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Hungary's unique 'gradualist' economic transformation has now reached a critical stage. Despite recent upheavals, Hungary has succeeded in attracting foreign capital, and has achieved its first current account surplus in convertible currency since 1984, but it is clear that privatisation will be a lengthy and difficult process, with significant repercussions for the future of the economy and profound social and welfare consequences.

This book presents some of the local arguments and perceptions informing the current debate, and critical examinations of these ideas from an international panel of scholars. The chapters address privatisation; financial, tax and legal systems; integration into the international financial and monetary systems; labour markets, unemployment and the social safety net; and the political economy of the current economic transformation. The analysis and results will be of major interest to economists and policy-makers concerned with transition throughout Eastern Europe.

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and
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Preface

This volume contains the proceedings of the conference 'Hungary: An Economy in Transition' organised by the Centre for Economic Policy Research and held in London on 7–8 February 1992.

Financial support for the conference was provided by the ACE programme of the Commission of the European Communities, Citibank and the Foreign and Commonwealth Office, to whom we express our gratitude. We would also like to thank the CEPR's permanent staff for their encouragement and support, especially to Stephen Yeo and Wendy Thompson for organising the conference; Lisa Dowling, Allyson Davies, and Jennifer Jones for making it run smoothly; Kate Millward and David Guthrie for organising the volume's production, and to Richard Portes for his leadership role. We also thank Barbara Docherty for essential editorial assistance. The editors would like to thank the participants of the conference, many of whom are the authors of chapters in this volume, for their contributions. Our thanks go also to the discussants of the chapters, who helped to clarify the nature of the problems and the special characteristics of the Hungarian case. Needless to say, the success or failure of this book depends mostly on their efforts.

Almost all the chapters in this volume have been written by Hungarian scholars and policymakers. The aim was to present some of the local arguments and perceptions informing the current debate to the critical examination of an international panel of discussants. By doing so, we hope to contribute to improved communication and exchange of ideas among economists both inside and outside Hungary, and to the ongoing debate about these matters in the country itself.

István P. Székely
David M. G. Newbery

June 1992

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Foreword

MARIO SARCINELLI

The CEPR is one of the most active research institutes in the field of economies in transition. In early 1990 it launched a major new research initiative on Eastern Europe and the complex problems of economic reform and system design now faced by its governments. Several research workshops have already generated substantial output.

The transformation of the economies of Eastern Europe and their integration into the international economy is a major challenge for politicians, civil servants, and scholars alike. This is the first reason why we should welcome CEPR's initiative in this field. The second lies in Hungary's role as a pioneer in attempting such an economic transformation, which 'has . . . been instrumental [also] in the acceleration of the transformation in the East–Central European region'.[1] Through the Hungarian experiment, we will be able better to understand what is at stake in other Central and Eastern European economies.

The Hungarian economy

The economic transformation in Hungary has now reached a critical stage. The cost of transition is huge, and higher than expected. It has become clear that economic transformation will take much longer than originally thought. The Hungarian economy is also characterised by both remarkable achievements and some less auspicious tendencies. On the positive side, the current account of the balance of payments in 1991 was in surplus for the second year running; new small enterprises emerged at an impressive pace; further steps were taken to improve resource allocation by freeing prices and liberalising foreign trade: 90 per cent of consumer prices are now free of controls (as compared to 50 per cent in 1988). Imports of goods representing around 70 per cent of industrial production are completely free. The average level of import tariffs has also decreased. The resulting high degree of price and import

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liberalisation has laid the foundation for competition in the private sector, the significance of which is expected to increase substantially over the next few years. So far, the increase in private economic activities has stemmed mainly from the rapidly rising number of small companies. However, the government aims to complement the process through broad privatisation of large state-owned enterprises. New laws on banking, insolvency and accounting were also passed by Parliament to encourage the move towards an economy based on market principles. The level of direct foreign investment rose sharply, providing the basis for a much-needed accumulation of foreign exchange reserves.

On the less auspicious side, production continued to decline; inflation is under control but has accelerated (at least temporarily); and the pace of privatisation was substantially slower than planned, although the government aims to reduce the state's share of assets in the competitive sector to less than 40 per cent by the end of 1993.

External economic relations and foreign investments

Convertible currency indebtedness remains high (US$19.7 bn by mid-1991, 63 per cent of GDP). The debt service ratio declined to 39 per cent in 1991, from 64 per cent the year before, on account of a smoothing of the maturity structure and a sharp increase in convertible currency exports resulting from the collapse of the CMEA and the switch to convertible currency settlements.

Hungarian debt policy differs drastically from that followed by some of its neighbours. While Bulgaria used to be considered a credit-worthy sovereign borrower, it declared a unilateral moratorium in 1990 and requested the opening of debt restructuring negotiations. Agreement was reached with the Paris Club in May 1991 to reschedule the official debt, but agreement has not yet been reached with the commercial banks which own 85 per cent of Bulgarian external debt. In 1990, Poland put pressure on its public creditors; in April 1991 an unprecedented debt forgiveness agreement was reached with the official Paris Club creditors, which may result in a 50 per cent reduction in the US$33 bn (at the time of the agreement) owed to Western governments.

Hungary's policy has aimed to service her international obligations in full, which the international financial community has greatly appreciated. Such an attitude imposes constraints and requires the definition of appropriate macroeconomic and financial policy objectives. From a theoretical standpoint, two main objectives could be followed: a current account surplus objective or an official reserves target. Many questions immediately arise:

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* How should the choice of Hungary with regard to its debt servicing policy be judged from a long-term point of view?
* What has been the prime target for Hungary's macroeconomic and financial policies?
* Which instruments have been relied upon?
* Would another policy have been possible?
* What are the consequences of the choice made in terms of exchange rate policy, and in terms of inflation?
* What will the exchange rate policy impact be on foreign trade and foreign investments?
* How have the interest margins on Hungarian bond issues on the international capital market developed recently? Have they responded to the strong increase in national reserves?

Foreign capital is finding its way into the Hungarian economy in fairly large amounts compared to the other countries in the region, although still not at the pace hoped for. The total number of business entities with foreign participation reached about 5700 by the end of 1990. Foreign participation represented 28 per cent of the equity in these companies and was valued at around US$1.5 bn, of which US$570 mn had been contributed in cash (the remainder in the form of goods, goodwill, and services). The cash contribution alone amounted to US$800 mn during the first eight months of 1991. We may ask here:

* How has the ability to serve its international obligations influenced Western capital inflows?
* Why has Hungary succeeded in attracting more foreign capital than its neighbours?
* What role do the rather high current tax incentives play in this process?

Chapters 8 (Király), 9 (Várhegyi), 11 (Oblath), 12 (Riecke), 13 (Sárközy) and 14 (Koltay) may help us answer the questions of debt servicing and 2 (Csaba), 3 (Mizsei) and 4 (Halpern and Székely) those on issues of foreign trade.

Privatisation

Privatisation has also reached a critical stage. The period of high expectations about a quick and easy privatisation process, based on a massive inflow of foreign capital, is perhaps now over. Here we need to consider:

* How should we assess the contribution of foreign capital to the privatisation process?

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* Is there a real threat of a slowdown in the inflow of foreign capital, and if so, why?

Chapters 5 (Járai), 6 (Mihályi), and 7 (Stadler) will help us elucidate the interplay between privatisation and foreign capital. It has already become clear that privatisation will be lengthy and difficult process, and particular attention must be paid to its repercussions on the future nature of the economy.

The role of the SPA

The State Property Agency (SPA)[2] was created in March 1990 with the authority to manage and privatise a large proportion of state assets. It was established in response to a recognised need for firmer central control, as some enterprise managers had been buying enterprise assets without involving independent auditors or open bidding. In spite of many initiatives, the pace of privatisation remains slow: by September 1991, about 15 per cent of the 2200 state-owned enterprises earmarked for privatisation had been fully or partly privatised, although most of these were relatively small. Here we need to ask:

* What judgement should we pass on the change made in SPA procedures and the privatisation methods adopted?
* How does the current process compare with the vouchers' distribution approach developed in Czecho-Slovakia?
* What are likely to be the next steps in the privatisation process, and if it is to be so slow what consequences may be envisaged at the political level?
* To what extent will the continuing public ownership of factories and companies negatively affect the growth of GDP through the persistent inefficiency caused by such things as relatively poor management, lack of incentives, and obsolete technology?

Restructuring and financial discipline

In such an economic transformation, restructuring and imposing financial discipline will have profound social and welfare consequences. Here three final questions must be asked:

* What will be the unemployment consequences of economic restructuring?
* Has a retraining strategy been devised and, if so, with what success?
* Has the government put in place a social security safety net to mitigate the consequences of economic reform?

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Chapters 15 (Köllő), 16 (Augusztinovics) and 17 (Ábel and Bonin) may give us some of the answers to these critical questions.

NOTE

1. Béla Kádár, *Rivista di Politica Economica* (June).
2. A Glossary of key acromyons will be found preceding the Index on p. 353.

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