements.

Perhaps the main conclusion is that for system change to be effective, a CPE needs a truly comprehensive reform, one that modifies - simultaneously, significantly, and consistently - all the main variables in the model of political economy. But that, of course, is the definition of system transformation.

On the positive side, the main lesson from Hungary's reform experience is the set of points I made in the previous section, when enumerating Hungary's "assets," under (1), which therefore I will not repeat here.

Lessons from Transformation

Transformation in Hungary and elsewhere in the region is at too early a stage to offer definitive lessons. But the considerable intellectual effort that has been devoted to an examination of the problem - such as under the auspices of the BRC, as well as the
comprehensive studies sponsored by international organizations\textsuperscript{13} - as well as early experiences in Hungary and elsewhere, do suggest certain preliminary lessons.

The main lessons are that system transformation is very complex and faces many constraints; that the economy operates as an organic whole, not as an unrelated collection of bits and pieces; and that transformation is an intensively political process.

That the issues are complex is worth stressing because, unlike Hungary, some of the transforming countries have practically no and others only a scattering of expertise to help formulate a comprehensive transformation strategy and to supervise its implementation.

Because the economy operates as an organic whole, measures must be packaged into large bundles, so that the linkages in the system can be relied upon for each action to effectively enhance every other action.

A yet unpublished study by the World Bank summarizes and presents visually on a single page the complexity, interdependence, sequencing and approximate time that is required for economic transformation (Chart 1). Its main conclusion is that transformation is likely to take approximately ten years, until about the year 2000.

The main elements of economic transformation are grouped into four broad analytical categories:

I. Internal and external macroeconomic stabilization, which involves appropriate fiscal and credit policies for governments and enterprises, and addressing the imbalances created by a monetary overhang and/or the large, unrealized losses that are buried within the banking system.
CHART 1

MAIN COMPONENTS AND SEQUENCING OF ECONOMIC TRANSFORMATION

I. Macrostabilization

II. Price and Market Reform

Goods and Services:
- Price Reform
- Trade Reform
- Distribution

Labor Market:
- Autonomous Banking System
- Other Financial Markets

III. Restructuring and Privatization

Small Scale Privatization and Private Sector Dev.
- Foreign Investment
- Large Scale:
  - Corporate Governance

IV. Redefining Role of State

Legal Reforms
Institutional Reform
Unemployment Insurance
Other Social Areas

Time (in years)

Revised February 26, 1991
II. Price and market reform, which requires a decontrolling of factor and product prices; deconcentration of production, trade, and transport; and foreign economic liberalization (of trade, foreign investment, and the introduction of currency convertibility).

III. Privatization and restructuring of state enterprises, which means clarifying all the legal issues of ownership; finding individuals and/or institutions who can effectively exercise the functions of ownership; and then privatizing as rapidly as financial and political conditions allow.

IV. Redefining the role of the state. In essence, economic transformation requires that the dominant role of the state, with its myriad of arbitrary and often incompatible priorities, be replaced with a system in which economic decisions are primarily made by individuals and enterprises, coordinated by a self-regulated market mechanism and consumer choice. At the same time, the transformation cannot be accomplished without restoring to the state some of the powers which had been dissipated in the course of the reform. Transforming and stabilizing the economy requires a strong government.

The state must have significant responsibilities in several areas:

-- reforms in public administration (including that of the central bank, of tax administration, and of prudential supervision and regulation, especially of the financial sector);

-- establishing a legal system that must underprop a market economy;
a major (though not necessarily direct) responsibility for improving the infrastructure and the environment; and

the creation or strengthening of the social safety net.

Recommendations to Hungary’s Government

The interplay between economics and politics, different in every country, will drive the transformation process. Transformation not only depends on political developments, but it also influences them. A critical variable is speed, the decisiveness of political action. This is what the Blue Ribbon Commission concluded on this issue for Hungary:

"Once a government has defined its objectives clearly, it must implement change in quantum leaps. Reforms must be packaged into large bundles because the economy operates as an organic whole, not as an unrelated collection of bits and pieces. When reforms are packaged into a large bundle, the linkages in the system can be relied upon for each action to effectively enhance every other action. Large packages will demonstrate that the losses suffered by any one group are offset by gains in other areas.

"Deciding on a quantum leap is also a matter of political efficiency. Slowness can cause the early consensus supporting the government’s program to collapse before implementation is completed and results become evident, because interest groups have time to mobilize and drag down the program. Requests from interest groups for a slower pace often turn out, on closer analysis, to represent fear that the government is not spreading the pain equally.

"A government need not have broad public support for each specific reform measure. Seeking ex ante support for each measure leads to excessive compromise that emasculates a
comprehensive program. Experience shows that political consensus develops progressively once the decisions are made and satisfactory results are delivered to the public.

"Concerning the pace of transformation, the place for caution is generally at the policy-deliberation phase. Extensive consideration should be given to alternatives, to the likelihood of achieving intended and unintended consequences, to sequencing, and to modes of implementation. This is all the more important because the new government should announce and begin implementing its program quickly, while it enjoys a "honeymoon period" with the electorate.

"We wish to underscore again that speed in implementing the program is essential. Any large program will take years to put into place even at maximum speed. The key is to provide a preannounced path, a clear sense of the new direction, and a firm timetable of the actions that will be taken. This will give the government time to prepare the implementation of its program and the economy's actors time to adjust to what they must be convinced are inevitable changes. West European integration by 1992 is a prime example. In this context, 1992 is not just a date but a process which began as soon as the goal was announced. The landing should therefore be "soft" because individuals, firms, and institutions will have had time to adjust to the rules that they know will go fully into effect by the preannounced date.

"Public policy must be consistent and credible to generate economic confidence at home and abroad. The keys to credibility are high-quality decisions, consistency of actions, and communications with the public - telling the truth about the economic situation, showing how the government will deal with it and why the alternatives to the government's proposals are less attractive. Credibility also means not raising unrealistic expectations. If government
policies lack credibility, people refuse to change their behavior to fit new policies and thus shackle the economy with psychological costs that otherwise could have been avoidable. Government policies that are not credible also will fail to generate the kind of external financial and political support needed to facilitate program implementation.

"Public education about the timing of the program is vital. It would not be prudent to promise that it is possible to find ways of correcting mistakes and distortions that have been accumulating for 45 years without causing pain during the early stages of the transformation. Shortages must be eliminated by allowing prices to rise, though this development should not be allowed to cascade into permanent inflation. Structural adjustment will involve significant unemployment but this should be partly temporary if free enterprise during the transformation can grow fast enough to absorb the resources liberated from the shrinking state sector. Therefore, the fact that there is pain should not be an indication of the failure of the transformation program, but rather that the program may indeed be effective. If the transformation is not attempted fully or is allowed to falter, then the entire country and each interest group within it will be worse off and decline will not easily be arrested. Speedy transformation is the only way, even though it will take time before sustained recovery gathers momentum. Certain benefits of the transformation program should be apparent within months - for example, the improved quality and availability of consumer goods and services; cuts in waste and inefficiency; and better employment opportunities for skilled, diligent, and reliable employees. Substantial benefits will be enjoyed first by a small segment of society (mainly the entrepreneurs); but in time, broader and broader segments will benefit."
D. Implications for Western Public Policy

Developments in Hungary are fundamentally driven by internal forces. At the same time, Western policies are very important. The interest of the West lies in seeing that a country like Hungary moves, with all deliberate speed, toward a democratic and market-oriented country in which human rights are respected and international obligations are observed. None of these goals, individually or in combination, is incompatible with policies that foster equal opportunity to pursue one’s interests and talents, the mitigation of extreme inequalities of income and wealth, a commitment to reasonable full employment, and a welfare state (at a level commensurate with the ability of the economy to pay for it). In brief, there is no reason why Hungary (and eventually the other Central and East European nations) cannot become a Finland, an Austria, or a Sweden.

More specifically, it is in the interest of the West to see that Hungary becomes increasingly and successfully integrated with the economies of Western Europe. There is no other way for the transformation to succeed. While integration with the West is a necessary, it is not a sufficient condition for the reform to succeed; that depends, most fundamentally, on creating the reform’s essential domestic preconditions.

The successful integration of the reforming East European countries with the West is in the vital interest of the West, first and foremost to prevent undesirable outcomes, such as (1) emigrants flooding Western Europe through by now practically open exit borders and (2) strengthening the bonds of conservatives in all countries that are still Communist ruled, who would like to turn back the clock. The successful integration of Hungary with the West is also attractive for the business and professional opportunities that would create; without
integration, Hungary would not be in a position to finance the huge pent-up demand for Western imports.

What can the West do to nudge the process of transformation along? Perhaps the most significant contribution the West can make in the long run is to help these countries establish - or reestablish - their economic, financial, managerial, administrative, political, technical, and cultural infrastructures. Their efficient functioning is absolutely essential for making the societies successful, an attractive place to live. The best investment the West can make is to help educate, train, and apprentice the best young minds of a country like Hungary in all aspects of how societies that are reasonably efficient must function. But, in addition, the West must make it possible, and to some extent promote, the reintegration of Hungary into the regional and global economic framework.

It is equally important that the West keep its markets open and reduce barriers to trade, technology and investment flows, to make it possible for Hungary to jump-start its economy through export expansion.

The West should also find ways to ease Hungary's very large burdens of servicing the huge inherited foreign debt; as a minimum, to ensure that there is no large net transfer of resources from Hungary to the industrial West during their most crucial and difficult early years of transition. It should assure that some new money will flow to Hungary, in part to give confidence to prospective foreign investors.

The United States and other Western countries should do what they can to encourage the European Community to state or strongly imply its intention to admit Hungary to full
membership, once democracy will have become firmly rooted and its economy sufficiently transformed to be compatible with those of Western Europe.

The West is thus in a position to offer Hungary (and to the other countries in the region) a powerful package of economic incentives - technical assistance, a dismantling of trade barriers, foreign investment, debt restructuring, subsidized credits (via mainly the international financial institutions), improved access to commercial credits, and eventual membership in the EC. The delivery of this package of economic benefits should be tied, partly explicitly and partly implicitly, to Hungary remaining a democratic country and its economic transformation persevering on course. This is a package that the West can easily afford to provide. The United States should lead Western efforts toward such "coordinated conditionality."