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Hungary

Towards a Market Economy*

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ASSESSMENT OF THE ECONOMIC SITUATION AND REFORM PROCESS IN HUNGARY

CONTENTS

List of tables:

List of graphs:

List of text boxes

PREFACE

The study focuses on the transition of Hungary to a market economy, with a review of the launching of the 1991-1994 "Programme of conversion and development for the Hungarian economy". The bulk of the work was finalized at the end of 1991, but some parts have since been updated.

The Hungarian transition entails specific features: unlike the other countries of Central and Eastern Europe, Hungary benefits from a tradition of gradual reform of the economy, which dates back to the end of the 1960s, but it is also committed to honour a large external debt through the whole programme period. Overall, Hungary expected a rather smooth transition to a market economy, with moderate growth. It was envisaged that by the end of the period of the programme the main aggregates would approach sustainable levels, with both the budget and current account in balance and single-digit inflation.

A year and a half into the programme, the picture looks somewhat different from these projections, and recent results confirm the trends indicated in the study. The Hungarian economy is suffering from a severe recession and no sign of recovery is foreseen before early 1993. The collapse of CMEA trade is the main factor in this recession. The loss of Soviet and East European export markets was responsible for at least half of the 10.2% decline in real GDP recorded in 1991.

These unfavourable developments did not hamper progress in structural reform, where the major commitments have been met. Thanks to the dynamism of the emergent private sector and the ability of the country to shift trade from the East to the West, the external performance even improved over the period, with a current account surplus at the end of 1991 of US$267 million instead of a planned deficit of US$1.2 billion. Hungary has also benefited from substantial spontaneous capital inflows of foreign investment, so that no foreign exchange problems are expected. The worrying developments concern unemployment, which reached 9.3% of the active population in April 1992, and the budget deficit, which was 1% of GDP higher than expected in 1991 and which in April 1992 had nearly reached its target for the whole year.

The challenge which Hungary is now facing is how to consolidate the achievements and continue with market reform in such an unfavourable economic climate. There is a risk that the current recession will undermine the stabilization and liberalization efforts of the last eighteen months. To avoid this, the economic policy programme will have to be revised. The shape that such a revision should take is beyond the scope of this study, but our main conclusions following the completion of the study can be summarized as follows:

- One of the effects of the collapse of CMEA trade, which has particularly hit the big companies that were more dependent on CMEA imports, is to accelerate the restructuring of the state sector. The Hungarian economy is better equipped to undertake this in 1992 than in 1991: the privatization methods have been diversified and decentralised in light of the experience of 1991; the bankruptcy legislation has entered into force; the new banking act has provided a mechanism to clear the bad debts from the past. However, full use of these new instruments will probably result in the closing down of a significant number of companies. Unemployment will rise. Other effects might be to generate a chain of bankruptcies or to weaken the emerging banking sector.

The private sector, though expanding and particularly dynamic in Hungary, has not yet reached the critical size to offset such contractionary trends. Consequently some measure of support to large companies is being restored. The Hungarian Government has to find a manageable compromise between enhancing competition and providing expansionary stimulus.

- How sustainable is the good external performance? This performance derives chiefly from the dynamism of the private sector in Western markets and from expanding tourism in Hungary. It is likely that there are still margins for improvement on both counts. But it would be unrealistic to assume that the current export growth rates could be maintained in the medium term. In 1992, the external surplus is growing, but this is more the result of a contraction of imports because of the recession than an expansion of exports. The dynamics of imports and its relationship with the restructuring is less known, and the effect of a recovery on the external balance is more than uncertain.

- The other key challenge for the coming years is the streamlining of public finance. The fiscal results have been continuously drifting away from the targets over the last eighteen months. This is only partly due to fiscal revenues contracting with the recession. So far, the situation has remained manageable, because the increased public deficit could be financed from domestic saving. However, there are two reasons to be worried about future stabilization of public finance. With the rise in unemployment and/or the increased support to state enterprises, public expenditures, which have so far remained within the programme ceilings might also run out of control. The tax return is also not known yet, and because of technical and institutional deficiencies, fiscal revenues might not increase as much as expected, even if the economy begins to recover.

I. INTRODUCTION

Hungary has a long-standing tradition of gradual but steady progress in reform. As early as 1968 it began efforts to adapt central planning in a more market-oriented direction. Thanks largely to this early start, the Hungarian economy is in many ways better placed than other Central and East European countries embarking on the process of transition to a market economy. It has been able to contain both inflation and the decline in output better; it has done more to introduce new legislation appropriate to a market economy; it has made an early start in privatization and in the development of capital markets; it has attracted foreign capital more successfully than any other country in the area; it has maintained current debt service payments.

Economic performance in the past decade has been mixed. Negative features have been a substantial decline in the rate of growth, increasing albeit moderate inflation, poor productivity of resources and declining investment. The deterioration in the standard of living has not been particularly severe, but only because of the rapid increase of external borrowing in the first half of the decade.

In tackling the transition to a market economy the Hungarian authorities clearly take the view that a gradual approach has proved effective until now, and they intend to maintain this stance. It is important to recognize, however, that the context and objective of this gradual approach have altered fundamentally since 1989. During the two preceding decades the possibility of a change of economic regime was not contemplated, and ideology prevented multi-party democracy. Hence there was no alternative to a gradualist approach, and in so far as it was possible to achieve improvements within the existing economic and political system, progress was made. In 1989, however, the last forms of central allocation were abolished and Hungary set its sights on thoroughgoing reform that will lead to a market economy fully integrated into the world economy and, in particular, equal to Hungary's goal of joining the European Community. This radical change places gradualism in a different light. No longer can it be judged by its ability to modify some aspects of the central planning system of the past. Now the criterion is forward-looking: whether gradualism can bring about the enduring reform necessary to transform Hungary into a market economy and to prepare it for membership of the European Community.

i) The goal of the government's reform programme is clearly to create a market economy. The time horizon is four years (1991-94), but the view is widely held, both within Hungary and outside, that the kind of gradualism that in the past permitted modification and reduced the cost of transition will not yield the same advantages in the context of fundamental change. The government programme maps out an appropriate course, but a successful transformation also requires that change proceed at an adequate pace. The Hungarian government should consider accelerating the implementation of the programme, especially during the early stages, in order to maintain sufficient momentum.

ii) Inflation in 1991, at 28%, was below expectations and, with Czechoslovakia, represented the best performance in Eastern and Central Europe. Nonetheless, the inflation rate projected by the government for 1992 remains well above those of Hungary's main western partners. Inflation differentials will continue to exert strong pressure on the exchange rate, whose continuous appreciation in real terms risks activating an inflationary spiral through the very expectation of exchange rate adjustments. Other sources of inflationary pressure appear to be on the side of costs and particularly wages; especially in a country without a fully fledged monetary and financial system, the importance of wage policy cannot be emphasized enough.

iii) There is a worrying financial fragility in a system which has inherited a significant amount of bad loans from a (pre-1987) situation where neither banks nor enterprises could be considered fully responsible for their operations. Clearly the state must be the ultimate guarantor, but the sooner these residual features of the old system are eliminated the better, and the stronger will be the financial underpinnings of the new system.

iv) Aggregate unemployment has so far remained quite low, mainly because of labour hoarding in the state sector, but sizeable increases are to be expected. How far unemployment can be contained will depend in large measure on whether the trilateral wage negotiation mechanism can be strengthened to bring wage growth into line with productivity growth at a low level of inflation. Equally important will be the degree of flexibility that can be introduced into the labour market. Regional divergences in unemployment which have recently begun to emerge indicate that labour is not sufficiently mobile, and it is clear that wage differentiation according to qualification is inadequate. Furthermore, the unemployment benefits offered by the new Solidarity Fund may be disincentives for job search. Direct transfers to the poorest and an expansion of active labour market policies may be more efficient.

v) The burden of the external debt inherited from the 1970s and 1980s is heavy by any standard. Hungary has long maintained a firm commitment to servicing its foreign debt obligations and to preserving good relations with western commercial banks, which account for the great majority of its creditors. The government aims to halt the accumulation of external debt by 1993 and has set as a medium-term objective the reduction of the ratio of debt service to export earnings to 28%, mainly by further improving the trade balance, restructuring the foreign debt (term and currency) and stabilizing its level. These objectives presuppose, however, a good macroeconomic performance, sustained over several years.

vi) Hungary and the Community both have an interest in ensuring that trade between them is as free as possible as reflected in the Association Agreement signed in December 1991. For Hungary, improved access to a large market close by offers opportunities to expand trade and to attract foreign investment, as well as strengthening competition in the domestic market and reinforcing the case for liberalizing the economy as a whole. The Community will also gain from increased trade and investment and will benefit from having a prosperous and stable neighbour.

The reunification of the European economy is a common end towards which Hungary and the Community can take mutually reinforcing action. By advancing economic reform Hungary can prepare for full participation in the European economy. The Community, in turn, can provide an anchor for Hungary's economic reform by offering a clear prospect of integration into the Community as that reform is accomplished.

II. HISTORY OF ECONOMIC REFORM

The first challenge to the Soviet-type economic and political system adopted by Hungary in the late 1940s took place in 1956; it was crushed by the military intervention of Soviet troops. Three stages of institutional changes followed. Until 1968 the object of reform was the piecemeal improvement of traditional central planning. In 1968 the so-called New Economic Mechanism (NEM) began to be introduced; it was a more ambitious attempt at a comprehensive reform ultimately leading to an alternative model of socialism, decentralized and market-oriented, which progressed at an uneven pace until the late 1980s. The latest round of institutional changes, beginning with the partial divestiture of state property to enterprises (1984-85), paved the way for the uncompromising return to a mixed, capitalist market economy, internationally open to trade and investment and backed by a parliamentary democracy. The early start and protracted reform efforts (though, until recently, abortive) instead of causing 'reform fatigue' have allowed Hungary to avoid drastic stabilization programmes and to follow a fairly gradualist approach rather than shock therapy, diluting structural changes over time. The economic transition is not yet complete but continuous progress is being made with a view to completing it by the end of 1994.

1. The creation of a decentralized planned economy

In 1945-47 Hungary implemented the basic changes leading to the adoption of a Soviet-type system; the entire post-war reconstruction effort was based on central planning and management. Financial institutions and industrial enterprises were nationalized; agriculture, previously characterized by large and low-productivity estates, was partly nationalized, mostly through the creation of state farms or small farms to which land was distributed, often with positive effects on agricultural performance.

After the 1956 events a first attempt to improve the traditional model was introduced in the late 1950s, when mandatory delivery of agricultural products to the state was ended and the number of normative indices in planning reduced.

A more comprehensive reform effort was attempted in 1968. The reform maintained the principles of communist party monopoly of power and state ownership. However, the breaking down of plans to enterprise level was eliminated and centrally determined targets abolished. Value indicators (including profits) of enterprise performance were used, and managerial incentives and penalties were geared to these measurements of enterprise performance. A parallel price reform introduced contractual prices for a range of products, although some prices continued to be administered and heavily subsidized.

The reform fell short of a market economy. Its incompleteness created problems of its own: inflationary pressures arising from persistent monopolies; localized shortages resulting from the combination of enterprise freedom in choosing the product mix and of inflexible prices aggravated by entry restrictions; social tensions generated by growing income differentials between peasants and workers, and between state-owned enterprises and the rest of the economy; the inadequacy of institutions for the recycling of profits across sectors. In the early 1970s some recentralization occurred in response to these problems and the reform process was effectively halted for a decade.

One of the beneficial consequences of the 1968 reform effort was a substantial reduction of shortages on the domestic market. Partial shortages continued until the end of the 1980s, but to a decreasing extent.

In 1981 branch ministries, which had remained the main vehicle of state control and planning, were merged into a single Ministry of Industry, whose powers were also reduced; external imbalance and inter-enterprise conflicts, however, led to the continuation of central regulation of economic activity.

In 1984 state enterprises were emancipated from ministerial and (partly) from party control; most enterprises were given a 'self-governing' statute, centered on enterprise councils with powers to appoint and dismiss directors and to approve enterprise plans. However, although this step reduced formal state control and virtually transferred some elements of state property to enterprises, it neither abolished central control nor subjected enterprises to full market discipline; ex-post ad-hoc budgetary transfers continued to equalize profitability across enterprises regardless of actual performance. Finally, during the period 1968-90 the strong linkage of the Hungarian economy to the economies of the other CMEA[1] countries remained, as well as the inter-state coordination of these relations, with all its negative consequences.

These failures and the parallel reform drive in other Central and East European countries led to a decisive change in the target model of Hungarian reform, with private property and the privatization of state assets being given a dominant role. The two decades of reform efforts had succeeded in reducing at least some of the drawbacks of the traditional model: the Hungarian economy was plagued to a smaller extent than other planned economies by disequilibria, distortions in the structure of relative prices, lack of innovation, bad management. Some essential components of market mechanisms had been introduced, along with greater exposure to market mentality and behaviour. Finally, comprehensive legislative changes were put in place, modifying norms concerning key sectors of the economy, very often many years earlier than in other planned economies.

2. Creation of an advanced legislative framework

The new banking legislation (1987) dismantled the classic monobank system and took away from the National Bank of Hungary commercial banking functions, granting them to new commercial banks, including private and foreign-owned institutions. The new act on the Central Bank, which was passed by Parliament in 1991, will supplement and complete those rules; the National Bank of Hungary, will be left to concentrate on central banking functions and will gain greater autonomy. A State Banking Supervision authority was also established in 1987 though it started to function only in 1989 (see section on banking reform).

The Companies Act (1988) gave business entities and persons, regardless of nationalities, the same rights as the state to establish or participate in business activities. This allowed the creation of small and medium-sized enterprises in almost all sectors of the economy and favoured the creation of private ventures.

Simplified procedures for external trade were introduced already in 1986, whereby companies were authorized to export and import, subject to limited administrative controls (the so-called 'negative list'). In 1988, an ambitious import liberalization programme, combined with a programme of liberalization of prices, was launched to open the domestic market to competition. Import licensing obligations have been progressively removed: at the end of 1991, 80% of industrial production was exempted from licensing obligations, compared to 14% in 1989. Over 90% of Hungarian imports require no licence. The tariff rates will be further lowered. Simulta-

1 Council for Mutual Economic Assistance, frequently referred to in the West as Comecon; see Box on page 26.

neously the proportion of consumer goods whose prices are free was increased from 50% in 1988 to over 90% in 1991.

Hungary was also the first planned economy to introduce legislation favouring foreign investment. Legislation on joint ventures had been first enacted in 1972, and then constantly modified. Foreign partners were allowed to hold a majority stake already in 1977, although certain sectors were excluded. The Foreign Investment Act (1988, with subsequent amendments) provides for the protection of foreign investments, repatriation of profits and compensation in case of expropriation. Together with substantial tax allowances, the law is regarded as one of the most liberal, not only in former centrally planned economies but worldwide. Some important modifications introduced in January 1991 limit the conditions and extent of tax allowances and abolish licensing requirements for joint ventures with majority foreign participation.

Reforms of the taxation system in 1988 and 1989 (see section on taxation) brought the system into line with that of many West European countries. As part of a comprehensive tax reform, Hungary has introduced VAT and personal income tax, and adjusted the profit tax system to make it consistent.

The Transformation Act (1989), which was designed to facilitate the introduction of private capital into state-owned enterprises, enables state-owned enterprises to be transformed into joint-stock or limited liability companies. Finally, with the creation of the State Property Agency (1990) and the adoption of the Management and Utilization of State Assets Act (1990) conditions have been created for the privatization of a large part of state property (see section on privatization). A stock exchange was re-established in mid-1990.

3. The 'Programme of conversion and development for the Hungarian economy'

The new economic programme, approved by Parliament in March 1991, set out in detail the objectives and measures for the transformation towards a 'social' market economy by the end of 1994 (here 'social' refers to a combination of competition and a social safety net). Acknowledging that by 1991 only a first set of legislative measures had been put in place, the programme emphasized accelerated privatization and reorganization of ownership, legal and institutional changes to promote market conditions and competition, and a general reduction in the economic role of the state.

The programme also included a short-term stabilization strategy, with containment of inflation and unemployment as prime targets. Debt relief or rescheduling were ruled out by the programme, which called for a continuing effort to maintain international solvency and access to international financial markets. Long-term growth was to be secured by a strategy of export-led growth.

Increased importance was given to market instruments, especially monetary policy and modernization of the financial system. Reform of pensions, health care and housing was also envisaged.

The programme reflected the important changes that had taken place in external economic relations (collapse of CMEA trade), the need for a new impetus after the lack of progress of a first programme drafted in September 1990 and the delays in a number of key areas (privatization, ownership structure, agriculture).

On the whole the programme was clear-cut, action-oriented, workable and feasible in the time allowed. It indicated a precise time schedule for specific legislation and actions. The quantitative alternative scenarios covering the main economic indicators over the coming years were very useful to understanding the underlying hypotheses.

The realism of some of the macroeconomic targets and assumptions was debatable, however. This concerned in particular the feasibility of the strong export expansion projected from 1992, which was to underpin overall macroeconomic expansion, and on the sustainability of a protracted fall in private consumption, which was expected to return to the late 1980s level only by 1993.

The programme realistically recognized that the new legal and institutional framework of a social market economy was not going to be fully operational in 1992-93, but many of the measures envisaged appeared to stretch out excessively the process of adjustment.

4. The pace of change

Until now Hungary's more gradualist approach seems to have enabled it to contain the costs of transition, in terms of output, living standards, employment, with respect to those incurred by other transitional countries which have chosen 'shock therapy'. This option was open to

Chronology of reform

Most relevant economic reform legislation

Bankruptcy Law	*1986 & 1991*
Banking Reform	*1987*
Companies Act	*1988*
Reform of the taxation system and VAT	
Personal income tax, Profit tax	*1988*
Foreign Investment Act	*1989 & 1990*
Transformation Act	*1989*
Securities Act	*1990*
Competition Law	*1990*
Law on Protection of State Assets	*1990*
Act on State Audit Office	*1990*
Law on Privatization of Domestic Trade	*1990*
Stock Exchange Law	*1990*
Central Bank Law	*1991*
Banking Law	*1991*
Law on Accounting	*1991*
Compensation Act	*1991*

Membership of international organizations

GATT	*1973*
International Monetary Fund	*1982*
World Bank	*1982*
International Finance Corporation	*1985*
MIGA	*1988*
EBRD	*1991*

Hungary because it had the advantage of earlier significant progress towards stabilization, reform, restructuring and opening to trade and investment. But the question arises whether Hungary has sufficiently adapted gradualism to its new circumstances. In the past, step-by-step changes were directed to modifying the existing system; now the aim is transformation into a market economy, an objective which requires that a greater impetus be given to change. In particular the collapse of CMEA trade is affecting Hungary just as much as the countries that have taken more radical and faster steps, and is shortening the time horizon over which action must be taken.

To consolidate the gains of past stabilization measures it may be necessary to speed up adjustment. Although inflation is still lower in Hungary than elsewhere in Central and Eastern Europe, it is now eroding previous adjustments, such as in the exchange and interest rates, so that the move to market-determined rates is being delayed and the risk exists that past distortions will be reintroduced. Although, in the short term, further devaluation might fuel inflation and higher interest rates might cause a deeper recession, they could, if coupled with slightly lower domestic absorption and appropriate structural reform measures, enhance exports, domestic savings or foreign investment - areas where the Hungarian economy has already proved to be highly responsive.

In structural reform, Hungary is reaching a stage where the main steps towards liberalization and the removal of distortions have been taken, and the principal challenge is to activate the supply side through privatization and the development of the financial sector. In these respects Hungary has made only partial progress. The country benefits from the dynamism of its small private sector. Little progress, however, has been recorded in streamlining the operations of the large surviving state sector: like other Central and East European countries, Hungary is behind schedule in dismantling monopolies, implementing bankruptcy proceedings, tackling bad debts of enterprises and privatizing large state enterprises. The emergence of a competitive supply side will in any event be a slow adjustment process, which should not be lengthened by delays at the decision-making stage.

III. ECONOMIC PERFORMANCE

1. Short-term adjustment and long-term performance

The Hungarian economy has embarked on a major effort of stabilization and restructuring. The ultimate goal is to transform Hungary into a competitive market economy. Since 1989, however, economic stabilization and the reform effort have contributed to a dramatic decline in economic activity.

The coalition government formed after the election of Spring 1990 elaborated two programmes of economic reform. The first, called the 'Economic programme of national renewal' was presented by the government in September 1990. A second, the 'Programme of conversion and development for the Hungarian economy' was approved by the Parliament at the end of March 1991. In addition, a memorandum on 'Economic transformation and medium-term policies' was negotiated with the IMF in January 1991, which gave Hungary access to the Compensatory and Contingency Financing Facility and to a new extended financing facility.

The main lines of the country's medium-term (1991-93) development strategy can be summarized as follows:

- to achieve external and internal balance consistent with the establishment of convertibility for current transactions of the forint;
- to reduce inflation to a single digit, through a reduction of the budget deficit and the maintenance of a tight monetary policy.
- to reduce the role of the state in economic activity, through the development of private entrepreneurship and privatization.
- to develop the financial system, the first step being the approval of a new Central Bank Law.

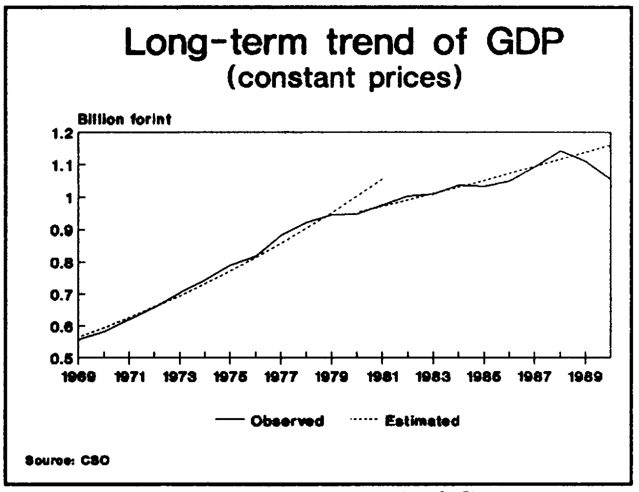
A radical transformation of public finance will also aim at reducing direct intervention of the state in the economy. A further reduction of subsidies (to no more than 4% of GDP in 1993), direct investment and the overall size of the public administration is envisaged. State intervention will be directed at improving infrastructure and restructuring and strengthening social welfare.

The aim of the present chapter is to evaluate these principal targets in the light of the past and the expected performance of the Hungarian economy.

a. Long-term trend

Over the past three decades the Hungarian economy has achieved a relatively high rate of growth. Graph 1 shows positive growth rates in real terms for the period 1969-88, with a sharp decline thereafter. However, the data indicate quite clearly that the deceleration of growth dates back to the late 1970s. Growth rates declined from an average of 5.6% per annum in 1969-80, to 2% in 1980-88, to become negative from 1989.

Various factors explain this declining trend. In the 1970s both exogenous shocks and economic policy mistakes contributed to slowing down the rate of growth and, even more importantly, laid down the conditions for the subsequent decline. Two factors were particularly significant. First, the reform attempted in the late 1960s failed in terms both of conception and of implementation of policies. It maintained central control over the economy (although reducing to a minimum the central compulsory planning indices) and left the ownership structure of the economy substantially unaltered. The world recession and changes in market conditions (above all the sharp increase in the prices of energy and raw materials) had a negative impact on a small, open economy like Hungary. The short-term negative impact of these exogenous shocks was partially cushioned by the transfer of resources from the Soviet Union (in the form of heavily subsidized exports of oil) and by cooperation within the CMEA. No attempt was made, however, to introduce forms of industrial restructuring or to rationalize the use of energy and raw materials, so future growth prospects were undermined.



Graph 1 Long-term trend of GDP

The 1980s were characterized by contradictory policies. The first half saw the introduction of a set of adjustment measures aimed at reducing domestic absorption by controlling private consumption and reducing hard-currency imports (see Table 1). As a consequence, the import-led growth strategy initiated during the previous decade came to an end.

Table 1 Macroeconomic performance, 1971-90 (% change at constant prices)

	1971-75	1976-80	1981-85	1985	1986	1987	1988	1989	1990
Gross Domestic Product	6.5	3.2	1.8	-0.3	1.5	4.0	-0.2	-0.2	-4.3
Industrial production	6.4	3.3	1.9	0.7	1.9	3.8	0.0	-1.0	-8.5
Agricultural production	4.6	2.4	0.7	-5.6	2.4	-2.0	4.4	-1.3	-6.7
Gross Fixed Investment	6.9	2.5	-3.2	-3.1	2.9	9.1	-9.0	3.6	-8.7
Personal consumption	4.7	2.6	1.4	1.4	2.0	3.7	-4.3	0.4	-4.5
Consumer prices	2.8	6.3	6.8	7	5.3	8.6	15.7	17.0	28.2
Real Wages	3.3	0.7	-0.8	1.3	2.0	-0.4	-5.1	-0.4	-

Source: Hungarian CSO Statistical Yearbook, various issues; OECD Economic Surveys - Hungary 1991; IMF Staff estimates.

Austerity measures came to a halt in the second half of the decade in order to buy public support for the old regime, whose legitimacy was being increasingly, and more openly, questioned. Despite signs of declining national income in 1985-86, private consumption increased, the budget balance turned into deficit, and the current account of the balance of payments deteriorated rapidly. The net debt in convertible currency doubled between the end of 1984 and the end of 1987.

A paradox in Hungarian trade became clear for the first time. Increased exports to the CMEA had a negative impact on the convertible current account because of the high hard-currency import content of Hungarian exports to the CMEA. Moreover, rouble exports 'crowded out' non-rouble exports because profits came easily on the rouble export market. Hungary began to run substantial surpluses in transferable-rouble trade, which de facto were an interest-free credit extended to the other members of the CMEA. This surplus was also a major source of domestic liquidity creation.

b. *Recent economic developments*

Since 1989 the Hungarian economy has embarked on a major effort of stabilization and medium-term adjustment designed to transform Hungary into a competitive market economy. This has required the Hungarian authorities to attempt to work out and implement:

- a stabilization-oriented economic policy for the short term;
- structural modification of the economic system for the medium and long term.

For the time being, however, economic stabilization and the reform effort have contributed to a decline in economic activity, which has been particularly pronounced since 1989. The recession was intensified in 1990 by the breakdown of the CMEA trading system and continued in 1991.

In 1989 economic performance fell far short of the initial targets set by the government, and the economy slowed down to virtual stagnation. GDP is estimated to have declined by over 2%, inflation accelerated to about 17%, from 15.7% in 1988, while the convertible current account deficit widened to US$1.4 bn from US$0.8 bn in 1988. The state budget deficit reached Ft54 bn (3.1% of GDP or US$836 million) for the year.

Three main factors contributed to this deterioration:

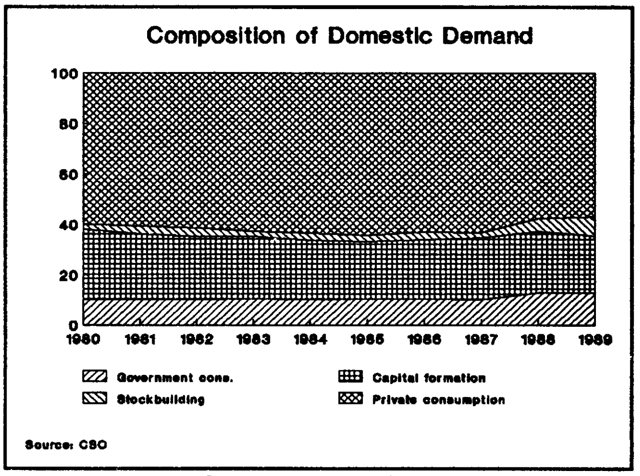
- policy slippage resulting in a higher than planned fiscal deficit;
- a large external payments surplus with the rouble area, which contributed to a significant increase in liquidity;
- a sharp deterioration in the balance on tourism.

Corrective measures were introduced in 1990. The rapid deterioration in Hungary's convertible balance of payments, which resulted mainly from excessive domestic demand, called for adjustments in demand-management policies. The government sought to reduce substantially the consolidated budget deficit, to tighten credit, and to enhance the credibility of the adjustment efforts in order to reverse inflationary expectations. Exchange-rate and interest-rate policies were also geared to helping to improve the convertible current account without resorting to administrative current account and trade restrictions. Measures to reduce the foreign exchange allowances for residents travelling abroad were temporarily introduced. The restrictive policy was somewhat weakened, however, by the electoral campaign that led to the election of a new Parliament in March-April 1990 and to the formation of a coalition government.

Macroeconomic results for 1990 point to a severe contraction of economic activity, although it is not completely clear to what extent official statistics are able to take into account the increasing rate of expansion of private activity (see section on statistics). Real GDP declined by 4.3% with respect to the previous year. The decline was due to the collapse of demand within the CMEA, the depressed condition of the domestic market, the effects of the oil price increase in the last quarter of the year and a severe drought, which caused losses in agriculture. Industrial production declined by 9%, with severe contraction in mining (-18%), iron and steel (-12.2%), engineering (-15.4%), and light industry (-9.6%). Agricultural production fell by about 6.7%. Particularly pronounced were the declines in production of grain (-18%), soya beans (-54%), and sugar beet (-12%).

In 1991, GDP fell by 7 to 9%, at least 3% more than initially forecast. Industrial production declined by 20.5% in the first eleven months of 1991 compared with the same period of last year. The number of registered unemployed increased to about 400,000 by the end of the year, corresponding to 8.3% of the work force and nearly 40% over the initial forecast. Actual unemployment has been increasing especially in those sectors more dependent on exports to the Soviet Union. However, the informal sector of the economy and the dynamic development of small enterprises made it possible for part of the shock to be absorbed. In 1991, they are thought to have contributed 2 or 3 percentage points to the growth of industrial production.

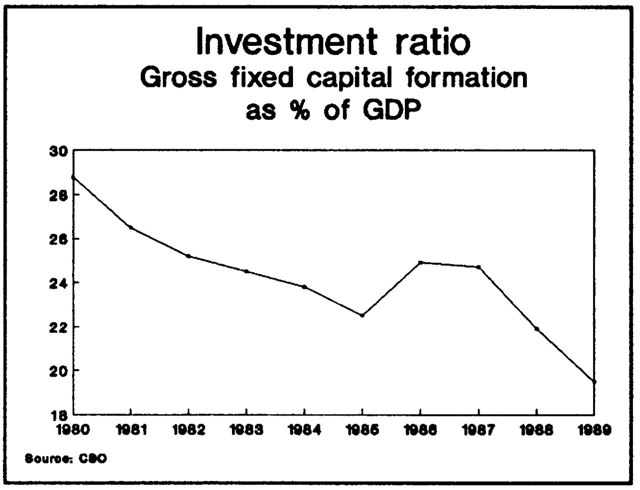
In 1990 consumption fell by an estimated 4.5% with respect to 1989. The fall, larger than originally planned (+0.5% to 1%) was due to a decline in labour incomes and to an increase in saving. Savings recovered their pre-1989 level after small-scale capital flights (mainly in the form of travel expenditure abroad) had substantially reduced this aggregate in 1989. Private consumption increased steadily from 1980 to 1987, thus helping to worsen the external disequilibrium. It then started to contract, and a further decrease of 4 to 6% is estimated to have occurred in 1991.



Graph 2 Composition of domestic demand

Gross fixed capital formation also declined in 1990. The distinct deceleration in investment in 1989 and 1990 was the result partly of the slower growth of output and available resources and partly of difficulties in adjusting to new business conditions, i.e. replacing previously state-funded investment with enterprise-financed investment.

Hungary, like all the other East European economies, had a rather high investment ratio (gross fixed capital formation / GDP), in line with the prescription of centralized planning which envisaged a very high rate of accumulation (see Graph 3). However, the process of adjustment seems to have begun well in advance of the other formerly centrally planned economies. Calculated at current prices, the investment ratio declined from 28.8 in 1980 to 19.5 in 1989, and with the exception of 1985 the ratio declined in each year of the decade. The present level of the ratio is similar to the EC average (20.6), and even lower than that of some member countries like the Netherlands (21.8), Spain (23.8), or Portugal (26.4).



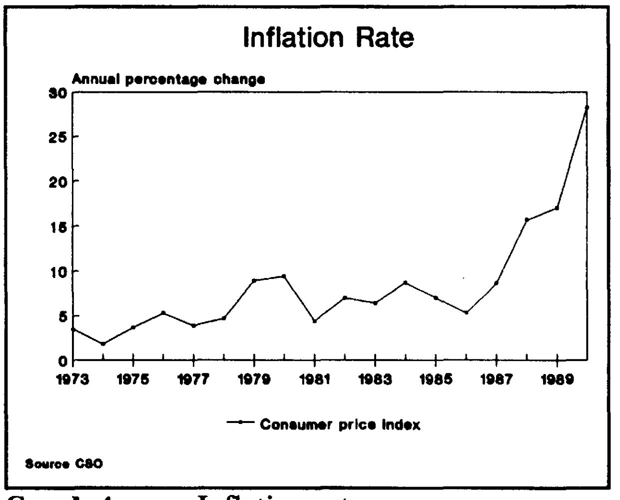
Graph 3 Investment ratio

The rate of inventory accumulation is much higher in Hungary than in industrialized countries. Changes in inventory represented 7.4% of GDP in 1989, against a value normally well below 1% in developed market economies. The value is comparable with that of other formerly centrally planned economies.[2] The relative 'inflexibility' of supply, which prompted individual enterprises to diversify their range of products (universalism of the enterprise), is often identified as the main cause. Inventory accumulation accelerated further in 1989 and 1990 (see Graph 2), in an effort to prevent losses resulting from supply problems and price increases, which led to a higher than necessary amount of purchases.

Inflation started to accelerate in 1987, with the annual inflation rate increasing steadily from an average of 8% over the period 1980-88 to 17% in 1989, and 28.2% in 1990. For 1991 inflation is estimated at 35-37%. In recent years the inflation target has been repeatedly overshot.

Inflationary pressures are part of the transition costs that Hungary has to bear. The move towards a market economy encompassing price liberalization, the removal of subsidies, the dismantling of the CMEA and its effects on the terms of trade, and the depreciation of the forint have pushed the inflation rate upwards. In 1991, although the price liberalization effect was becoming marginal and was unlikely to account for more than 5 percentage points of the overall inflation figure, the deterioration in the terms of trade and the devaluation of the forint in January 1991 may alone have generated a two-digit inflation figure. In addition, Hungary had to face external shocks, such as the Gulf conflict.

But the acceleration in inflation also reflects the lack of control on the wage-price nexus. Government projections of inflation have not been taken as credible, and wage negotiations have resulted in higher than expected wage increases. In 1991, the contribution of wage increases to the inflation rate may have been close to ten percentage points.



Graph 4 Inflation rate

The Hungarian Government has relied on a policy mix of restrictive monetary, budgetary and income policies in its attempts to keep inflation under control. However, the survival of past distortions has made the trade-off between growth and inflation even more severe. The budget could not be more restrictive without affecting standards of living, which have already been eroded by fiscal reform, which has reduced social security expenditures and removed subsidies and interest subsidies on housing. Similarly monetary policy needs to accommodate the still high public deficits in the transition phase and to support at the same time the emergent private sector and the development of new financial instruments, such as export credits following the dismantling of the CMEA. In the past the policy mix adopted by the government has been only mildly anti-inflationary. However, the risk that the stabilization process could be undermined is now recognized by the Hungarian authorities. As a result, monetary controls are being strengthened and inflation might slow down in 1992.

2 In Poland change in stocks, as reported by the UN Economic Commission for Europe, represented 6.3% of GDP in 1987, 10.1% in 1988, and 22% in 1989. By contrast, in the CSFR the ratio was 1.2% in 1989 and 3.3% in 1990.

c. *Public finance*

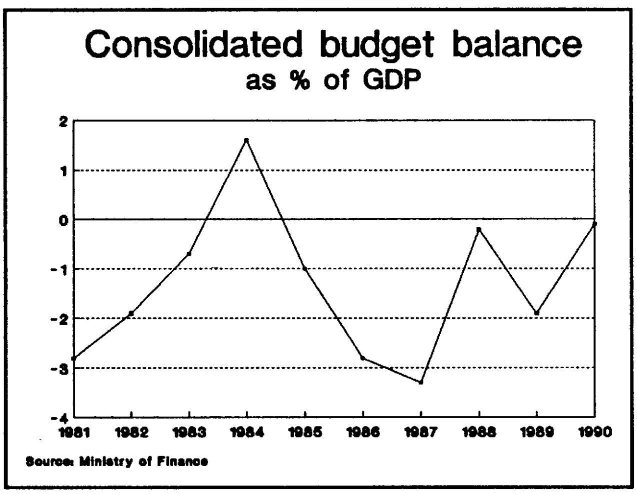
As Table 2 indicates, the government budget has been in deficit throughout the second half of the 1980s, irrespective of whether the extra-budgetary funds are included.

Table 2 Revenue and expenditure of the government budget (in billion Forint)

	Central government and social security[1]			Central government, social security and extra-budgetary funds[2]		
	Revenue	Expenditure	Balance	Revenue	Expenditure	Balance
1986	572.5	619.4	-46.9	606.8	637.7	-30.9
1987	631.2	666.0	-34.8	660.4	700.7	-40.3
1988	713.8	733.5	-19.7	789.9	793.1	-3.2
1989	829.3	858.6	-29.3	926.6	959.2	-32.6
1990	1001.0	1003.0	-2.0	1105.9	1089.2	16.7
1991 planned[3]	1224.6	1302.9	-78.3	1279.0	1332.2	-53.2

[1]. Hungarian presentation
[2]. Consolidated budget according to IMF-GFS presentation
[3]. Initial projection, which has since been revised
Source: Ministry of Finance, IMF

The deficit declined from 1986 to 1988, and then rose again in 1989 reflecting the sharp increase in housing loan subsidies. As a percentage of GDP the deficit fluctuated widely during the 1980s, although it remained below 4% (see Graph 5). In 1990 tight fiscal policy led to a sharp reduction of the budget deficit to Ft 2.6 bn, against a forecast of Ft10 bn at the beginning of the year (see Table 2). The increase in expenditure (14.2%) turned out to be lower than the increase in revenue (18%). The deficit reflects strong cuts in subsidies which, in accordance with the World Bank programme, should be reduced from 13% of GDP in 1989 to 4% in 1993.



Graph 5 Consolidated budget balance

Table 2 includes also estimates for 1991 as initially approved by the Hungarian Parliament. This preliminary estimate was the result of a sharply higher state budget deficit and a sizeable surplus on the extra-budgetary funds. Structural changes affect the comparability of 1991 data with the figures for the previous years: the State Development Institute was incorporated into the central government, and local government finances have been reformed; the overall impact on the budget balance is estimated at between Ft 10 and 20 billion. State revenue was intended to increase less

The state budget (1)

The structure of the state budget differs somewhat from the standard IMF presentation. In the Hungarian practice some debt service items (domestic and foreign credit operations of the government), which in the GFS presentation are below the line, are included in the expenditure side.

There are two levels of budgets: the state (central) budget; and the general government budget, which is made up of the central budget, some extra-budgetary funds and a social security fund, and the local government budgets. Recent practice is to attempt to reduce the number of extra-budgetary funds and to transfer the relevant items to the government budget.

The revenue side of the central government budget includes:

- *Payments of enterprises*
  Enterprise profit tax, customs duties, dividends of state property, income taxes, payments on various producer turnover taxes, previously mostly related to CMEA trade.
- *Payments from consumption*
  Two kinds of taxes, VAT and excise. At present there are three VAT rates: a general rate (25%), a rate for foodstuffs (0%), and an intermediate rate (15%) on some services. A revision of VAT is under review, with the intention of reducing the rates to two: 10% and 20%.
- *Payments of households*
  This item includes personal income taxes, other taxes (i.e. car taxes, fees, etc.).
- *Payments from central budgetary institutions and from extra-budgetary funds*
  Activities of the central budgetary institutions outside their institutional activity are taxed.
- *Income from international transactions*
  Includes repayment of credit extended to LDCs, credit extended to the Hungarian government by other governments, as well as credit from the World Bank (only for the part directly extended to the government).
- *Other income*

The main expenditure items are:

- *Subsidies to enterprises*
  Subsidies to enterprises are extended for several purposes: producer price subsidies, agricultural products subsidies, import price subsidies (abolished from 1991), subsidies related to CMEA trade.
- *Transfers to central budgetary institutions*
  Central budgetary institutions include institutions dealing with health care, education, infrastructure (e.g. road maintenance), for the most part working under direct supervision of a ministry. In the framework of the reforms of the general government their scope of activity will be revised.
- *Transfers to local government*
  Previously 100% of the local government budgets came from central transfers. Local taxes have recently been introduced, and about 20% of expenditure is now funded by local revenues.
- *Transfers to social security fund*
  The budget covers transfers only for certain components, the main one being family allowances.
- *Transfers to extra-budgetary funds (includes Housing Fund (see below))*
- *Investment expenditure*
  Since 1989 a sharp decline in direct investment activity by the state has occurred. Three main items remain:
  i Financing of infrastructure and defence;
  ii Financing of the Yamburg pipeline project, which is going to be taken over by the State Development Institute;
  iii Housing subsidies
  Under the previous regime, the state granted loans to individuals at a very low interest rate (3% p.a.). The Housing Fund, financed by direct transfers from the state budget, paid the difference between the subsidized and mortgage interest rates. The item is substantial, about Ft100 bn in 1991. The Parliament passed a bill which offered two options:
  a) The government would take over 50% of the debt, and the interest rate on the remaining 50% would be increased to the market level; this option was chosen by 80% of those concerned.
  b) The interest rate on the entire debt would be increased to 15% in 1991.
  The financial losses incurred have been included in the budget.

The state budget (2)

- *Expenditure on international transactions*
  Includes credits granted to other governments, recently reduced, and insurance, export guarantees and other trade-related credits.
- *Debt service*
- *Other expenditure*
  This represents a small amount.
- *Reserve (Ft 7 bn in 1991)*

The deficit is financed for the most part by long-term credit from the National Bank of Hungary. The issuing of Treasury bills is a relatively new instrument in Hungarian practice.

than expenditure; in particular, the expected decline in revenue from enterprises could not be completely offset by the increase in household payments.

The deficit was to be financed for the most part by long-term credit from the National Bank of Hungary and by issuing state bonds, and for the rest by increasing the stock of Treasury bills. The interest on NBH long-term credit, which was previously extended at a below-market rate, is gradually being raised to the market level, although, according to the Hungarian authorities, this measure will apply only to new loans (about Ft 60 bn). Debt service, rose from Ft70.7 bn in 1990 to an estimated Ft110 bn, adding a further burden to the budget, and though the high level of inflation will reduce the real interest payments on the old domestic debt, this will not apply to the external component of the debt.

Table 3 shows the structure of public debt as at end-December 1990. The total amount of the public debt represented about 65% of GDP in 1990. The debt is the result of loans granted by the central bank to cover the deficit (portfolio and refinancing loans), as well as Ft519.2 bn which is debited as the cumulative amount arising from successive devaluations of the forint. As the table shows, bonds and treasury bills represent only 2% of the debt. In particular, the issuing of Treasury bills is a relatively new instrument in Hungarian practice. It was used for the first time in 1989. Interest on bills of 3, 6 and 9 months' maturity currently is 31%, 32% and 34%, at an annualized rate, respectively.

The deficit in 1991 turned out to be Ft114 bn instead of Ft78 bn, that is one percentage point of GDP higher than planned. Both revenues and expenditures were lower than planned, with a more marked decline for revenues as a result of a larger than expected fall in output and consumption, which affected both direct and indirect tax revenues. On the expenditure side, unemployment benefits exceeded the targets and the delay in raising energy prices increased the expenditure on subsidies.

In the future the size of the state budget deficit could be substantially higher if payment arrears among enterprises and bad loans in the banking sector and provisions for the consequent necessary recapitalization are included. The rationale for including these items in budget expenditure is that the state should be considered the ultimate guarantor for the state sector. State-owned enterprises cannot be held responsible for their performance under the previous regime.

Table 3 Public debt at 31 December 1990

	Ft billion
Portfolio loans by the NBH to the budget directly and government bonds	503.2
Portfolio and refinancing loans granted by NBH to the State Development Institute	259.5
Bonds sold to commercial banks, other financial institutions and insurance companies	17.5
Treasury bills	10.2
Domestic national debt without provisions for forint devaluations debited to budget	790.4
Forint devaluations debited to the budget	519.2
Total	1309.6

Source: National Bank of Hungary Annual Report 1990, p.32.

Both arrears among enterprises and bad loans in the banking sector are present in Hungary on a large scale and are worrying, though not to the same extent as in other transitional countries. Enterprise payment arrears, although difficult to calculate, are estimated by the Hungarian authorities at about Ft 150-200 bn as at the end of 1990. They are a form of quasi-money. Since November 1990, to discourage enterprises from delaying payments the penalty interest rate on arrears has been increased to equal to twice the basic rate. However, since the actual cost of borrowing by enterprises at the margin is much higher than the basic rate, the penalty differential is not very large and the measure has not been effective.

Bad loans, calculated by the National Bank of Hungary in accordance with international auditing rules, amounted to Ft36 bn at the end of 1990, which is less than 4 per cent of bank assets. They are concentrated in three banks: the Hungarian Credit Bank, the Hungarian Commercial Bank and the Budapest Bank, which together inherited about half of the bad loans of the NBH when they were established in 1987. The other banks do not account for much of that debt and have made ordinary provisions in line with Basel Agreement regulations. Recently the government proposed that a budget guarantee be provided for about half of the doubtful debts inherited by the commercial banks and that the share capital of the three banks most affected be raised. The banks will be given three years gradually to increase their reserve funds to the level prescribed in the new Banking Law, in accordance with the Basel guidelines. The state guarantee will be allocated in proportion to the size of the bad debts that the three banks inherited. The government proposal, however, is still subject to the approval of Parliament.

d. *Money and credit*

A restrictive monetary and credit policy, focused in particular on stabilizing the domestic currency and on controlling emerging strong inflationary pressures, was initiated in 1989 and continued throughout 1990 and into 1991, in line with the agreements reached between Hungary and the IMF in March 1990 for a 12-month stand-by arrangement and in February 1991 for a three-year extended financing facility.

Since 1989 the National Bank of Hungary has made more effective use of traditional instruments of monetary and liquidity control. In particular, in 1990 broad money expanded by 29.3%, (Table 3) higher than the growth rate recorded in 1989 (+ 15.3%). The broad money velocity during the year was fairly stable, after an acceleration in previous years. The broad money growth essentially reflected the remarkable expansion during the year of deposits in domestic currency owned by enterprises (+ 39%). Also, foreign currency deposits at enterprise level expanded significantly during the year (+ 261.3%), though the amounts involved were modest. This trend reflects the view prevailing among enterprises during the year that they should increase their monetary holdings to meet transaction requirements and to protect themselves against financial uncertainties stemming from the ongoing process of transformation, privatization and liquidation. Households also in 1990 expanded their holdings both of forints and of foreign currencies. The high liquidity propensity of households in 1990 was a result partly of the urge to use financial resources for consumption and investment promptly in a generally more volatile financial environment (rising inflation) and, partly of the fact that real interest rates offered by banks, particularly on short-term deposits, were unattractive. Preliminary results for 1991 confirm these developments.

The issuance of bonds, savings notes, certificates of deposit and other instruments increased remarkably in 1990 (+ 39.7%) and expanded further in 1991 (+58.4% in June 1991 compared to June 1990), reflecting the government's determination to develop new market-based financial instruments. To make this type of financing attractive enough, at the end of 1990 annualized interest rates on Treasury bills were raised from 28 to 33% for three-month bills, from about 29% to a maximum of 31% for 6-month bills and from 31 to 34% for 9-month bills. However, only a small proportion of these bills were placed with non-bank investors.

Demand for money remained high in 1991, as a result of the high public deficit and reflecting growing financial needs at enterprise level for start-up, restructuring and investment purposes. The changes in the intra-CMEA settlement system and the reduction in turnover could also increase enterprises', demand for credit. On the other hand, the household sector is moderating its preference for liquidity, though this depends largely on the state and commercial banks' ability to implement a positive real interest rate policy to attract savings.

The primary concern of the NBH in 1990 and 1991 has been to keep credit expansion under tight control and to use it more selectively. Total domestic credit after recording growth of 16.8% in 1989, expanded by an average of 10.6% in 1990, substantially in line with initial forecasts. This growth rate was maintained over the first half of 1991.

In particular in 1990 credit to the central government declined by 2.4% while credit to local authorities expanded significantly (+20.3%), though the amount of funds involved was relatively small. In 1990 credit to enterprises also expanded at quite a high rate (+23.8%), reflecting an urgent need for recapitalization rather than for investment. The need to recapitalize indicates that many companies have not yet achieved a satisfactory degree of financial discipline and still look to assistance from easy credit policies. Many banks (because of their specialized nature) still maintain unhealthy financial relations with enterprises. New credit to small (newly established) entrepreneurs more than doubled in 1990, albeit the amounts were still very low. Preferential loan schemes for strengthening export capabilities and for promoting privatization were granted in 1990, in accordance with government priorities in these fields. Credits to the State Development Institute expanded moderately (+7%) and by less than originally planned.

In general, credit to enterprises in 1990 reflected banks' growing reluctance to make loans to loss-making enterprises, which are now exposed to more rigid financial discipline imposed by the government, including liquidation and bankruptcy.

Table 4 Monetary Survey
(in bn forints)

	End 1989	I 1990	II 1990	III 1990	IV 1990	End 1990/ End 1989 (% var.)	I 1991	II 1991	Mid 1991/ Mid 1990 (% var.)
1. Domestic credit	1540.7	1546.8	1584.6	1627.8	1703.4	10.6	1693.2	1749.5	10.4
Central government,net	482.0	477.2	481.5	469.4	470.2	-2.4	478.6	503.9	4.7
Other government, net	5.9	3.6	3.4	5.4	4.3	-27.1	4.8	4.9	44.1
Local government	18.2	19.4	20.2	20.7	21.9	20.3	21.5	22.0	8.9
Financial institutions (essentially State Development Institute)	237.8	242.0	244.5	246.2	254.5	7.0	257.0	254.4	4.0
Enterprises	464.4	471.5	493.6	528.1	574.9	23.8	590.7	622.1	26.0
Households	313.3	308.8	309.7	320.5	329.8	5.2	279.9	271.1	-9.6
Small enterprises	18.5	23.2	31.0	36.4	43.6	135.7	46.1	49.2	48.7
2. Other assets	306.3	327.5	312.5	304.3	329.9	7.7	492.8	524.1	57.7
3. Net domestic assets	1847.0	1874.1	1897.1	1932.1	2033.3	10.1	2186.0	2273.6	19.8
4. Net foreign liabilities	1019.4	1043.0	1040.7	1052.8	1029.1	1.0	1166.1	1190.1	14.4
5. Broad money of which (in forints):	706.1	732.6	762.1	796.2	912.9	29.3	915.2	960.3	26.0
- Household deposits	297.2	299.3	307.7	320.7	360.4	21.3	362.2	379.0	17.7
- Enterprise deposits	161.1	166.4	183.5	189.6	224.1	39.1	269.8	207.1	12.9
6. Bonds and savings notes	66.8	72.6	77.8	83.1	93.3	39.7	104.7	123.2	58.4
Memo									
1) Household forex deposits (expressed in forints)	20.5	25.5	35.4	48.9	62.5	204.9	n.a.	n.a.	n.a.
2) Enterprise forex deposits (expressed in forints)	13.7	23.5	27.5	35.2	49.5	261.3	n.a.	n.a.	n.a.
Source: NBH									

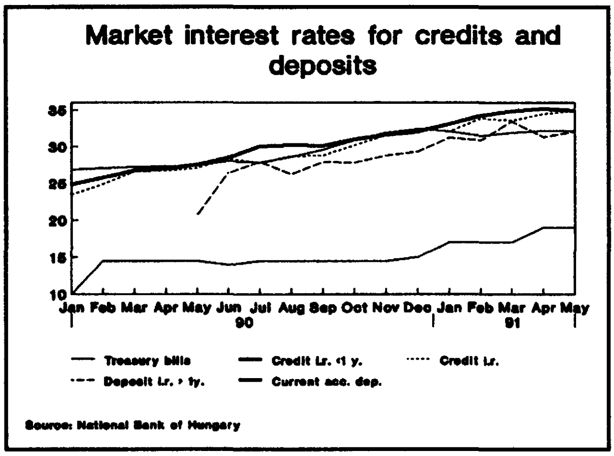
The practice of inter-enterprise credits became more evident in 1990. Reliable figures on this phenomenon are difficult to gather. Surveys undertaken by the NBH indicate that these credits rose from Ft127 bn as of end-1989 to over Ft250 bn during the second half of 1990.[3] They may have offset, at least in part, the stabilizing effects of the NBH's restrictive policy.

During 1990, short- and long-term refinancing rates were used with more flexibility. The NBH basic refinancing rate (rediscount) was raised to about 22% (+10% vis-à-vis the previous year),

3 Annual Report of the National Bank of Hungary for 1989 (Budapest, 1990)

and the short-term refinancing rate was raised by almost the same percentage, to about 28%. The automatic refinancing of the commercial banks by the National Bank of Hungary was reduced to about 20% of the total capital of the main commercial banks. From the beginning of 1991 this automatic refinancing was further reduced to 10%, the NBH's target being to abolish it completely from the beginning of 1992. The lower obligatory reserve requirements introduced for commercial banks in 1990 were extended to cover foreign currency deposits as well in June 1991.

Following this trend, bank interest rates on credits and deposits were raised. Interest rates charged by commercial banks for loans to their customers averaged about 28-32% at year-end. They were set by each commercial bank on a competitive basis, as a function of the term of a loan, the financial risk involved and the cost of lending. Interest rates on deposits increased during the year by 5-7%, to an average of between 26 and 28% at year-end. During the first half of 1990 interest rates on credits and deposits were roughly on a par with the official average inflation rate, but they then became slightly positive. This real interest rate trend did not amount to a particular incentive for households and small enterprises to increase their saving rate. The evolution of banks' average interest rate in 1990 is shown in graph 6.



Graph 6 Market interest rates for credits and deposits

During the first half of 1991 the interest rate rose to some extent, to level off around mid-year. The NBH is committed to maintaining positive real interest rates through adjustments in the refinancing rate and changes are expected if the slowdown in inflation is confirmed. However a minor increase might come from the increase by the NBH in the forint refinancing rate for foreign currency deposits.

e. *Balance of payments, international reserves and external financing*

The process of reorienting foreign trade away from the CMEA (and the USSR in particular) and towards Western markets began in 1989 and was successfully pursued in 1990 and 1991. The developments in foreign trade reflected the government's policy of encouraging enterprises to limit their trade relations with former CMEA partners, the progressive opening of EC markets to Hungarian products, the forint devaluation policy adopted in 1989 and 1990, the continuing application of subsidies to some export products and a sharp decline in domestic demand.

As a result of these trends, Hungarian exports to CMEA countries fell by 27% in volume terms between 1989 and 1990 and imports from them decreased by 20%. At the same time convertible-currency exports rose by 10% in volume and imports by 3%. As a result, the share of trade with Western economies rose from 50% of the total in 1989 to 70% in 1990. This significant result was achieved despite Hungary having to pay higher prices for oil imports, particularly in the last quarter of 1990.

The convertible-currency trade balance in 1990 showed a surplus of US$ 348 million. Owing chiefly to a better than expected tourism balance, and despite increased interest payments, the current account in convertible currencies showed a small surplus of US$ 127 million, which implied a striking turnaround from a deficit of US$ 1.4 bn in 1989, an improvement of US$ 1.5 bn (4.4% of GDP) (Table 5).

As regards Hungarian rouble-denominated foreign trade (essentially with the USSR), despite several efforts in 1990 designed to reduce Hungary's cumulative outstanding claims on the Soviet Union (probably as much as the equivalent of US$ 2 billion) no major progress was achieved. In 1990 Hungary's trade balance in non-convertible currency still exhibited a surplus (Table 6) reflecting partly the inability of the Soviet Union to offset its debt through exports of oil and raw materials.

In 1991 Hungary's foreign trade performance was expected to be badly hit by further external shocks associated with growing domestic constraints. Trade volumes, particularly with the USSR and with some former Comecon partners, are estimated to have declined by 50-55% as compared with the previous year, reflecting the shift, from 1 January 1991, to hard currency trade at world market prices, the virtual collapse of the Soviet economy, the closure of several East German enterprises which used to be leading participants in intra-Comecon trade and the overall hard currency shortage in Central and Eastern Europe.

The collapse in 1991 of Hungarian trade with former Comecon countries was partly offset by a 25-30% expansion of exports (in volume terms) to traditional Western markets such as Austria, Germany, Switzerland and Italy. According to preliminary figures, during the first seven months of 1991 the trade balance in convertible currency showed a slight surplus of US$ 93 million. Because of a better than expected travel balance and reduced costs of transport, the surplus of the current account in convertible currency for this period was even higher, at US$ 370 million, compared to the initial forecast of a current account deficit as high as US$ 1.2bn. This outcome in 1991 was quite an encouraging performance.

In 1990 Hungary's convertible currency capital account showed some weakness, particularly during the first part of the year, because of substantial withdrawal of short-term inter-bank deposits valued at around US$ 900 million. The capital outflow continued during the second half of 1990 though at a slower pace. These withdrawals and the reluctance of Western banks to advance new credit were a consequence of domestic political and economic uncertainties (elections in Spring 1990) and of external factors that caused increased disquiet in international financial circles, such as Bulgaria's request for a debt moratorium and the growing payment difficulties of the Soviet Union (with the consequent deterioration in its credit standing). In 1991 the original target of raising about US$ 1 bn was exceeded, though the cost to Hungary of some fund-raising operations was higher than expected, reflecting the country's current financial risk.

Hungary also experienced difficulties in 1990 in concluding some medium-term borrowing operations with Western banks which were needed mainly to refinance external debt obligations, to support the balance of payments and to strengthen the country's overall reserve position. In fact, according to the National Bank of Hungary, only one syndicated loan, worth US$ 40 million, was negotiated in 1990, compared with US$ 570 million in 1989. Trade-related financing facilities obtained in 1990 were modest too (US$ 250 million).

To cope with this situation Hungary turned increasingly to issuing bonds and notes on international capital markets, though the financial costs of these operations increased significantly during the second half of 1990, reflecting the country's financial risk. In 1990 slightly less than US$ 1 billion were raised in this way. A substantial part of these bonds, though issued through the banking system, were sold to non-bank private creditors.

Hungary's limited access to the private capital market in 1990 was compensated by a greater reliance on official multilateral and bilateral creditors. In an effort to strengthen its reserve position and in view of the expected release of a tranche of credits granted by multilateral institutions, Hungary obtained from the BIS a bridging loan worth US$ 280 million.

The IMF 13-month stand-by arrangement agreed in March 1990 provided a total of US$ 170 million (30% of Hungary's quota). However, because of ordinary repurchases and extraordinary repayments, Hungary's net borrowing with the IMF was negative by about US$ 160 million.

In February 1991 Hungary agreed with the IMF on a three-year Extended Financing Arrangement equivalent to SDR 1,114 million (210% of Hungary's quota) in support of the country's three-year programme of economic stabilization and structural transformation. In addition, a compensatory and contingency financing facility equivalent to SDR 226.2 million has been provided, with the possibility of a second purchase in 1991 of SDR 121.8 million, if the necessary conditions are met.

Disbursements from other multilateral institutions included a structural adjustment loan and project aid from the World Bank, a co-financing loan from the Ex-Im Bank of Japan, and a medium-term loan up to a maximum of ecu 870 million (equivalent to about US$ 1 bn) from the Community, as well as some lending from the International Finance Corporation and the European Investment Bank. In 1990 official bilateral creditors pledged some US$ 2 bn to Hungary. This included a US$ 1 bn short-term credit line from Germany, with a 90% federal government guarantee. Also a net amount of US$ 460 million was secured from private creditors.

In 1991, Hungary also secured the second tranche of the Community's medium-term loan, a World Bank structural adjustment loan, Japan's co-financing of the World Bank loan, and project finance from the European Investment Bank. In addition, the Group of Twenty-Four in July 1991 approved a loan of US$ 500 million, of which the Community will contribute 50%. The first tranche of the EC contribution was disbursed in August. The funds are to be used to support the balance of payments and to strengthen the country's reserve position.

In 1991 Hungary was also able to increase significantly its medium- and long-term borrowing on international capital markets, which totalled US$ 1.6 bn.

Foreign direct investment in Hungary is beginning to play an important role in external financing. In 1990 contributions in cash made available by foreign investors (mainly American, Japanese and German) amounted to about US$ 300 million. In 1991 it is reckoned that foreign contributions in cash exceeded US$ 1.4bn, well above the US$ 550 million originally forecast. Debt amortization projections in 1991 have been scaled down from US$ 2.4 to 2.2 bn, reflecting fluctuations in the US dollar exchange rate. Short-term capital movements at present appear to be balanced with outflows, which seem to be under control.

As a direct consequence of growing external financing constraints in 1990, hard currency official reserves decreased by 40% in 1990 to about US$ 1.1 bn (against US$ 1.7 bn at the end of 1989), equivalent to about 2 months' convertible currency imports. At the end of 1990 and throughout 1991, the reserves increased again, to reach nearly US$ 3.2 bn in October 1991 (3.2 months' imports), well above the target for the end of 1991 (US$ 1.9 bn).

Table 5 Balance of payments in convertible currencies
(million US$)

	1988	1989	1990	1991 Jan-Oct
Exports	5505	6446	6346	7358
Imports	5016	5910	5998	7265
Trade balance	489	536	348	93
Services (net)	-1410	-2100	-94.8	-436
Unrequited transfers (net)	114	126	727[1]	713
Current account	-807	-1438	127	370
Medium- long-term capital	556	1563	204	2479
. assets (net)	-27	32	-76	-52
. liabilities (net)	583	1351	280	1461
. direct capital investment	-	180	-	1071
Short-term capital	288	-44	-893	-659
Capital Account	844	1519	-689	1820
Overall balance	37	81	-562	2190
Reserves (increase = -)	-39	-71	562	-2190
Stock of reserves	1976	1725	1166	3214

Source: National Bank of Hungary

1 The item includes transactions related to trade following the foreign exchange liberalization, the decentralization of foreign trade and the increase in the number of small private entrepreneurs.

Table 6 Balance of payments in non-convertible currencies
(million US$)

	1988	1989	1990	1991 Jan-Oct
Exports	4484	4047	2719	413
Imports	4390	3540	2529	259
Trade balance	94	507	190	154
Services (net)	140	363	112	-55
Unrequited transfers (net)	2	4	52	5
Current account	232	866	250	104
Medium- long-term capital	-268	-278	-97	14
. assets (net)	-69	-127	23	23
. liabilities (net)	-199	-151	-120	-9
Short-term capital	-41	-109	69	-29
Capital Account	-309	-387	-28	-15
Overall balance	-77	479	222	88
Reserves (increase = -)	77	-479	-222	-88
Source: National Bank of Hungary				

f. Foreign debt

Hungary's total external debt in foreign currency has increased significantly in recent times. In the early 1970s it stood at less than US$2 bn, then reached US$9.7 bn in 1980 and since then doubled to reach more than US$22 bn in 1991. The continuing expansion of the debt reflected in part Hungary's pressing need over the past few years to obtain growing external financing resources for investment and consumption purposes in the framework of the implementation of the New Economic Mechanism programme. However, investment financed by external borrowing simply led to an expansion of the production capacity of state enterprises (which did not devote sufficient attention to growing restructuring problems) and to the construction of heavy and expensive infrastructure with limited social impact. External borrowing for consumption, on the other hand, allowed the government to import badly needed goods to meet the growing demands of a population more and more dissatisfied with the inefficiencies of the domestic supply side.

At present Hungary has the highest debt per capita in Central and Eastern Europe. During the last few years total debt service obligations (capital amortization and interest) averaged between US$ 3.5 and 4 billion a year.

Table 7 Gross foreign debt of Hungary (end of period) Millions of USD

	1987	1988	1989	1990	1991
	In convertible currencies				
Gross foreign debt	19.884	19.602	20.390	21.270	22.658
By original maturity:					
Short-term	3.103	3.363	3.306	2.941	2.177
Long and medium term	18.401	18.239	17.084	18.329	20.481
By type:					
Financial loans	17.600	17.469	18.060	17.687	18.135
Trade-related credits	1.852	1.626	1.763	1.080	1.777
Intergovernmental credit	0	0	0	0.472	1.612
Other credits	423	607	667	1.231	1.234
	In non-convertible currencies				
Gross foreign debt	947	583	361	235	154
By original maturity:					
Short-term	184	120	87	80	38
Long and medium term	763	463	274	155	110
By type:					
Financial loans	211	138	68	71	35
Trade-related credits	0	0	0	0	0
Intergovernmental credit	728	439	280	140	104
Other credits	0	0	13	24	15
Foreign debt total	22.631	20.105	20.751	21.005	22.812
Source: National Bank of Hungary, 1992					

The debt service ratio declined from 45.5% in 1990 to around 30% in 1991. As of end-1991 around 90% of the total debt consisted of medium- and long-term obligations. Publicly guaranteed debt to Western private creditors (commercial banks and Western bond-holders) predominates (about 90% of the total medium- and long-term debt), the balance being debt to official creditors, in particular multilateral, and other credits.

The country has never been in arrears. This reflects Hungary's traditional firm commitment to servicing its foreign debt obligations and to preserving good relations with Western commercial banks.

In the light of current prevailing trends it is likely that in the near future the share of commercial bank debt will decrease while that of international financial institutions and official bilateral creditors will expand. However, the increasing external assistance granted by international financial institutions, such as the IMF, as well as the European Community and the Group of 24, and aimed in particular at supporting the balance of payments is intended to be an extraordinary and temporary form of support, which will cease to be needed once the most delicate phase of stabilization and economic reform is over.

Table 8 External borrowing, US$ million

	1989	1990 (forecast)	1990 (outcome)*
1. Issuance of bonds on international capital market	1006	800	994
2. Syndicated loans	570	500	40
3. Bank-to-bank loans	497		200
4. Trade-related credit	311	500	250
5. Loans from international organizations	315	700	934
6. Structural adjustment loan co-financing			116
7. Direct capital	116	200	350(est)
Total	2815	2700	2884

NBH and IMF preliminary estimates
Source:NBH and IMF

During the next few years Hungary's total external debt obligations may slightly decrease. It is clear, however, that debt servicing will continue to constitute a serious financial constraint on Hungary's external position and economic policy mix. The government continues to be committed to servicing promptly its foreign debt obligations, since it believes that this is essential to the success of its policy of maintaining Hungary's creditworthiness on international capital markets and seeking to attract larger amounts of foreign direct investment. The government's medium-term objective is to reduce the debt service ratio to 28% essentially by avoiding further increases in the external debt by 1993 and reducing it thereafter, by further improving trade performance and by restructuring where possible the terms and profile of the foreign debt as well as the currency mix (with the aim of minimizing valuation effects).

A necessary precondition for the policy of staying current on debt obligations is a sustainable balance of payments position, together with an active financial policy on the international capital markets. The results of 1990 and of the first months of 1991 were very encouraging. The large current account deficit of US$ 1.4 bn in 1989 practically disappeared. After some fears during the first half of 1990, Hungary's creditworthiness on international capital markets was restored and private direct investment started expanding (US$ 337 million in cash in 1990 and US$ 1.4 bn in 1991). In the medium term, as the economy recovers, a sustainable balance of payments can be achieved only if the supply side of the economy substantially improves its margins of productivity and international competitiveness through privatization programmes and the establishment of joint ventures. Moreover, sound monetary and fiscal policies are required to encourage domestic savings and induce spontaneous foreign capital inflows.

The medium-term challenge for Hungary is to move from recession to expansion and at the same time improve its trade performance and keep its external debt at a manageable level.

2. Trade with the CMEA

During the past forty years the other CMEA countries were important trade partners for Hungary. As indicated in Table 27, in Chapter IV.5, the CMEA in 1990 accounted for over 29% of total Hungarian exports, and more than 32% of Hungarian imports. Recent developments within the bloc, and in particular the collapse of trade that has occurred since 1989, therefore have important consequences for the Hungarian economy. This section analyses recent developments in intra-CMEA trade and develops a few observations on the macroeconomic impact on the Hungarian economy of the collapse of CMEA trade.

Hungary is a net exporter of machinery and equipment (which account for slightly less than half of its total exports to the CMEA), industrial consumer goods and agricultural products, and a net importer of energy, raw materials and semi-finished products, which together account for more than 60% of Hungarian imports from the CMEA. On the export side the 'specialization' in machinery and transport equipment increased during the last decade, while the share of agricultural products has declined, reflecting an effort to redirect part of this trade towards other areas.

Trade relations with the CMEA have entailed a massive trade diversion with respect to the pre-war situation, when Hungary used to trade mostly with Germany and Austria. Furthermore, despite the resource transfer during the period 1960-80, in the long run the CMEA has damaged the economic interests of Hungary (and more generally of all the Central and East European countries), because it entailed forced patterns of specialization and normative allocation of industrial output; and trade dependence on the Soviet Union, particularly for imports of raw materials.

a. *The collapse of CMEA trade*

At the beginning of 1990 Hungary seemed locked into trade dependence on the Soviet Union and to stand to lose greatly from an immediate move to trade at international prices settled in convertible currencies. Nonetheless, Hungary has responded better than other formerly centrally planned economies to external supply shocks and to the change in CMEA arrangements. It proved able to respond quickly to a dramatic decline in intra-CMEA trade, reorienting a large part of its exports to the hard-currency area.

Trade with former CMEA partners accounted in roubles contracted markedly in 1990. Exports declined by nearly 23% with respect to the previous year, adding to the decline already recorded in 1989 (-4%). Similarly imports declined by about 17% in 1990, after a decline of 9% in 1989. Export contraction was particularly evident in machinery (-27%) and raw materials and semi-finished products (-27%). Imports of machinery decreased by 27%, fuels and energy declined by 21%, although this decline in the value of energy imported is less dramatic than the decline in volume. However, Hungary experienced an improvement in its rouble terms of trade in 1990. At the same time, its hard-currency trade increased substantially. Exports rose from US$217 m in 1989 to US$322 m in 1990, and imports from US$157 m to US$287 m.

CMEA trade probably reached its lowest point in 1991. The switch to dollar accounting was nearly complete by the end of the year, rouble transactions representing about 4% of total Hungarian trade instead of 25-30% in 1990. In addition, the collapse of trade had a multiplier effect in the

The Council for Mutual Economic Assistance

The Council for Mutual Economic Assistance (known as CMEA or Comecon) was founded in 1949 to assist the economic development of its member countries. Members were: Bulgaria, Cuba, Czechoslovakia, the German Democratic Republic, Hungary, Mongolia, Poland, Romania, the USSR and Vietnam. Albania, a founding member, ceased to participate in 1962. Angola, Laos, Mozambique, Nicaragua and Yugoslavia were observers.

The organization included several operational committees and two financial institutions:
- *the International Bank for Economic Cooperation (IBEC), to overcome the disadvantages of the bilateral payments system of intra-CMEA trade;*
- *the International Investment Bank (IIB), to provide medium- and long-term loans for investment projects common to several countries.*

The effort to integrate the CMEA economies produced extremely poor results, and centrifugal forces developed well before the economic and political crises of 1989. Trade remained the most important form of economic co-operation. However, owing to the inconvertibility of currencies and the cumbersome procedures of state-trading organizations, trade took place under strict bilateral agreements with annual protocols specifying in detail the quantities and prices for transactions. The mechanism of price determination - based on a moving average of world prices over the preceding five years - created enormous problems, especially from the second half of the 1970s.

A 'star-shaped' pattern of trade developed, with the USSR at the centre and the East European countries at the points of the star, and mainly comprising complementary trade (raw materials against manufactures).

This was the result not of comparative advantage but of the trade diversion which occurred after the Second World War, away from the former natural trade partners in Western Europe. Trade between CMEA members, which accounted for 9% of their total trade in 1948, grew to 51% in 1981.

A massive transfer of resources took place during the 1970s from the USSR to the East European countries. This transfer consisted of:

- *a substantial USSR trade surplus with other CMEA countries;*
- *implicit trade subsidies, i.e. the opportunity cost to the Soviet Union of trading raw material and energy products at below world prices.*

The trade pattern changed in the late 1980s, when the USSR began to run trade deficits with almost all its East European partners.

At a meeting in Sofia in January 1990 it was decided to conduct trade in convertible currencies from 1 January 1991, and to apply world market prices to intra-CMEA trade, without a time lag. The collapse of the Soviet market and in 1991 the lack of hard currency turned a slow-down in trade to near-collapse, aggravating the recession in the East European countries.

Finally, after a number of meetings and negotiations, at the 46th Session of the CMEA on 28 June 1991 in Budapest, a protocol was signed providing for the complete dismantling of the organization with all activities ending at the end of September.

CMEA zone, generating a regional recession and a shrinking of the ex-CMEA markets. The overall impact on trade volume is hard to assess at this stage. The decline in export volume to the CMEA is estimated at between 30 and 50%. But convertible currency export earnings on the CMEA market were as high as US$ 1.2 bn in the first ten months. Imports, mainly affected by the increase in the energy bill, amounted to US$ 1.5 bn over the same period.

Table 9 Hungarian trade with CMEA partners in 1990
(Roubles m)

Country	Imports	Exports	Balance
Bulgaria	94	48	-46
CSFR	835	849	14
Cuba	6	20	14
Poland	308	207	-101
Mongolia	7	16	9
Romania	154	127	-27
USSR	3200	3880	680
Vietnam	21	4	-17

b. *Macroeconomic impact of CMEA collapse*

(1) The overall impact

The CMEA collapse has had a negative impact on output, inflation, and the state budget. In particular, Hungary, like the other East European countries, faces three external shocks:

- oil price increases;
- further decline in CMEA trade;
- and worsening of the terms of trade.

The increase in the oil price has come primarily from the change in the rules for determining price within the CMEA. The price of crude oil has increased from an estimated TR13.7 per barrel (US$5.89)[4] in 1990 to US$20 per barrel in 1991.

The income effect of the change of regime was estimated by the NBH at US$1-1.5 bn for 1991. The current account of the balance of payments has not necessarily suffered a commensurate deterioration, since the terms-of-trade losses expected from the regime change in the CMEA will be in part offset by the sharp decline in volume.

A large part of the deterioration expected by the NBH will be reflected in the state budget. Roughly half of the impact of the shocks is accounted for by losses on the revenue side resulting from the disappearance of the price equalization mechanism that was a feature of intra-CMEA trade.[5] Future outcomes will depend on how rapidly and to what extent Hungarian enterprises

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4 Calculated using the cross rate of the NBH of TR2.325 = $1. However, determining the prices applied in intra-CMEA transactions is controversial. The same price would be $23.4 per barrel if the official Soviet exchange rate of TR0.58 = $1 were applied instead. Moreover, quite apart from which exchange rate is used, the barter nature of trade means that the world market price of the goods exchanged in return for oil under bilateral clearing agreements should also be taken into account.

5 The mechanism entailed payments to or from enterprises to offset the difference between domestic prices and CMEA trade prices. On balance it generated net revenue for the budget

are able to reorient their production towards western markets. In this respect, performance in 1990 and 1991 was extremely positive. Even sectors heavily engaged in CMEA trade, like machinery and light industry, were able to expand the volume of their exports towards western partners. The process of industrial restructuring is partially linked to that of trade reorientation. The reduction of trade relations with the Soviet Union reinforces the need for a radical transformation of industrial capacity.

According to a study by the Central Statistical Office, the decline in trade with the CMEA in the period 1986-90 caused a reduction in gross production of Ft120 m, with a loss of 120,000 jobs. Particularly affected were the machine-building and metal-working sector, especially transport equipment (29% decline in production over the period), telecommunications (-17%), shoe industry (-17%), and iron and steel industry (-15%). The reduction also had beneficial effects. In particular, the NBH estimated that Ft10.6 bn of hard-currency imports, i.e. 17% of total hard-currency imports, were saved, because declining exports to the CMEA reduced requirements of inputs imported from the hard-currency area.

(2) Hungarian-Soviet trade

The great bulk of the deterioration is accounted for by trade with the Soviet Union. The impact of the decline in trade with the other CMEA countries including the former GDR is not significant for the Hungarian economy. In 1990 Hungary accumulated another TR800 m surplus in trade with the Soviet Union. In 1991 the Soviet Union exported goods worth US$ 1.7 bn to Hungary. It imported from Hungary US$ 1.1 bn. Attempts by the Soviet Union to obtain goods on credit terms, especially letters of credit, have failed not so much because of direct controls by the Hungarian government, but because Hungarian enterprises have judged such deals too risky.[6] There is, however, an interest in continuing trade with the Soviet Union, especially importing oil, natural gas and electricity, mainly because of lower prices and transport costs. By the end of 1991, Hungary had concluded trade agreements with most of the republics of the former Soviet Union, securing, in particular, minimum requirements for energy.

An agreement between Hungary and the USSR (in Spring 1990) stipulated that trade between the two countries had to be conducted in dollars starting on 1 January 1991. The trade surplus accumulated in 1989 (TR658 mn) had to be converted into dollars at a rate of US$0.92 to one transferable rouble.

The parties failed, however, to set a deadline for the conversion, or to establish an interest rate on credit up to full reimbursement. The Hungarian authorities suggested the end of 1992 as the final date for using up the accumulated surplus, while the USSR proposed five years. Moreover, the Soviet side asserted that the sum should be traded off against financial claims on Soviet military installations, estimated by the USSR at TR2.5 billion. Although the troops left Hungary on schedule, the issue still remains to be settled.[7]

At the end of June an agreement was reached whereby bilateral barter trade will be maintained for the short run. Soviet enterprises are allowed to use 65% of the revenues they obtain from

6 Although regulations on foreign trade and foreign exchange have become very confused in the former Soviet Union, exporters are obliged to relinquish a substantial part of their export earnings to the bank dealing officially with foreign exchange or directly to the government. This substantially reduces the enterprises' autonomy, and their ability to import.

7 Soviet troops were scheduled to leave Hungary by 30 June 1991 and had left by 26 June.

sales to Hungarian partners to buy goods from them. The agreement has been extended for 1992 on the basis of accords with several of the successor states of the Soviet Union.

Table 10 **Hungarian trade with the Soviet Union, 1988-90**
(Rouble m)

	1988	% change on previous year	1989	% change on previous year	1990
Exports	4943	-2.6%	4813	-7.8%	4436
Imports	4484	-6.6%	4188	-13.8%	3610
Balance	459		625		826

Source: USSR Foreign Trade Yearbook 1989-90 Goskomstat

3. Medium term macroeconomic framework

The dominant features of Hungarian economic policy are, internally, the gradual approach to economic reform and, externally, the strategy for dealing with the country's large foreign debt. Initially, in the "Programme of conversion and development for the Hungarian economy", presented in early 1991, the main policy objective was to improve the convertible-currency balance of payments and to honour the debt. Since Hungary had advanced further than other East European economies in the transition to a market economy, it was envisaged that the domestic economy would not be too much affected by the balance-of-payments constraint. Overall a moderate growth path was projected. This scenario assumed a stable external environment. But the collapse of the CMEA obliged Hungary to speed up adjustment. It succeeded in maintaining the external balance, but the domestic economy is now caught up in a recessionary cycle. The projected trend for the main macroeconomic aggregates for the period 1991-93 are shown in Table 11.

Real GDP declined in 1991, but the Hungarian economy is assumed to return to a positive growth path already in 1992. However, the performance of the real economy in 1991 was far worse than expected, as a result of the disruptions in trade with the Soviet Union. The revised target of a decline by 5% of GDP in 1991 proved to be optimistic, since GDP is now estimated to have fallen by 7 to 9%. Given that inflation or the public deficit might require further restrictive policy, a recovery in 1992 may also be on the optimistic side.

A difficulty arises from the projections for the external sector. The Hungarian authorities foresee a substantial reduction of the deficit on the current account of the balance of payments in 1992, and a balanced account by 1993. Since foreign direct investment is not supposed to be the main contributor over the period, a consistent improvement in the trade balance is implied. Even if export volumes increase at the rates which are envisaged (5-7% in 1992 and 6-8% in 1993) and the terms of trade do not deteriorate, import growth seems to be low in view of Hungary's intention to restructure radically its industrial structure, and in view of the expected growth rate of between 3% and 5% in 1993. Import elasticity with respect to income is supposed to remain constant (at 1) in 1992 and 1993, despite the different growth assumptions for the two years, and almost at the same level recorded in 1990 (1.1), a year of steep decline in the growth rate.

Indeed, the trade surplus recorded in 1990 was achieved in the context of domestic recession, with a fall in domestic demand. The great emphasis placed on macroeconomic stabilization produced a steeper than expected output decline, but had the positive effect of alleviating pressures on the balance of payments. This is unlikely to happen in periods of sustained growth, which are an essential prerequisite for a successful policy of reducing the burden of the debt.

The decision to gear all policy instruments to honouring the foreign debt entails significant short- and medium-term costs. The debt already imposes a serious burden on domestic resources, which is likely to increase further in the years to come. The government's strategy is to reduce absorption sufficiently (i.e. to channel enough domestic resources to servicing the debt), for the debt burden to decline. The short-term reduction of absorption is expected to pay off in the long run, when structural reforms raise the efficiency of resource allocation.

However, in the case of formerly centrally planned economies (and Hungary is no exception) the reduction of domestic absorption does not just take the form of reduced private and public consumption, but materializes mostly in a massive reduction of investment. Gross fixed capital formation declined by 8.7% in 1990, in line with a trend that has been present in the Hungarian economy since the beginning of the 1980s. In Hungary, as in all other planned economies, the investment ratio was very high (see section 1.3), but it has been dramatically reduced and is now similar to the EC average. The decline in investment was sharp in 1990, exceeding 40% in mining and metallurgy, 16% in engineering, 35% in light industry and 28% in agriculture. Obviously these data reflect a declining role of direct state investment in the economy. However, there are other factors that discourage savings and constrain private investment.

In particular, a large spread exists between banks' deposit and lending rates. This reflects partially structural deficiencies of the banking system (bad loans, limited inter-bank competition, etc.). It is, however, mostly the result of the increasing costs of servicing the debt, external and public, the latter benefiting from preferential interest rates. To meet these the National Bank has set a high refinancing rate, which amounts to an implicit tax levied on the banking sector. In other words, the spread on interest rates is necessary to enable the banks to service their indebtedness to the NBH.

Such market distortions act as a disincentive to investment. In spite of a good external performance and a slow down in inflation, there is no sign in Hungary of a reversal in investment trends. This will be a major constraint on growth in the medium term.

Table 11 **Programme for conversion and development of the Hungarian economy**

		Targets/Projection			
	1990	**1991**		**1992**	**1993**
		init.	rev.		
	Annual percentage change				
Real GDP	-4.3	-3.0	-5.0	1-3	3-5
Domestic demand	-5.3	-4.7	-6.5	0-1	1-3
Private consumption	-4.5	-4.0	-6.2	0-1	2-4
Gross fixed investment	-8.7	-4.0	-8.4	1	1-2
Consumer prices (end-year)	33.4	31	30	17	9
GDP deflator	25.6	27	28.4	19	12
Export volumes	-6.9	-6.2	-6.0	5-7	6-8
Import volumes	-6.4	-6.9	-5.0	1-3	3-5
	As percentage of GDP				
Domestic					
Consolidated budget balance	-0.7	-1.2	-1.9	-0.5	0
Revenue	51.8	49.2	48.0	48	46
Expenditure	52.5	50.7	49.9	48.5	46
Gross domestic investment	24.8	24.6	22.3	23	23
Gross national savings	24.8	20.8	24.5	22	23
External sector					
Current account[1]	-0.4	-3.6	-2.4	-2	0
Gross debt[1]	64.3	65.7	63.1	64	59
	In millions of US$ (unless otherwise specified)				
External current account[1]	-80	-1200	-800	-650	0
Overall balance of payments[1]	-607	-168	57	-488	-537
Foreign direct investment	356	550	716	550	550
Gross official reserves[1]	1029	1955	2046	2400	2600
(months of merchandise imports)	2.0	1.9	2.3	2.2	2.2
Debt service ratio[1] (in % of merchandise export earnings)	57.0	36.2	39.0	33	28
Subsidies (% of GDP)	9	7	7	5	4
Privatization (% of business assets)	--	8-10	8-10	20-24	35-40
Import liberalization (% of industrial production)	32	72	72	at least 80	at least 80

[1] in convertible currencies

Source: Hungarian Ministry of Finance

IV. ECONOMIC STRUCTURE

1. Labour market and social safety net

a. *The administered labour market of the 1980s*

Since the end of the 1970s labour supply in the Hungarian labour market has been in steady decline. Its demographic base eroded as the total Hungarian population shrank by 0.13% p.a. throughout the 1980s to 10.6 m in 1989. The main reason was that fertility fell below reproduction level, after increasing briefly in the first half of the 1970s; this increase is evident today in a temporary 'bulge' in young labour market entrants. In addition, life expectancy is among the lowest of all East European countries: 66.1 years for men and 74.2 years for women. There was some migratory inflow from the Hungarian minority in Romania, but no visible emigration.

The potential labour supply has been constrained further by a low retirement age (men >60, women >55), which may reflect the low life expectancy, but early retirement has also been used to adjust the labour supply to employment losses. 'Total manpower resources', i.e. the population of working age and all those above or below the working age who are active, declined by 0.6% p.a. to 6.2 m in 1988. Economic participation, however, which had always been high, edged higher still to 69.3% in 1988, compared to an EC average of 65.3% (total labour force/population 15-64), limiting the decrease in the total labour force to -0.4% p.a., or 4.8 m in 1988. As total employment shrank by virtually the same amount, the Hungarian labour market was kept in overall equilibrium. Vacancies always substantially exceeded the minimal open unemployment, for which official registration was introduced only in 1986.

The management of labour supply showed little differentiation among individuals: e.g. general cuts in working time introduced in industry in two steps in the late 1960s and the early 1980s, amounting to some 20% between 1960 and 1987, were preferred over individual part-time work, which provided only 1.5% of total employment in 1985. More differentiation was probably found in the extensive second economy: in 1988, 70% of women and 81% of men were recorded as having a second gainful activity, most of them in agriculture-related activities on smallholdings (48% of women, 42% of men).

Table 12 Employment by major sector (as % of total)

	1975	1982	1988
Agriculture	22.6	23.1	20.4
Industry	35.6	32.3	30.9
Construction	8.2	7.6	7.1
Services	33.6	37.0	41.6
of which			
Transport and telecomm.	7.7	7.9	8.3
Trade	9.0	9.8	10.7
Total employment (million)	5.1	5.0	4.9

Source: IMF - Hungary - Recent Economic Developments - April 1989.

The sectoral development of employment (see Table 12) reveals a decline in industrial employment by one-fifth between 1975 and 1988. The construction sector shrank to a similar extent, in spite of a chronic shortage of housing. Throughout this period employment in the service sector expanded, a development which accelerated after 1982 as private activities were gradually legalized.

Even in 1988, the socialized sector (including socialized agriculture) was the main employer, providing nearly 95% of total employment. In the 1980s the socialized sector, however, lost employment much faster than the economy overall. The private sector, on the other hand, has become a source of dynamic output and employment creation. Major areas of private activity are agriculture, housing construction (95% of which is private) and services (in consumer services, e.g. repair work, maintenance, trade, the private sector share is some 60%). 'Workers' associations' using facilities of socialized enterprises outside official working hours were popular until the introduction of personal income tax, and today they have virtually ceased to exist. Estimates of the share of private sector employment in 1991 range from 7% to 15%.

b. The emergence of open unemployment

Towards the end of the 1980s open unemployment became noticeable: labour shedding increased as a result of some rationalization in certain crisis industries (mining, metallurgy) and of a system of tax-based wage control (see 2.4), which induced the dismissal of marginal employees, mainly unskilled workers and pensioners. Nevertheless, registered unemployment had only crept up to some 23,000 (0.5% of the labour force) at the end of 1989.

Since the beginning of 1990, however, the restrictive macroeconomic policy, the collapse of CMEA trade, the temporary demographic 'bulge' (100,000 additional young labour market entrants in 1990-92) and, to a lesser extent, rationalization and modernization of the large socialized enterprises have drastically changed the picture: industrial employment, which had declined by 4% in 1989, fell by 11% between January 1990 and January 1991. Registered unemployment increased to about 400,000 (8.3% of the labour force) by the end of 1991, while vacancies fell to a negligible level. Although the unemployment level is still low, the sheer speed of the increase has created much insecurity and prompted repeated adjustment of policies.

Reflecting this insecurity, forecasts for unemployment range widely: different sources expect 10-15% by the end of 1992, a peak in 1993 and some decline in 1994. Estimates of the total amount of non-profitable employment under market conditions amount to 15-20% of current employment (20-30% in the state enterprise sector). The impact on unemployment may be attenuated by some voluntary withdrawal from the labour market, but it will mainly depend on job creation, which is currently very small, at least to the extent that it is captured by official statistics.

The composition of registered unemployment in summer 1990 indicates that unemployment is becoming a widespread phenomenon, even if professional and skilled workers are still far less affected. Furthermore, strong regional differences have emerged: in greater Budapest, where some 30% of the labour force is located, unemployment is still minuscule; in fact, workers with knowledge of western languages or business practices are very scarce and well remunerated. But unemployment in some other regions already exceeded 7-11% of their labour force in July 1991. The development of regional mobility, which is at the moment virtually non-existent, should thus be a key priority of labour market policy, but has to be addressed by other policies as well, in particular with regard to transport and housing (see 2.3).

c. *The search for an effective social security net*

Along with the economic reforms of the 1980s, institutions were created or adjusted to address the growing involuntary job losses: labour offices, active employment promotion policies and unemployment insurance emerged. The gradual tightening of labour market conditions prompted a search for the most appropriate solutions, but the sharp acceleration of unemployment from 1990 is stretching labour market policies to their limits.

In the traditional paternalistic approach to labour, income was provided only through employment, and it was the obligation of the state to provide employment to every citizen considered fit for work. Thus the employment offices, which became institutions in their own right in 1981, initially focused on matching employment requests with registered vacancies - though even in 1989 only 6-7% of total labour market turnover involved the employment offices - and on active labour market policies. The major policies available at one time or another included retraining support (which provided some 30,000 places in 1990), temporary payments to larger enterprises to delay redundancies (4,000 in 1988), work-fare (20,000 in 1990), marginal employment subsidies (10,000 additional employed until 1990), early retirement (10,000 in 1990) and loans for independent activities (20,000 in the first half of 1990), which had to be suspended in mid-1990 because the funds were being abused. In 1988 the expenditures for these measures were consolidated in an Employment Fund, which was nevertheless still fully financed from the budget. Today the employment offices have grown to a network of 20 regional employment centres with some 150 branches and 1,200 staff. The share of the resources allocated to labour market administration in the Hungarian budget is still 5 percentage points lower than in most OECD countries. Their work is complemented by private placement agencies, which focus in particular on professional and managerial employees.

More and more, however, the growing number of unemployed exceeded the state's capacity to act as the 'employer of last resort' which, in the absence of any welfare system outside the work sphere left a growing number of people without means of subsistence. Therefore from the start of 1989 unemployment benefits were introduced: eligibility was based on previous gainful employment of at least eighteen months within the last three years (which excluded school leavers), the replacement ratio was 50%-70% of the last salary for one year, after which a 'temporary' unemployment allowance of 75% of the benefit would be granted. The introduction of such an individual transfer based on previous income stimulates mobility towards higher paid private-sector activities, as it partially covers the much higher unemployment risk. Because of the limited eligibility and the unfamiliarity of the scheme, only some 40% of registered unemployed were receiving benefits at the end of 1989, but that share increased to 80% at the end of February 1991.

By then it had become obvious that the financial requirements of the unemployment benefits were overwhelming the means allocated to the Employment Fund, which forced active employment measures to be aborted. The Employment Promotion Act of 1 March 1991 therefore separated the two tasks: the Employment Fund continues to be financed by an annual budgetary allocation and focuses on active labour market policies; unemployment compensation and early retirement payments are now provided from a newly created 'Solidarity Fund', which is mainly financed by contributions of employers (1.5% of gross wages, from 1 July 1991) and employees (0.5%). The Hungarian Solidarity Fund is in fact the first unemployment insurance fund in Eastern Europe.

Eligibility for unemployment benefits now depends on a minimum of 360 days of contributions over the past four years. State employees are automatically considered to have contributed over the past four years; the transitional rules for employees in the private sector are not clear. In the future a system based on contributions will provide an incentive to employees to seek legal employment. The length of the period during which benefit is paid varies between 180 and 720 days, depending on the accumulated contribution periods; the replacement ratio is 70% of the last income in the first half and 50% in the second half of the period, but never below the minimum wage. The last condition may turn out to be a disincentive to take up legal employment. Graduates of colleges and universities can now also receive benefits of 75% of the minimum wage. A tripartite Labour Market Committee supervises the working of the system and decides on the use of the funds for active labour market policies. Given the recent rates of increase in unemployment, the budget contribution to the Solidarity Fund had to be increased by 50% in 1991 and will have to be raised again in 1992; higher contributions and reductions in the benefits are under discussion.

The pension system, which is to be transformed into an insurance system, is also under heavy strain because of the deteriorating demographic structure and the low retirement age. If an improving economic situation has beneficial effects on health, the retirement age will have to be raised along with rising life expectancy. Higher contributions would run the risk of a growing tax-wedge increasing the incentive for prime-age workers to work in the hidden economy. Although the real value of small pensions appears to have been maintained better than that of pensions in general, the average pension level is clearly below what the Statistical Office considers the minimum subsistence income (Ft8200 per month for a single person). This explains the high participation of pensioners both in the open and in the hidden economy.

Eventually a system of income supplements based on need (measured by family structure, income and possibly assets) will have to be created to provide the bottom level of the social safety net. This becomes more urgent as subsidies on specific consumption (food, transport, rents) are phased out. The net effect of such a transformation would still offer budgetary savings, as direct income transfers are a more efficient means of targeting support to the lowest income groups.

Housing policy is of key importance in the context both of social security and of labour market mobility. The average number of private houses (supplemented by state provision) built between 1976 and 1985 was 58,000, compared with 24,000 state dwellings. But high real interest rates for new mortgages and reduced budgetary means for housing subsidies have curtailed construction. While the availability of private housing, which is often inhabited by several generations, provides some social cushion in periods of structural transformation, it is also one of the strongest obstacles to labour mobility. A real-estate market and a regulatory environment which permits flexible tenancy contracts and sub-letting should be established.

d. From direct wage control to collective wage bargaining

Wage determination is gradually changing to collective bargaining with a significant national component. In the past, central wage control was used to control private consumption and inflation. Workers or enterprises were subject to direct wage regulation. In the process of economic reform, however, wage determination devolved to the level of the enterprise, which tended to exploit its soft budget constraint to obtain high wage increases for its employees. To control the potential development of inflation a tax-based incomes policy was introduced: in 1988 an incremental tax rate of 100% was applied on wage growth exceeding nationally determined limits of 2.5% for the wage bill or 3.5% for the average wage. Strong state enterprises obtained exceptions ('wage clubs'), but overall the policy succeeded in keeping wage inflation to 4% (7% in industry).

At the beginning of 1989 wage determination was transformed further to a system of collective bargaining: since then a tripartite 'National Council for Reconciliation of Interests' has negotiated the minimum wage and a reference rate of wage growth. Further collective bargaining takes place on the enterprise level, no sectoral bargaining structures exist yet. In the absence of an effective bankruptcy threat for state enterprises, this system was unable to prevent wage inflation from accelerating quickly: already in 1989 the actual wage growth of 16-17% exceeded by far the planned rate of 6-7%. In 1990 gross monthly wages in industry are estimated to have grown by 23%, and there are estimates of a further acceleration to 30% in 1991. The nominal wage push is an important component of the inflationary pressures which have built up since 1987, although real wages have declined since the beginning of the 1980s.

There is now a strong reliance on national tripartite negotiation to steer labour market adjustment (also with regard to the Employment Fund and the Solidarity Fund, see 2.3). The organizational foundations of such a structure are still weak, however, as private employers' organizations are only beginning to emerge, and the main trade union is still the descendant of the former communist trade union, which was the only legal union until 1988.

Wage differentiation was in the past limited by the traditional rigidly egalitarian system under which the government determined minimum and maximum wages ('brackets' or 'tariffs'): under this system skilled workers could earn no more than 1.5 times and top executives no more than 4 times the wages of unskilled workers. Today enterprise managers have larger margins for differentiating wages, but actual wage differentiation appears slow to move away from the old bracket system. The main wage differentiation is developing between the state and the private sector, with foreign firms as the driving force.

e. *Education and training*

Employment and income in Hungary will depend critically on the quality and flexibility of its human resources. In some respects Hungary appears to have a reasonable starting position: the literacy rate is 98% of adults, primary school enrolment reaches 97% of the age group (it is compulsory up to the age of 16), secondary school enrolment is 70%, but about half of this is in 'apprentice schools' which offer little additional training. While total expenditure on education (5% of GDP in 1986) exceeds the level of Germany (4.5%; for comparison: France 5.8%, Netherlands 6.8%), these expenditures are mainly focused on basic education. Only 15% of the university-age population attend college or university, compared with about 30% in OECD countries.

Hungary has an important tradition in science and technological research and has tried to maintain its capacity by investing about 2.6% of its GDP in R&D, a much higher proportion than other countries with similar levels of development. The restricted access to Western technology has, however, hampered the quality of the efforts. The risk of a brain drain involving the best scientific and engineering professionals is already present.

2. Energy

Hungary's primary energy consumption has increased steadily since 1970. In 1988, the last year for which detailed data are available, 23% of primary energy requirements were satisfied by coal and coke, 32% by oil and oil derivatives, 27% by natural gas, and the rest by electric energy, nuclear power and wood.

Hungary is relatively poor in natural resources and imports slightly more than half of its energy needs. The main domestic sources of energy are coal, which accounts for 22% of final consumption, and natural gas (19%). Domestic production of crude oil represents 11% of final consumption. According to the Hungarian authorities, however, this contribution will decrease substantially in the next few years, and additional annual imports of 1 million tons will be required by 1995.

The main energy supplier is the Soviet Union, which in 1989 exported over 6 million tons of oil, 1.5 million tons of oil derivatives, 11 million Kw/H of electric energy, and 1.4 million tons of coal, as well as natural gas worth 0.5 billion roubles.

Table 13 **Energy supply, 1988**
(m tons oil equivalent)

	Oil	Gas	Coal	Elec.	Other	Total
Production	2.9	4.9	5.5	2.7	0.7	16.7
Imports	-9.6	-5.1	-2.9	-3.0	--	-20.6
Exports	2.5	--	0.2	0.5	--	3.2
Primary supply	10.0	10.0	8.2	5.2	0.7	34.1
Final consumption	8.3	7.8	6.0	2.5	0.7	25.3

Source: Energy Data Associates

Oil supply difficulties emerged in 1990. At the beginning of the year, Hungary and the Soviet Union had reached an agreement for delivery of 6.5 m tons, which was subsequently revised down to 5.1 m tons. Both in September and in October, however, further cutbacks were announced, as a result of the Soviet Union's inability to meet requirements, and total deliveries for the whole year amounted to about 4.9 m tons. In 1991, the Soviet export capacity was further reduced and Hungary imported only 3.2 million tons of crude oil from the region.

Hungary's reliance on Soviet energy supplies is not likely to change in the future. A further decline in oil imports from the Soviet Union can be envisaged, because of the switch to hard currency settlement at world market prices, but lower transport costs will mean that Soviet oil will remain competitive.

3. Agriculture

The agricultural sector accounted for 20.8% of Hungary's gross domestic product, and employed about 20% of the total labour force in 1989. It is organized in state farms, cooperatives, private and small-scale farms. In 1989, cooperatives and small-scale farms accounted for the bulk of production. The cooperative sector dominates in terms of the number of productive units, employees and percentage of cultivated land. It also predominates in the output of arable crops, especially wheat, maize and sugar beet, and is a large producer of cattle and sheep, whereas the private sector is somewhat strong in animal production, notably pigs and poultry. Private output is also very important in fruit and vegetables (see Table 15).

The main crops are maize and wheat, but Hungary also has a sizeable production of sugar beet, fruit and vegetables. The livestock sector is strong in pigs and cattle, and poultry production is also important. Wheat, cattle and poultry are important export items (Table 15).

Up to 1989 Hungarian agriculture was viewed as a success. Reforms began earlier than in any other sector, and already in the early 1970s central control was less stringent in agriculture than in industry. Reforms succeeded in increasing crop yields at least up to 1989. It is difficult, however, to evaluate the real extent of the success, because of the lack of transparency resulting from the price-subsidy-tax regime and massive subsidies.

Although Hungarian agriculture made gradual improvements from 1964, market mechanisms never replaced state control. Agriculture, like other sectors of the economy, continued to be characterized by price distortions, output restrictions and soft-budget constraints. The lack of incentive was partly solved by permitting farmers to work on private plots and allowing decentralization of agricultural activity within a farm. To ensure output of an assortment of products corresponding to the needs of the population and to CMEA commitments, an array of financial incentives was constructed, which resulted in bargaining between state and farms.

In 1990 and 1991, Hungarian agriculture faced several shocks. Both domestic demand and demand from the CMEA declined, though this was partly counterbalanced by improved access to the EC and other western markets. Severe drought affected crop yields in 1990, and costs were increased substantially by inflation and reduced subsidies on agricultural credits. Given these shocks, it is not surprising that agricultural production has contracted, although the decline has been less than that in industry.

In 1991, domestic price distortions and output restrictions were almost completely eliminated, and nearly all of Hungary's external trade is now conducted at market prices and in convertible currencies. Nonetheless, Hungarian agriculture needs further liberalization and an infusion of western capital, which it is hoped will come from privatization.

The process of privatization, which began with cooperatives in 1989, has been very slow, mainly because of the difficulties in settling the property rights issue. The transition process is unlikely to accelerate until the government has a coherent set of policies designed to promote the privatization of agricultural cooperatives.

Moreover, as for many other economic activities, under present conditions it is quite difficult to distinguish those enterprises in temporary difficulties from those which will remain unprofitable in the long run. The low level of net investment is a major constraint for the immediate future.

Table 14 **Main Data on Agriculture, 1989**

	Number of Units	Aver. Employment (1000)	Aver. size of farms (ha.)	Cult. land (per cent)	Production (in per cent)	
					Animal	Plant
State farms	136	118	6887	26.1	17.3	12.7
Cooperatives	1388	424	4177	62.1	40.4	55.3
Small-scale	1435	–	–	11.9	42.3	32.0
Total	2959	-	-	100.0	100.0	100.0

Source: CSO Statistical Pocket Book - 1989

Table 15 **Value of Output of Main Products by Social Sector**
1988, Ft. billion

Forint bn	State farm	Cooperative	Small scale	Total	Volume of exports as % of production[1]
Total crops	24.1	99.3	54.5	177.9	-
Wheat	4.1	25.6	0.7	30.4	22
Maize	5.1	22.7	7.0	34.7	3
Sugar beet	0.9	5.1	0.6	6.5	-
Vegetables[2]	0.6	3.6	23.1	27.3	41
Fruits	2.6	4.1	10.4	17.1	39
Grapes	2.2	2.4	7.5	12.2	-
Total livestock	33.5	73.5	77.4	184.4	-
Pigs	11.8	20.7	37.8	70.3	5
Cattle	10.4	30.0	10.0	50.5	26
Poultry	7.3	17.1	23.3	47.6	31
Sheep	0.8	4.9	2.3	7.9	74
Total output	57.6	172.8	131.9	362.3	-

1 As percentage of production in 1989.
2 incl. potatoes
Source: CSO: Statistical Pocket Book - 1989;
Economist Intelligence Unit, Hungary: Country Profile 1990-91

Table 16 **Production of Basic Crops, 1971-89,** million tons

	1971-75 Average	1976-80 Average	1981-85 Average	1987	1988	1989
Grain crops	11.4	12.6	14.4	14.2	15.0	15.4
of which: Wheat	4.3	5.2	6.1	5.8	7.0	6.5
Maize	5.9	6.4	7.0	7.2	6.3	7.0
Sugar beet	3.1	4.0	4.5	4.3	4.5	5.3
Vegetables	1.8	2.0	1.8	2.2	2.3	2.0
Fruit	1.4	1.5	1.7	1.6	1.7	1.6
Wine[1]	495	516	498	326	471	385

1 Million litres
Source: Economist Intelligence Unit, Hungary: Country Profile 1990-91

Table 17 **Production of Livestock, 1984-89 ('000 head)**

('000 Head)	1984	1985	1986	1987	1988	1989
Cattle	1901	1766	1725	1664	1690	1598
Pigs	9237	8280	8687	8216	8327	7660
Sheep	2832	2465	2337	2336	2216	2069

Source: Economist Intelligence Unit - Hungary: Country Profile 1990-91

4. Industrial structure and policy

This section seeks to describe the structural changes under way in the Hungarian economy and certain policies which may affect those changes. The first part examines the current structure of the Hungarian economy and industry and the structural changes which took place during the 1980s. The second part is devoted to the aims and constraints of Hungarian industrial policy.

a. Current structure of the economy and structural changes during the 1980s

(1) Overall structure

The overall structure of the Hungarian economy differs markedly from that of western countries. Table 18, which compares the structure of employment in the major sectors (agriculture, industry and energy, construction and services) in Hungary with that in the EC, the United States and Japan, shows that:

- the share represented by agriculture is appreciably greater in Hungary: 18.4% compared with 10.3% in Japan, 6.6% in the EC and 2.8% in the United States;

- the share represented by industry is also much higher in Hungary: 30.4% compared with 24.4% in the EC, 23.9% in Japan and 16.7% in the United States;

- the share represented by services, by contrast, is lower in Hungary: 44.2% compared with 56.3% in Japan, 61.8% in the EC and 75.2% in the United States.

During the 1960s and 1970s, the Hungarian economy underwent a process of industrialization, which had the effect of reducing the importance of the agricultural sector (which accounted for more than a third of the working population in 1960, as compared with 18% in 1989). The trend in the 1980s was more one of 'tertiarization', with the result that industry's share of GDP and total employment fell, while that of services rose. Between 1980 and 1989, the share of industrial employment decreased from 33.3% to 30.4%, while that of services increased from 37.7% to 44.2% (see Table 19). Recent data suggest that this trend is likely to continue, the services sector being less affected by recession than the industrial sector.

However, the contribution of the services sector to GDP in Hungary is still well below that in western countries. This discrepancy provides an indication of the potential growth of this sector in the East European countries, particularly as it is bound to play a key role in their transition to market economies. Efficient transport, communications, banking and insurance services are necessary if firms are to operate effectively and the private sector is to develop.

(2) Structure of Hungarian industry

An analysis of the structure of Hungarian industry shows that 'heavy' industry[8] accounted, in 1989 for 68.8% of industrial output and for 60.5% of industrial employment (see Table 20). Within heavy industry, the extractive and metal-manufacturing industries still play a relatively important role (accounting for 16.2% of industrial output and 12.2% of industrial employment), a pattern of industrial specialization which is scarcely consistent with Hungary's comparative advantage, given its scarce energy and mineral resources. An effort is currently being made, however, to reduce the role of these industries in the Hungarian economy and to boost that of the capital goods industries, whose share of industrial output and employment is relatively low by western standards. In 1989 the engineering sectors accounted for approximately a quarter of industrial output and a third of industrial employment.

Light industry accounts for 12.6% of industrial output and for 22.2% of industrial employment, while in the agri-foodstuffs sector the equivalent percentages are 17.8% and 15.2%. Within light industry, textiles, clothing and footwear occupy an important position, accounting for 7.4% of industrial output and for 14.6% of industrial employment.

Table 21 compares the industrial structures of Hungary and the EC. The comparison is only approximate because of different nomenclatures which mean that, although sectors may have the same names, they do not always cover the same field of activity. In Hungary some sectors account for a higher proportion of industrial employment than in the EC. Such is the case with the extractive and metal-manufacturing industries (12.6% compared with 3.8% in the EC), the

8 In Hungarian industrial statistics the definition of heavy industry is wider than that commonly used in western countries and includes power generation, the extractive and metal-manufacturing industries and chemicals.

construction materials sector (4.7% compared with 4% in the EC), textiles, clothing and footwear (16.2% compared with 9.9% in the EC) and agri-foodstuffs (15% compared with 8.8% in the EC). This would seem to suggest that Hungary's industrial specialization is closer to that of the countries in the south of the EC than to that of those in the north. In countries such as Greece, Portugal and, to a lesser extent, Spain, a higher proportion of industrial employment is also accounted for by the more traditional and labour-intensive industries than is the case for the rest of the Community. By contrast, sectors such as engineering and chemicals play a lesser role in Hungary than in the EC. Within the engineering sector, it should be noted that the discrepancy between the share of industrial employment in Hungary and that in the Community is more marked in the transport equipment and metal-manufacturing sectors and less marked in the machinery and electrical and electronic equipment industries, which seem to be relatively developed in Hungary.

In the course of the 1980s changes occurred in the structure of Hungarian industry: the shares of heavy industry and the agri-foodstuffs industry increased, while that of light industry diminished. This trend is more apparent in the case of employment than in that of production. some industrial restructuring seems to have taken place. The role of some branches diminished. For example the share of the mining and metal-manufacturing industries in industrial employment fell from 13.1% to 12.2% between 1980 and 1989, transport equipment from 6.5% to 5.5% and the textile and clothing industry from 12.2% to 10.9%. By contrast, such sectors as mechanical engineering, electrical and electronic equipment, precision instruments, man-made fibres and pharmaceuticals saw their shares of industrial output and employment rise. This trend was consistent with one of the aims of Hungarian industrial policy, which is to strengthen the role of sectors with a higher technology content.

b. *Trend of industrial production*

The Hungarian economy is currently experiencing its sharpest recession of the entire post-war period. The decline in industrial output began in 1988 and has accelerated since then, reaching 3.4% in 1989 and 8.5% in 1990. In 1991 the fall in industrial output accelerated; the Ministry of Industry and Trade has estimated a fall of between 10% and 15%. This fall in Hungarian industrial output is principally due to two factors: the low level of domestic demand and the contraction of Hungarian exports to CMEA countries.

It should be emphasized, however, that the decline in industrial output may have been overestimated for statistical reasons. For the output of firms employing fewer than 50 people only estimates exist . These are based on the tax returns completed by the managers of these small and medium-sized firms. The number of such firms has increased very sharply, and, according to estimates made by the Ministry of Industry and Trade, their output is likely to have grown by 70% in 1990. The underestimation of industrial output has grown in parallel with the development of the small, private sector and, according to the Hungarian Statistical Office, probably amounted to 15% in 1990.

As Table 22 shows, the decline in industrial output is not evenly distributed over all industries. In 1990 the sectors hardest hit by the recession were the metal-manufacturing and extractive industries (falls of 19% and 11.8% respectively), the engineering sector (-15.7%) and light industry (-10%). By contrast, the chemical industry (-5.4%), the construction materials sector (-5%) and the agri-foodstuffs industry (-0.9%) suffered a below-average fall in output, while power generation even recorded a slight rise (+0.2%).

The slump in CMEA trade, in particular with the Soviet Union, has affected a number of industries whose output went mainly to that market. This is the case with certain capital goods industries (for example, transport equipment (buses), telecommunications and instruments), the metal-manufacturing industry (in particular aluminium production, where there was a fall of 30% in orders from the rouble area) and the footwear industry.

c. *Industrial policy*

Hungarian industrial policy is subject to a number of constraints which, more than the adoption of a clearly defined strategy, guide decisions in this field. The major constraints affecting the reorganization of Hungarian industry include the need to accumulate foreign currency because of the economy's high level of indebtedness, the scarcity of raw material and energy resources, inadequate infrastructure, the lack of domestic capital, technological backwardness and the lack of managerial expertise; these last three factors explain the favourable treatment afforded to foreign investment.

The restructuring currently under way in the Hungarian economy is designed first and foremost to reduce the activities of the raw-material- and energy-intensive industries, and in particular those of the metal-manufacturing industries. The measures adopted in these industries are intended to cut subsidies and protection, to reduce the number of production plants and to modernize existing plants. In the extractive and metal-manufacturing industries generally, which are major consumers of energy and are also liable to generate environmental problems, the Ministry of Industry is especially anxious to ensure that the privatization process is not accompanied by the creation of additional production capacity but instead by the modernization of existing capacity which will pave the way for the manufacture of more processed and higher quality products.

By contrast, the activities of a number of capital goods industries are being encouraged, particularly through tax rebates. These sectors include those producing agricultural machinery and machinery for the agri-foodstuffs industry, the electronics and data-processing industry, the telecommunications equipment sector and the car industry. In the last case, the aim is to create assembly activities and plants to produce spare parts in order to satisfy domestic demand better.[9] In these capital goods sectors cooperation with foreign investors is being sought. In the car industry, for example, joint ventures have already been undertaken with GM, Ford and Suzuki.

A principal objective of the restructuring process is to increase Hungary's export capacity. How far and how fast firms that have traditionally exported to CMEA will improve the quality of their products sufficiently to meet the standards of western markets has yet to be seen. The greater openness of the economy should promote specialization in Hungarian industry that is more consistent with its comparative advantage than was the case within the CMEA framework. This should make it easier for Hungary to disengage from energy-intensive activities.

Industrial restructuring is being held back, however, by a number of obstacles, of which the most important are:

- the lack of capital;
- the underdeveloped banking system, the consequent difficulty of gaining access to credit and the excessively high cost of credit;

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9 Nestorovich, C. (1990), 'L'industrie automobile à l'est: stratégies nationales et internationales', le Courrier des pays de l'est No. 350, Mai-Juin, pp. 3-33.

- the difficulty of gauging the value of firms, though the new accounting law could improve the situation;
- problems linked to the rigidity of the labour market, the lack of labour mobility and the necessity of lengthy negotiations with trade unions over redundancies.

Instead of pursuing a highly centralized industrial policy, therefore, the Hungarian government wishes to create conditions favourable to industrial reorganization by providing transport, communications and business service infrastructures, by facilitating foreign investment, by stimulating innovation and by liberalizing trade.

Privatizations should also help to bolster the industrial restructuring process. Privatization is seen not as an end in itself but rather as a means of making Hungarian industry more competitive. To that end, the privatization strategy set out by the Ministry of Trade and Industry clearly focuses on the interrelationships between privatization and restructuring by identifying the firms for which privatization should be combined with reorganization. In the extractive industries, for example, privatization should be accompanied by the closure of unprofitable production units, while in the engineering sector partners are being sought as a means of promoting firms' technological development.

Table 18 Structure of employment; Hungary compared with the EC, the United States and Japan

	Employment (%)[1]			
	Hungary	EC[2]	US	Japan
Agriculture	18.4	6.6	2.8	10.3
Industry and energy	30.4	24.4	16.7	23.9
Construction	7.0	7.2	5.3	9.5
Services	44.2	61.8	75.2	56.3
Total economy	100.0	100.0	100.0	100.0

1 The figures relate to 1989 in the case of Hungary and the United States and to 1988 in the case of Japan and the EC.
2 EC = D + F + I + UK + NL + B + DK + ES

Source: 1989 Hungarian Statistical Yearbook for Hungary; Commission's sectoral database for the EC, the United States and Japan.

Table 19 Structure of GDP and employment in Hungary

	GDP (%)		Employment (%)	
	1980	1989	1980	1989
Agriculture and forestry	19.6	16.6	21.0	18.4
Industry and energy	37.2	33.3	33.3	30.4
Construction	8.0	7.8	8.0	7.0
Services	35.2	42.3	37.7	44.2
Total economy	100.0	100.0	100.0	100.0

Source : Hungarian Statistical Yearbook.

Table 20 Structure of industrial production and employment in Hungary

Branch	Production		Employment	
	1980	1989	1980	1989
Mining	8.1	5.7	7.1	6.9
Electricity	5.7	6.2	2.2	3.1
Metal manufacturing	9.1	10.5	6.0	5.3
Engineering	23.5	24.8	31.9	32.6
of which				
machinery	5.5	6.5	8.0	9.7
transport equipment	6.8	5.5	6.5	5.5
electrical and electronic equipment	6.5	7.7	10.1	10.0
instruments	2.0	2.6	3.6	3.6
mass-produced metalware	2.7	2.5	3.7	3.8
Construction materials	3.5	3.1	4.9	4.5
Chemicals	18.6	18.5	6.8	8.1
of which				
petrochemicals	6.9	4.6	0.4	0.4
man-made fibres	1.9	2.6	1.7	1.7
pharmaceuticals	2.1	3.0	1.4	1.7
HEAVY INDUSTRY - TOTAL	**68.5**	**68.8**	**58.9**	**60.5**
Wood processing	1.8	1.9	3.0	3.0
Paper	1.3	1.5	1.0	1.0
Publishing	0.9	1.3	1.2	1.4
Textiles	4.7	4.2	7.4	6.5
Leather and furs	2.2	1.8	3.7	3.7
Clothing	1.9	1.4	4.8	4.4
Handicrafts, etc.	0.9	0.5	4.3	2.2
LIGHT INDUSTRY - TOTAL	**13.7**	**12.6**	**25.4**	**22.2**
FOOD INDUSTRY	**16.7**	**17.8**	**12.2**	**15.2**
OTHER INDUSTRY	**1.1**	**0.8**	**3.5**	**2.1**
Industry total	100.0	100.0	100.0	100.0

Source : 1989 Hungarian Statistical Yearbook.

Table 21 **Industrial structure of Hungary and the EC compared (1989)**

	Production (%)		Employment (%)	
	EC[1]	Hungary	EC	Hungary
Mining and metal manufacturing	5.9	17.3	3.8	12.6
Engineering	44.1	26.4	49.5	33.6
of which				
machinery	9.8	6.9	11.6	10.0
transport equipment	14.2	5.9	12.4	5.7
electrical and electronic equipment instruments	13.2	11.0	16.1	14.0
mass-produced metalware	6.9	2.6	9.4	3.9
Construction materials	3.6	3.3	4.0	4.7
Chemicals	15.7	19.7	13.0	8.4
of which				
pharmaceuticals	2.3	3.2	1.7	1.8
Wood processing	2.7	2.0	3.5	3.1
Paper and publishing	6.1	3.0	6.1	2.5
Textiles	3.4	4.5	4.6	6.7
Leather and furs, footwear	1.0	1.9	1.5	3.8
Clothing	1.9	1.5	3.8	4.5
Food industry	14.5	19.0	8.8	15.7
Other industry	1.1	1.4	1.4	4.4
Total[2]	100.0	100.0	100.0	100.0

1 EC = D + F + I + UK.
2 Unlike in Table 20, industry is here defined according to the Community definition; i.e. excluding electricity

Source : Commission's VISA databank for the EC. 1989 Hungarian Statistical Yearbook.

Table 22 **Trend of industrial production in Hungary (volume)**

Branch	1990 index (1989 = 100)	Average annual rate of growth 1980-90
Mining	88.2	-2.2
Electricity	100.2	+2.3
Metal-manufacturing	81.0	-1.6
Engineering	86.3	+0.6
Construction materials	95.0	+0.05
Chemicals	94.6	+1.1
Light industry	90.0	-0.8
Food industry	99.1	+1.0
Other industry	77.2	-3.6
Industry total	91.5	-0.3

Source: National Bank of Hungary for 1990 index and 1989 Hungarian Statistical Yearbook.

Table 23 **Breakdown of firms by size, 1988-90**
Percentage of economic units in each category[1]

Number of employees / Year	1-20	21-50	51-300	300 or more	Not specified	Total
1988	18.7	14.5	28.2	23.3	15.3	100.0
1989	33.5	15.7	22.7	17.2	10.9	100.0
1990	52.7	14.4	16.4	9.7	6.8	100.0

1 The figures for 1988 and 1989 refer to the situation at 31 December, whereas for 1990 they refer to the situation at 30 September

Source: Grosfeld I. and Hare P. (1991), 'Privatization in Hungary, Poland and Czechoslovakia', in European Economy Special Edition No. 2.

5. Foreign trade

This section highlights the geographical reorientation of Hungarian trade against the background of the dissolution of the CMEA and examines the present structure of Hungary's exports and imports and the most recent developments, with emphasis on the relations between Hungary and the EC.

a. *Structure of trade*

(1) A small open economy

With a population of 10.5 million and a surface area of 93,000 square kilometres, the Hungarian economy has a small domestic market. International trade can therefore provide important outlets and should play a vital role in the future development of Hungarian industries. However, the Hungarian economy can already be termed a small open economy; in 1989, exports were equivalent to 34.1% of GDP and imports to 31.2%. By way of comparison, the degree of openness of the Austrian economy, as measured by exports as a proportion of GDP, is 40%.

The export ratio varies sharply from one industry to another. In 1989, it ranged from 0.3% in the energy sector to 42.7% in the engineering industry (see Table 24). The most export-oriented sectors include - in addition to the engineering industry, whose exports used to go mainly to the rouble area - the chemical industry (31.2%), metal manufacturing (30.2%) and light industry (27%), where exports go mainly to the non-rouble area. The engineering industry is therefore particularly affected by the slump in trade with the CMEA countries.

(2) Geographical redirection of trade: the EC as Hungary's prime trading partner (Table 25)

In 1980 the CMEA countries constituted the main outlet for Hungarian exports, accounting for 50.5%. Of those countries, the USSR took the lion's share (29%). Hungary's other main trading partners were the EC (20.1%), the former GDR (9.8%), Austria (5.6%) and Switzerland (5.4%).

By 1990 the geographical breakdown of Hungarian exports had altered radically. Trade with the CMEA countries had collapsed, with the proportion of exports going to those countries accounting for only 28.9% of the total, the USSR's share being 18.4%. Conversely, the proportion of exports going to the industrialized countries had increased sharply, and the EC now constituted the main outlet for Hungarian exports, accounting for 35% of the total. The importance of Austria as a trading partner had also increased (12.6% of Hungarian exports).

The same phenomenon can be observed in the case of imports, although it is a little less marked because of Hungary's dependence on energy and raw material imports from the USSR. Between 1980 and 1990, the proportion of Hungarian imports coming from the CMEA countries fell from 47% to 32% and from 27.8% to 17.6% in the case of the USSR, whereas the EC's share rose from 23.1% to 32.5%. In 1990, the CMEA countries and the EC therefore each supplied a little less than a third of Hungarian imports. However, while the amount of imports from these two areas is identical, their composition varies sharply, with the CMEA countries providing mainly raw materials and energy products and the EC manufactured products.

Various factors determined this geographical realignment of Hungarian trade. First, the payment difficulties of the USSR led the Hungarian government to urge firms to restrict their exports there. Second, the increased opening-up of the Community market (reduction in quantitative restrictions except for sensitive products, participation in the GSP from 1 January 1990) played an important role. According to Hungarian official statements,[10] a third of the growth in Hungarian exports to the EC in the first half of 1990 may have been due to Community concessions. Finally, the reforms designed to liberalize trade in Hungary, the devaluation of the forint[11] and the fall in domestic demand, which has increased the proportion of domestic resources available for export, have also boosted the growth in exports to western markets.

However, this realignment of trade requires the conversion of some production capacity to enable Hungarian products to satisfy western quality standards. Consequently, in order to limit the problems in certain sectors where the bulk of production goes to the CMEA countries, the Hungarian authorities are envisaging action to prevent the sharp fall in trade with those countries (and particularly with the former USSR) from continuing.

In the medium term, the EC and the EFTA countries are bound to play an increasingly important role as trading partners of Hungary, since it is unlikely that Hungary will be able to expand its exports to the other East European countries, which are also undergoing reforms. By contrast, the geographical proximity, size and purchasing power of the Community market make it a logical outlet for Hungarian exports, all the more so as Hungary has already aligned itself on some of the norms and standards applied in Germany. This is also the conclusion reached in a recent study by Tovias and Laird,[12] which demonstrates the impact of liberalization of trade between Hungary and the EC on Community imports from Hungary. That study suggests that, with a status comparable to that of an EFTA country, which is almost what the new European Agreement implies for Hungary, the growth in these imports over the next decade could reach 15%. It should be pointed out, by way of comparison, that Hungarian exports to the EC grew by about 75% between 1989 and 1991, according to national sources.

(3) The structure of trade with East European countries differs from that with the EC

Table 26 provides a breakdown of Hungarian exports and imports by product in 1989. The overall figures show Hungary to be an exporter of machinery and transport equipment (30.2% of total exports), manufactured products (27.6%, mainly metal products, textiles and clothing) and agri-foodstuffs (19.9%). However, there are marked differences in the structure of exports according to whether the recipients are other East European countries or the EC.

In the case of East European countries, exports of machinery and transport equipment dominate, since they alone account for almost half of exports to that area. A prime example is exports of buses and spare parts, which account for 30% of Hungarian exports to the USSR.[13] The other main products exported to East European markets are other manufactured products (20% of exports to East European countries) and agri-foodstuffs (17.4%). These three product categories account for 85% of total Hungarian exports to East European countries. The structure of exports to the EC area is more varied, although other manufactured products and agri-foodstuffs again play an important part, accounting for 32.4% and 27% respectively of all exports to that area.

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10 Comments made by Mr. B. Kadar, Minister of Foreign Trade, at ECE symposium. See ECE (1991), 'Economic Survey of Europe in 1990-1991', p. 89.

11 It should be pointed out, however, that the real effective exchange rate appreciated in 1990.

12 Tovias A. and Laird S. (1990), 'Whither Hungary and the European Community', World Bank Working Paper.

13 Figure quoted by OECD (1991) in 'Changes in Regional Trade Patterns of Central and Eastern European Countries', CCEET/TD(91)92.

The export specialization indices which can be used to compare the structure of Hungarian exports to a given area with that of Hungarian exports to the world[14] confirm that Hungary's export specialization is different in respect of East European countries on the one hand and the EC on the other. Thus, Hungary specializes in exporting capital goods to East European countries (index figure of 1.6) and agri-foodstuffs (index figure of 1.4) and other manufactured products (index figure of 1.2) to the EC.

The structure of Hungarian imports also differs according to whether they come from the other East European countries or from the EC. Thus, a little less than half of Hungarian imports from the USSR consist of energy products, although capital goods account for 32.5% of Hungary's imports from the East European countries. Capital goods account for 38.6% of Hungarian imports from the EC, from where Hungary also imports chemicals (25.8%) and other manufactured products (27.2%), especially textiles and clothing.

The import specialization indices which can be used to compare the structure of Hungary's imports from a given area with that of its world imports confirm the high level of the East European countries' specialization in energy products (index figure of 2.4) and therefore Hungary's heavy dependence on the USSR. In the case of imports from the EC, there is a marked specialization in chemicals (index figure of 1.6), capital goods (1.2) and other manufactured products (1.1).

(4) Rapid growth of Hungarian exports to the Community market, even in the case of certain sensitive products

Table 28 shows the recent trend of Hungarian exports to the EC. Between 1989 and 1990, the fastest growing sectors were machinery and electrical equipment (+36.9%) and metal products (+36%). Exports in the agri-foodstuffs sector, by contrast, fell by 5.9%. Over the period 1986-90, good performances were recorded by non-metallic products, capital goods, chemicals and also textiles, clothing and footwear. Generally speaking, the trend in such sensitive products as steel and textiles has therefore been fairly favourable in recent times, this despite Community protection. The importance which the Hungarians authorities attach to access to the Community market can be gauged, however, from the fact that agricultural, steel and textile products accounted in 1990 for a little less than half of Hungarian exports to the EC.

By contrast, Hungarian imports from the EC fell overall by 3.1% between 1989 and 1990 as a result of weaker domestic demand (see Table 29). The sectors most affected were intermediate products and capital goods, whereas imports of consumer goods continued to rise. According to Gacs[15], following the liberalization of imports, demand for imported products from consumers increased more than that from firms. The reasons put forward by Gacs to explain this phenomenon are, first, the higher levels of liquid reserves held by consumers than by firms, and, second, the shortages on the consumer goods market, whereas forced substitutions have taken place on the capital goods market.

14 This is defined as the ratio of the share of Hungarian exports of products i to area j of total Hungarian exports to area j to that same share vis-à-vis the world.

15 Gacs J. (1990), 'Liberalisation of Trade in Reformed Centrally Planned Economies: the Case of Hungary', paper presented to the fifth conference of the European Economic Association in Lisbon.

Table 24 Export ratio in industry in 1989

Branch	Rouble and non-rouble exports as percentage of total sales		
	Rouble	Non-Rouble	Total
Extractive industries	2.0	2.4	4.4
Energy	0.2	0.1	0.3
Metal manufacturing	3.4	26.8	30.2
Engineering	27.5	15.2	42.7
Construction materials	1.5	11.1	12.6
Chemical and petrochemical industry	7.7	23.5	31.2
Light industry	8.6	18.4	27.0
Agri-foodstuffs	2.0	5.9	7.9
Other industries	5.1	17.4	22.5
Total	10.8	17.0	27.8

Source : CSO Statistical Yearbook.

Table 25 Geographical breakdown of Hungarian trade

COUNTRY	EXPORTS		IMPORTS	
	1980	**1990**	**1980**	**1990**
CMEA	50.5	28.9	47.0	32.0
USSR	(29.0)	(18.4)	(27.8)	(17.6)
Other socialist countries	3.6	3.4	3.1	2.2
Industrialized countries	37.1	60.8	41.5	59.2
EC	(20.1)	(35.0)	(23.1)	(32.5)
Austria	(5.6)	(12.6)	(7.2)	(14.8)
Switzerland	(5.4)	(3.4)	(4.4)	(5.6)
USA	(1.4)	(3.5)	(1.7)	(1.6)
Developing countries	8.8	6.9	8.4	6.6
Total	100.0	100.0	100.0	100.0

Calculations have been made using export and import figures in forints.
Source : Institute for Economic and Market Research and Information.

Table 26 Breakdown of Hungarian trade by product, 1989

Branch	World	East European Countries	USSR	EC12
a) Exports				
Food, beverages, tobacco	19.9	17.4	20.3	27.0
Raw materials	5.2	2.2	1.7	7.6
Mineral fuels	2.9	0.7	0.5	2.7
Chemicals	12.4	9.8	9.9	12.8
Machinery and transport equipment	30.2	48.4	48.1	14.8
Other manufactured products	27.6	20.0	19.1	32.4
Miscellaneous	1.9	1.4	0.5	2.6
Total	100.0	100.0	100.0	100.0
b) Imports				
Food, beverages, tobacco	6.9	1.9	0.8	3.5
Raw materials	6.4	6.4	9.4	3.6
Mineral fuels	11.8	28.5	45.4	1.0
Chemicals	16.3	10.2	8.4	25.8
Machinery and transport equipment	33.4	32.5	19.0	38.6
Other manufactured products	24.5	19.3	16.7	27.2
Miscellaneous	0.7	1.3	0.3	0.3
Total	100.0	100.0	100.0	100.0
Source: COMTRADE - UN database				

Table 27 **Specialization indexes by product**

1989 Branch	Export specialization vis-à-vis		Import specialization vis-à-vis	
	East European countries	EC12	East European countries	EC12
Food, beverages, tobacco	0.87	1.36	0.27	0.51
Raw materials	0.42	1.46	1.00	0.56
Mineral fuels	0.24	0.93	2.41	0.08
Chemicals	0.79	1.03	0.63	1.58
Machinery and transport equipment	1.60	0.49	0.97	1.16
Other manufactured products	0.72	1.17	0.79	1.11

Source : COMTRADE - UN database

Table 28 **Structure of Hungarian exports to the EC**

	1990				1989	
	Ecu m	% of total	% change in 90/89	1986=100	Ecu m	% of total
Agri-foodstuffs	714	24.5	-5.9	126	758	29.5
Mineral products	95	3.3	2.1	96	93	3.6
Chemicals	338	11.6	12.0	156	301	11.7
Leather goods and footwear	156	5.3	21.4	155	128	5.0
Wood, paper	118	4.1	24.7	170	95	3.7
Textiles, clothing	465	15.9	21.9	156	381	14.8
Non-metal products	220	7.5	21.2	516	182	7.1
Metal products	232	7.9	36.0	127	170	6.6
Machinery and electrical goods	412	14.1	36.9	204	301	11.7
Transport equipment	35	1.2	20.7	273	29	1.1
Precision instruments	15	0.5	2.0	104	15	0.6
Other manufactured products	116	4.0	-2.2	153	119	4.6
Total	2915	100.0	13.3	155	2573	100.0

Source: Eurostat, COMEXT.

Table 29 Structure of Hungarian imports from the EC

	1990				1989	
	Ecu m	% of total	% change 90/89	1986 =100	Ecu m	% of total
Agri-foodstuffs	119	4.3	6.5	100	112	3.9
Mineral products	11	0.4	-28.1	33	16	0.6
Chemicals	492	17.7	-14.2	93	573	20.0
Leather goods and footwear	142	5.1	26.2	141	112	3.9
Wood, paper	96	3.5	20.6	153	80	2.8
Textiles, clothing	384	13.8	15.5	119	332	11.6
Non-metal products	132	4.8	-9.7	308	146	5.1
Metal products	124	4.5	-10.9	64	139	4.9
Machinery and electrical goods	909	32.8	3.3	141	880	30.8
Transport equipment	183	6.6	-33.1	178	273	9.6
Precision instruments	108	3.9	-8.4	113	117	4.1
Other manufactured products	72	2.6	-8.3	95	78	2.7
Total	2771	100.0	-3.1	120	2860	100.0

Source: Eurostat, COMEXT.

6. Foreign investment and joint ventures

The Hungarian government is keen to attract foreign direct investment (FDI) and to encourage the formation of joint ventures (JV) with western partners. Such foreign investments will have an impact on the structural changes in the Hungarian economy. This section tries to expand upon this issue by describing, first, the role that FDI and JVs are expected to play in the development of the Hungarian economy; second, the evolution of FDI and JVs in the economy (giving some idea of their relative importance); third, the sectors in which FDI and JVs are concentrated; fourth, the conditions in Hungary which favour or encourage FDI and the setting up of JVs; and, fifth, the conditions which discourage FDI and the formation of JVs. Joint venture is defined here restrictively, as foreign participation in companies set up under Hungarian law.

a. *The role of FDI and JVs*

Official Hungarian expectations of the role that FDI and JVs can play in developing the economy are high indeed - they are expected to make a major contribution to the transformation of the Hungarian economy from a socialist-type (albeit reformist) system into a market system. FDI and JVs will accomplish this by being conduits from the West of new technology, marketing skills and better managerial techniques, as well as providing examples of efficient work organization which indigenous companies can profitably emulate. At the same time, JVs and FDI are expected to increase domestic competition, thereby, it is hoped, raising the quality of goods for sale. Finally, JVs and companies which are the target of FDI are expected to open up Western export markets, so contributing positively to the balance of payments and reducing Hungary's foreign debt burden.

However, the Hungarian authorities also harbour some fears about foreign interest in their economy. These fears are a reaction to popular concern that some national assets have already been sold off too cheaply to foreign investors. The other reason for cautiousness is the lack or weakness of the regulations necessary to open the market (prudential legislation related to FDI, taxation of multinational enterprises, foreign exchange regime). As a result, the authorities have temporarily reserved the state's right to intervene in some sectors (natural resources, transport, infrastructure -including telecommunications-, some sections of the energy industry and heavy industry) where state ownership will be maintained.

b. *The evolution of FDI and JVs*

In 1972, Hungary passed legislation which aimed to encourage FDI and the setting up of JVs. As a consequence, a number of JVs were registered over the following years. However, the numbers remained low, even after a revision of the laws covering foreign investment in 1978. Only in 1985, when the economic climate in Hungary began to be liberalized somewhat, did the rate of JVs being set up accelerate. This meant that whereas in 1984 there were 27 joint ventures in operation, the number of operating JVs in 1985 was 45.

It was not, however, until Act XXIV covering foreign investment entered into force on 1 January 1989 (following its acceptance by the Hungarian parliament at the end of 1988) that the value of FDI into Hungary and the number of registered JVs increased significantly. Act XXIV, which is covered in Section IV.6.d below, radically revised the laws on foreign investment very much in favour of potential investors. This Act, in conjunction with the simultaneous political and economic upheavals occurring in Hungary, meant that the 176 JVs operating in 1988 grew to approximately 1000 by the end of 1989, over 5000 by the end of 1990, and stood, at the beginning of 1991 at over 7000 (see Table 30). Roughly US$800 million flowed into Hungary during 1990, taking total capitalization to approximately US$1.2 billion. In the first quarter of 1991, it was over US$1.5 billion. This makes Hungary the largest recipient of FDI in Eastern Europe.

Nevertheless, despite the enormous increases in the numbers and value of Western participation in the economy, care should be taken not to overestimate its importance for the overall balance of payments. Trade flows still far outweigh FDI flows - exports to the West in 1989 were worth US$6.7 billion, while imports from the West cost US$5.9 billion.

As for the size of individual foreign investments, the bulk have been, and continue to be, rather small. In 1990, about 57% of all new ventures with foreign participation had a startup capital of roughly US$20,000, while only 2.4% had start-up capital exceeding US$2 million (although the latter constituted 77% of total initial capital provided in 1990). Furthermore, the average share of start-up capital provided by the foreign participant has typically been about 45% (for JVs and non-JVs).

c. Sectors in which FDI and JVs are concentrated

The 1989 figures for the total value of capital invested showed that 38% of JVs were involved in manufacturing, 30% in the provision of financial services, and 18% in the running of hotels and restaurants. However, the capitalization of individual JVs in manufacturing has hitherto been generally rather small, and of the absolute number of JVs operating in 1989, 60% were engaged in manufacturing.

Within manufacturing, data for 1990 on capital invested show that 42% of JVs were operating in machine engineering, 23% in the construction materials industry, 19% in light industry, 8% in the chemicals industry, and 4% in metal manufacturing (see Table 31). Recent, sizeable investments in Hungary include the purchase by General Electric of a controlling interest in Tungsram (the light-bulb producer, which is one of Hungary's largest industrial companies) and the agreement between General Motors and Raba to co-produce engines and motor cars.

If, however, the sectoral breakdown of JVs within manufacturing is done on the basis of the number of JVs involved in each sector, then machine engineering maintains its supremacy (55%), but light industry accounts for only 16% of manufacturing JVs, the chemicals industry accounts for 16% too, construction materials 7%, and 2% of JVs operate in metal manufacturing (see Table 31).

Comparison of 1990 data with 1988 data (see Table 31), indicates that JVs are increasingly concentrating on machine engineering. Furthermore, JVs engaged in machine engineering, accounted for only 41% of the total number of JVs operating in 1988, a significantly lower figure than in 1990. Light industry, by contrast, seems to be declining in relative importance, as does the construction materials industry (to a lesser extent). It is too soon to discern any firm trends in these figures. The apparently increasing relative importance of the machine engineering industry could reflect the favourable tax treatment it has received following tax reforms introduced in 1989 (see section (d) below).

The nationality of foreign participants in JVs and the main sources of FDI tend to mirror traditional links and foreign trade patterns. In terms of numbers, JVs are dominated by Austria, then Germany and Switzerland. However, of the JVs started in 1990, 30% had German partners, 25% had Austrian partners, and about 18% had US partners. As for the division of capital from abroad invested up to 1990, Germany was the largest source at 23.5% of the total and Austria second with 21.1%. The USA has also been a major source, responsible for 20.2% of the total. Other important sources of FDI include firms from the UK, Italy, Liechtenstein and other West European countries, as well as South Korea.

d. Conditions favouring FDI and the creation of JVs

Hungary is considered the most favourable and attractive country in Eastern Europe for Western firms to engage in business activities. This judgement is based principally on its liberal foreign investment laws and its tax policies. Foreign investment in Hungary is governed by Act XXIV on foreign investment, introduced on 1 January 1989. This act, first, gives a foreigner (whether an individual or a firm) the right to own up to 100% of a Hungarian-based company. Second, JVs with a majority foreign participation can now be set up without first receiving official permission in the form of a licence (thus avoiding bureaucracy) - something that was not possible before 1 January 1991. Third, a foreign company now has a number of possible ways of acquiring real estate, and the remaining obstacles to real estate ownership are being reduced. Fourth, foreign investors are guaranteed full protection for their investments - in other words, Hungary is committed to compensate fully any investor whose company or assets are nationalized or expropriated; furthermore, the compensation must be paid in the currency used for the original investment. Fifth, the foreign participant can freely transfer abroad its share of the profits, in the currency of the participant's original investment - even if the profits have come from domestic sales and have consequently produced forint profits.

Radically revised Hungarian tax laws were introduced on 1 January 1989. As a consequence, the many different taxes and tax rates facing companies were reduced to a uniform entrepreneurial profit tax, which significantly reduced complications and enhanced transparency. This encouragement to foreign investors was reinforced by the provision of a number of generous tax allowances aimed specifically at them. Thus, companies with foreign participation can obtain either (i) tax allowances of 100% for five years, followed by tax allowances of 60% for another five years, or (ii) tax allowances of 60% for five years followed by a further five years' tax allowances of 40%. To qualify for either set of tax allowances, it is necessary first of all that the initial start-up capital of the company exceeds Ft 50 million, of which more than 30% is provided by the foreign partner. Second, it is essential that more than half of the company's annual income comes from the physical production of goods, or the provision of hotel services (provided that the hotels were built by the company which runs them). These represent the minimum conditions which must be fulfilled to qualify for either of the two sets of tax concessions.

However, to qualify for the more advantageous set (i) of tax allowances, the company must also be producing so-called priority or economically important goods, as defined by the Hungarian government. These priority goods are electronics; vehicles and vehicle components; machine tools; engineering components; agricultural, food-processing or forestry machinery and equipment; products enhancing Hungary's convertible-currency trade in agriculture; and machinery and materials used for packaging.

Another significant tax allowance available only to companies with foreign participation is provided in the case where operating profits are used for reinvestment in the Hungarian economy. Should such a company increase the capital base of its operations or invest in another enterprise operating in Hungary using income earned in Hungary, then that company is entitled to a tax rebate. This amounts to repayment in full of the tax paid on that part of company income subsequently used for investment purposes.

Further characteristics favouring Hungary as a site for JVs and western FDI include its increasingly liberal foreign trade regime (90% of imports have been liberalized and can be purchased with forints), its relatively low wage rates, and its stock of human capital skilled in mathematics and science.

e. *Conditions discouraging FDI and the setting up of JVs*

At a general level, western investors are made nervous by Hungary's macroeconomic environment high inflation by western standards, declining industrial production, high interest rates and rising unemployment. They worry also that economic depression could exacerbate social tensions. Furthermore, although institutions essential for the operation of a market economy do now exist, or are being created, they do not yet work smoothly (a failing recognized by the government) - too many administrative controls still hinder free enterprise and foreign trade, and the procedures and inclinations of the Hungarian administration still lack transparency.

Among other problems are the lack of people with the type of managerial skills required by a functioning market economy, and the legal position of companies concerning the risk insurance that they must purchase - especially insurance covering the workforce against work-related injuries. A less important constraint may be recent legislation which raised the capital-base threshold (of a company with foreign participation) necessary to qualify for tax allowances from Ft25 million to Ft50 million. The Hungarians did this with the aim of encouraging foreign participation and JV arrangements in the production sector rather than the trading sector.

Hungary's infrastructure is also a problem. Roads and telecommunications especially need a great deal of expensive investment if they are to be modernized and extended. There are also insufficient warehouses and customs clearing facilities available relative to the needs of western firms.

Table 30 Growth of Operating Joint Ventures, 1974-91

Year	Foreign Capital (US$ m)	Number
1974	4.9	2
1980	21.7	6
1982	29.0	12
1983	34.3	20
1984	35.5	27
1985	44.1	45
1986	64.5	62
1987	95.8	102
1988	259.8	176
1989	~400	~1000
1990	~1,200	>5000
1991[a]	~1,500	>7000

[a] Data as of end of 1st quarter 1991.
Source: UN, EC, WEFA.

Table 31 Breakdown of JVs engaged in manufacturing by industry

Activity	Percentage of total joint ventures		Share of total value of equity of JVs	
	1988	1990	1988	1990
Machine engineering	41.1	54.6	33.7	42.3
Construction materials	11.6	6.6	27.0	23.3
Light industry	24.2	16.4	25.7	19.3
Chemicals	18.9	16.1	9.0	8.4
Metal manufacturing	1.0	2.1	1.8	4.1
Miscellaneous	3.2	4.2	2.8	2.6
Data: Hungarian national statistics; 1990 data as at end of 1st quarter.				

V. ECONOMIC REFORMS AND POLICIES

1. A framework for assessing reform

Before discussing the various reform measures undertaken in Hungary during the past few years, it may be useful to attempt an overall assessment of the reform process. The current status of reform can be judged against the analytical framework developed in a number of studies published recently by the Commission's Directorate-General for Economic and Financial Affairs.[16]

The first issue is the irreversibility of the regime change. What remained of the old system of planning and management has been dismantled, and there is a clear commitment to political and economic democracy. The government was democratically elected, and economic policy measures are debated and adopted according to democratic rules.

Irreversibility is a necessary condition for transition to a fully fledged market economy, but alone it is not sufficient. Sound macroeconomic stabilization is also needed, as well as a more long-term commitment to restructuring.

Although stabilization in Hungary is not complete, stabilization measures have helped to improve budgetary discipline and control of the money supply by the monetary authorities. Liberalization is fairly advanced, in terms both of price and of trade liberalization. These measures have helped to remove distortions and to establish an element of competition in goods markets.

The process of transition to a market economy is fairly advanced, a legislative framework is being created and institutions are being adapted to the new market environment. None the less, problems remain in some areas, such as ownership structure and the under-development of the financial sector, etc. Furthermore, privatization is proceeding slowly, and its implementation is proving more difficult than originally envisaged. The promotion of new private firms is only at a preliminary stage, and the tutelage system has not been completely broken down. Only a few bankruptcies are taking place, and the banking system, heavily burdened with bad loans, is unable to exercise financial control over enterprises.

Experience since 1989 both in Hungary and in other economies in transition shows that restructuring needs to be far-reaching in order to produce meaningful results: the distortions are so deeply rooted in the system that there is little alternative to trying to move on all fronts at once. Too long a delay between adjustment and reforms could lead to an undue lengthening of the contraction of the economy that stabilization inevitably causes, and to repeated, continuous efforts to stabilize.

It may be argued, and indeed the Hungarian authorities have repeatedly stressed, that the social costs associated with a too sudden transformation of the economic system can be unbearable. Moreover, the task of liberalization is more far-reaching than in many LDCs, for example, where it has mainly consisted in abolishing various constraints that prevent the proper free interplay of economic agents who already operate in accordance with the basic principles of decentralized, profit-oriented economic systems. In the case of the Hungarian economy in the past fifty years, as in the other former centrally planned economies, markets simply have not existed, except

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16 See European Commission (1990), 'Economic Transformation in Hungary and Poland', European Economy 43; and European Commission, 'The Path of Reform in Central and Eastern Europe', European Economy Special Edition No. 2.

perhaps for small (marginal) segments of the economy. Thus, liberalization cannot be a short-term phenomenon.

In some aspects of reform, such as the long-term effort at rebuilding market institutions, there is no alternative to gradualism. But necessary gradualism should not be used to justify delay in the implementation of much-needed short-term adjustment measures. Such delay would not necessarily lead to a reduction of the social costs associated with the transition, let alone eliminate them. Nor should gradualism be used as a rationale for economic policy choices that are driven by other objectives, such as the commitment to debt servicing.

In this chapter various institutional changes that have taken place so far will be discussed, in particular the reform of the financial sector, privatization, and the reform of the tax system.

2. Reform of the financial sector

a. *Institutions*

In January 1987 a comprehensive banking reform was launched in Hungary. An essentially monobank system was transformed into a two-tier system. In this new system the government granted the National Bank more autonomy. Its role was strengthened, and its instruments of monetary and credit control and management were better defined. The central bank was relieved of its commercial banking activities by the transformation of commercial banks that it had previously controlled into independent entities with the role of providing credit to enterprises. Besides these main commercial banks, the National Savings Bank and 260 savings cooperatives managed the credits and deposits of households. The National Bank of Hungary assumed traditional central bank functions, particularly regarding the regulation of credit and liquidity (money supply), the management of interest rates, the determination of official exchange rates, the management of hard currency and gold reserves, fixing of compulsory reserve ceilings for commercial banks, the implementation of open market operations, etc. Deposit and loan transactions with households and enterprises were transferred to the newly established or existing commercial banks and specialized financial institutions, whose autonomy was strengthened appropriately.

The Hungarian banking reform of 1987 has done much to meet the urgent need to introduce a greater transparency into the financial sector, to establish a dynamic commercial banking system aimed at supporting investment, consumption and the rising costs of transformation in industry, agriculture and services, as well as to generate greater competition among banks and other financial institutions in mobilizing and allocating national savings.

A complementary, but not secondary, objective of the reform was to achieve a significant improvement in the quality, costs and efficiency of financial intermediation. The appropriate policy and regulatory framework was to be set out by the National Bank and supervised by the new State Banking Supervision in the Ministry of Finance. The banking reform foresaw that, at least initially, the National Bank would maintain direct responsibility for commercial and official transactions in foreign exchange (only in mid-1990, in the framework of a further stage of decentralization, were these functions in part transferred to commercial banks and to enterprise level).

Following the reform, at the end of the first year (1987), 21 commercial banks and other financial institutions were operating in Hungary, including 3 joint venture banks. At the end of 1991 the number of banks in Hungary was 37, of which 32 were operating with commercial banking licences and 5 were specialized financial institutions. Of the 37 banks, 15 have foreign shareholders. In addition to these banks, there were 17 representative offices of foreign banks operating in Hungary.

The 1987 reform was followed up by a further set of banking regulations introduced in January 1989, which entitled all commercial banks to service both households and enterprises and ended the distinction between them and savings banks. The new system was further enhanced in the course of 1990 with the setting up of a Bank Association, an International Training Centre for Bankers and, later in 1991, of a Clearing Centre.

Despite recent government efforts to encourage the national banking system to extend its business to non-traditional clients and in particular to newly established and privately owned medium- and small-scale firms, the links between commercial banks and the traditional selected business activities and sectors, such as construction, agriculture, foreign trade are still strong, partly as a result of the inherited structure of assets. The client diversification policy, which is aimed at assisting financially the transformation process and at reducing banks' financial risks through a proper portfolio management, has so far achieved only limited results.

Also the degree of concentration in the banking sector appears still to be abnormally high with the National Saving Bank and the four largest commercial banks owning about 75% of the total assets and controlling over 50% of the total business volume. The state is still a major shareholder in the three major commercial banks, holding an average of 40% of the shares. In this respect Hungary would benefit from a better client diversification and a lower degree of bank concentration, which would minimize financial risks and give newly established and privately run medium-sized banks the opportunity to capture 'business niches' by providing new packages of financial services on a competitive basis.

Banks' reluctance to grant loans at competitive costs to newly established small- and medium-scale firms partly reflects their prudence regarding the uncertain business future of new firms, high start-up costs, uncertain returns on investments and more general financial uncertainty related to existing and potential inflationary pressures. To minimize their financial risk banks usually request their clients to provide adequate collateral, which many new companies or individual entrepreneurs simply cannot provide.

On the other hand, financially unhealthy bank-enterprise and inter-enterprise relations still prevail, particularly in the state-run heavy industry, where restructuring, privatization and liquidation have proceeded relatively slowly so far. This may help to explain the continuing high dependency of banking institutions on the industrial sector.

A securities market has recently begun to develop with the trading of state bonds, certificates of deposit, notes etc.[17] Its further evolution will be essential for promoting capital mobility and efficient use of earnings. New financial services have also been developed and are now being provided both to enterprises and to households. This reflects the government's efforts to increase competition among banks in both the range and the costs of the financial services they offer.

A stock exchange was re-established in mid-1990, following the approval of a stock exchange law effective from 1 January 1990. Only thirty companies are quoted, however, and the number and value of transactions has so far been quite small.

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17 Commercial bills were introduced in Hungary in 1985 and Treasury bills in 1988.

Further improvements derive from the new Central Bank law, effective since 1 December 1991, which redefines the role of the NBH and its relations with the commercial banks, and allows a greater degree of autonomy from political authority. At the same time, new legislation on banking and finance came into effect (Investment Funds Act, Financial Institutions Act). These provide a legal basis for the introduction of new financial regulatory and supervision instruments for banking control and management. It includes, in particular, a comprehensive regulatory framework to reduce lending concentration, to lower the proportion of non-performing or sub-standard loans in the banks' portfolios and to enhance competition in commercial and retail banking. The law gives banking supervision key functions, such as credit monitoring, reviews of the quality of banks' assets and implementation of prudential regulations on risk exposure, capital adequacy, investment limits, liquidity ratios and licensing. It also ensures the autonomy of the State Banking Supervision authority. These new laws will be complemented by a new law on accounting, which became effective at the beginning of 1992. Legislation is also being prepared to introduce a system of deposit insurance.

Monetary policy will rely entirely on market-based instruments. A policy of maintaining positive interest rates will be pursued. Regulations regarding a new role for the NBH in foreign exchange transactions will be considered in the framework of further decentralizing foreign exchange policy.

The completion of the banking reform started in 1987-89 is also intended to encompass key items such as the future and role of state ownership in the banking sector, the setting of reserve requirements, management of low-interest loans (particularly for housing), inter-bank ownership criteria and principles, interest practices, minimum capital adequacy, appropriate rules governing entry and exit of banks, and other urgent matters that are particularly relevant at present, in view of the growing financial risks and economic uncertainties.

New legislation on the establishment of venture capital institutions is being discussed. The role and function of the State Development Institute will also probably be modified in the light of the emerging requirements.

The development of key financial services such as export guarantees and export credits, mortgage banking and banking for economic development and enterprise promotion also needs to be addressed quite urgently by the Hungarian authorities. An export credit agency is already being established.

During 1992 banks with foreign participation are to be authorized to grant loans, take deposits and run cheque accounts for personal customers (so far foreign banks were authorized to provide funds only to enterprises).

b. Monetary and credit policy

Traditionally in Hungary the role of monetary and credit policy was to control the overall credit volume so as to meet the economic policy targets laid down in an annual plan, and the Central Bank had a monopoly in banking and credit (mono-bank system). Under this system the National Bank of Hungary had unlimited capacity to create bank deposits and provide financial resources to finance the budget and other central government requirements. In this system the amount of money in circulation in the economy was determined directly by central government authorities, which also retained a complete monopoly over foreign exchange transactions. In addition, some specialized financial institutions and more or less autonomous departments of the NBH provided banking services and credit to well-defined sectors and enterprises in the framework of central government directives issued for the implementation of the national central plan.

In this system interest rates and exchange rates had no allocative or redistributive role. Foreign exchange and external borrowing were intimately linked to import plans at central planning and enterprise level. In this respect, the exchange rate was mainly an accounting mechanism used only to effect consistent conversion of foreign prices into domestic prices.

As a result of far-reaching reforms that began in 1987 and were further extended in 1989 in the framework of the process of liberalization, macroeconomic stabilization and restructuring, the National Bank of Hungary assumed most of the typical central bank functions and, in line with western practice, began to use more actively the traditional instruments of monetary and credit control and management, such as the regulation of the money supply, interest and exchange rates, etc.

The principle that the National Bank should not finance the Treasury's requirements with additional monetary instruments and that commercial banks should not provide state-owned enterprises with soft credit was also affirmed. At the same time, it was recognized that the introduction and eventual expansion of open-market operations represented a most useful way of regulating saving and providing investment in the framework of anti-inflationary policy. In 1989/90 the financial and banking regulatory framework was further liberalized to permit new lending opportunities, to encourage the establishment of new financial institutions and to provide a new range of services. The government regards these changes as significant steps towards the adoption of an effective financial policy which will focus on a more active use of available financial instruments, more appropriate distribution of competencies among the public entities responsible for monetary and financial policies and a higher degree of independence for the National Bank of Hungary as the principal authority responsible for applying control and regulatory instruments.

The government's medium-term strategies and policy objectives focus on the need to create a favourable domestic environment for mobilizing domestic and foreign capital for investment purposes. The government intends to attain this objective by pursuing a policy of positive real interest rates and by encouraging saving with various instruments, in the framework of a continuing demand management policy.

The National Bank of Hungary (NBH), for its part is committed progressively to reduce its direct financing of state budget deficits, in line with the IMF agreement. At the same time, the use of open-market financial instruments (government bonds, Treasury bills, certificates of deposit, etc.) will be encouraged, with the aim of mobilizing private savings for public financing purposes.

The NBH is committed to providing financial resources to the government and to commercial banks at non-preferential rates. As agreed with the IMF, basic refinancing loans at lower rates of interest will be granted only on past loans to the government and for medium-term investment projects. In principle, strict monetary policy would imply that during the next few years the growth of the monetary base and the degree of system liquidity would probably fall behind the growth of nominal GDP.

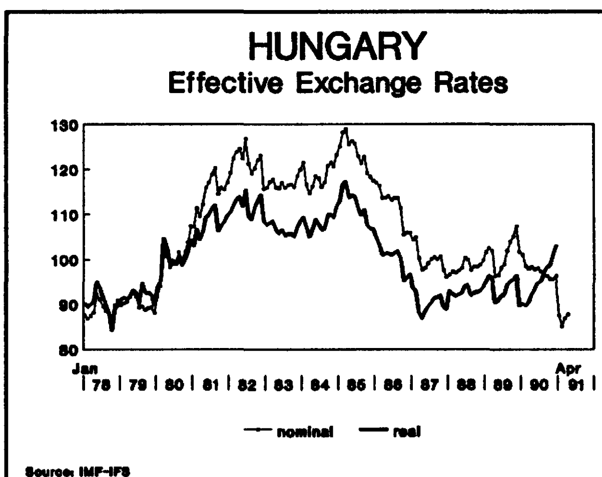
The government's strategies and medium-term objectives in credit management include continuing to regulate credit expansion in line with the country's external payments position. The government intends to address urgently unhealthy financial relations between banks and state enterprises, with the ultimate objective of setting up a more effective credit policy aimed at improving the overall efficiency of resource allocation. It also plans to strengthen the homogeneous and harmonized system of interest rates and keep the reserve requirements of commercial banks at an acceptable and satisfactory level.

As regards credit distribution to final users, general credit management will become more selective and credit to the State Development Institute will be progressively reduced. Credit to state enterprises will focus on their particular financial needs in view of their restructuring and privatization. Credit to medium- and small-scale privately owned enterprises and business is to be expanded significantly.

c. *Exchange rate policy*

At present, the Hungarian forint is de facto fully convertible for current account transactions carried out by resident enterprises, banks and foreign joint ventures (repatriation of profits).

The move towards this kind of current account convertibility has been supported by a policy of progressive devaluation of the forint. Since the beginning of 1989, the forint has been devalued seven times (Table 32), depreciating overall by 77% in nominal terms. Through these adjustments, the Hungarian authorities have avoided major misalignment of their currency and restored a good degree of confidence in the forint. The differential between the official and parallel exchange rates was reduced from about 40% in 1989 to 10 to 15% in 1990 and disappeared almost entirely in 1991. However, with the growing domestic inflation in 1990 and 1991, the real effective exchange rate showed a net appreciation which partly offset the gains of previous devaluations (Graph 7). This divergence between the nominal and real rates is the result of a compromise between policy objectives: the declared priority was to minimize the foreign exchange constraint by, in particular, improving competitiveness through devaluations; however, the inflationary consequences of such a policy were not compatible with the inflation target, which was already threatened by the effects of price and trade liberalization.



Graph 7 Effective exchange rates

In the future, this policy trade-off should be mitigated. The competitiveness policy will more and more rely on productivity gains expected from restructuring and privatization. Inflationary pressures will be kept under control, provided the Hungarian government succeeds in tightening fiscal and monetary policies. Under these circumstances, the Hungarian authorities will be able to pursue a policy that avoids appreciation of the real exchange rate. A debate about the appropriate exchange rate regime has already been launched, with those who support a controlled exchange rate mechanism which allows the forint to fluctuate within a pre-determined band, as adopted recently in Poland, ranged against those who recommend keeping a fixed but adjustable exchange rate system. The recent simplification of the currency basket to which the forint is pegged[18] will anyhow enable external competitiveness to be monitored more closely.

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18 Since December 1991, the forint has been pegged to an average of the US$ and the ECU, instead of the previous basket of 10 currencies.

Foreign Exchange Regulations

Foreign exchange regulations are enforced by the Ministry of Finance. Non-residents and resident individuals may hold convertible-currency accounts with commercial banks. These accounts carry tax-free interest payable in the currency of deposit and have a guarantee of repayment. The interest rate is set as a function of the currency and maturity of the deposit to be competitive with those in the international market. No particular authorization is required for the use of these resident accounts in foreign currency, although they may be used only for private purposes like tourism and travel abroad and not for commercial activities.

Payments in forints to non-residents must be deposited in blocked forint accounts and can be freely disbursed. Only the transfer of these funds is subject to authorization.

Imports of foreign goods by Hungarian enterprises for settlement in convertible currencies are now completely free. Imports of consumer goods settled in convertible currencies are subject to a global quota established periodically in US dollars by the Ministry of International Economic Relations. Payments for invisibles related to merchandise transactions, including transport and advertising, are unrestricted.

Foreign exchange allowances for travel are subject to low ceilings, for balance of payments control purposes: only $50-worth of forints may be purchased annually for tourism purposes, but transport tickets can be paid for in forints. No minimum spending or conversion requirement any longer applies to non-resident travellers to Hungary. Legal entities must surrender their foreign exchange earnings to the banks and consequently are not allowed to hold foreign exchange accounts.

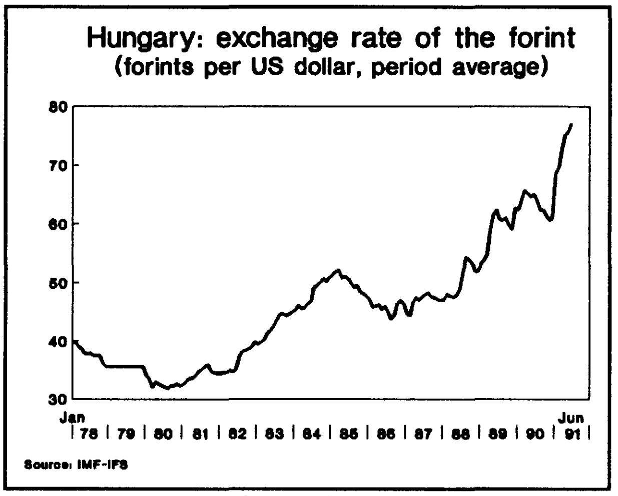
Non-residents may now freely take out of the country their foreign exchange assets, in addition to their personal effects, without a licence from the foreign exchange authorities, provided that local taxes have been paid. Non-resident employees of joint ventures may freely transfer 50% of their after-tax income abroad. Foreign investment, as well as the transfer abroad of capital (in the case of liquidation) and profits are now liberalized and protected, provided that fiscal obligations in Hungary are met. Reinvestment of profits is encouraged by appropriate profit tax concessions, which act as an incentive.

As regards exchange rate regulations and administrative reforms, during the first half of 1990 a first phase of foreign exchange decentralization was introduced. Commercial banks were authorized to undertake commercial transactions with foreign partners. Banks that wish to provide foreign exchange services may obtain a licence, which is approved by the National Bank and by the State Banking Supervision Office.

The Hungarian authorities are currently setting up an interbank market, which would reduce the intermediary role of the NBH in foreign-exchange transactions. Full current account convertibility of the forint will be introduced by the end of 1994.

Table 32 **Most recent forint devaluations**

1989 March	5%
April	6%
July	-1.5%
December	10%
1990 February	5%
March	15%
1991 January	15%
November	5.8%
Source:NBH	



Graph 8 Forint-dollar exchange rate

Table 33 **Exchange rates 1988-91,** period averages

	Ft/US$	Effective rates[1]	
		Nominal	Real
1988	50.4	79.6	83.0
1989	59.0	82.1	83.7
1990 Q1	64.0	80.3	80.5
1990 Q2	64.9	79.4	83.5
1990 Q3	62.9	78.3	86.6
1990 Q4	61.0	77.7	90.3
1991 Q1	70.3	70.1	n.a.
1991 Q2	75.9	72.3[2]	96.8[2]

[1] 1985=100
[2] April-May figures for the nominal rate; May figures for the real rate.
Source: IMF-IFS

3. Privatization

a. *Historical background and legal framework*

Although privatization was not part of the economic reform launched in 1968, Hungary already had a private sector before the collapse of the one-party state in 1989; it was smaller than in Poland, but larger than in other Central and East European countries. In 1990 the private sector provided a significant share, estimated at around 10%, of Hungarian national income.

Privatization in Hungary is characterized by several distinctive features:

- it was preceded by a gradual but substantial legislative and institutional build-up: company law (1988), law on transformation of business organizations and associations (1989), law on foreign investment (1988), bankruptcy act (1986, revised in 1991);

- it is carried out through competitive sales of state assets, similar to the mode of operation of the Treuhandanstalt, in the ex-GDR, and has never indulged in mass distribution to the public of free ownership titles, as in Poland, CSFR, Romania, and Bulgaria;

- it has relied as much on the promotion of new private enterprises and joint ventures as on the transfer of state assets.

The legal framework for privatization was put in place by three major laws adopted early in 1990: the law establishing the State Privatization Agency (SPA), to which the responsibility for state property and privatization was given, the law on protection of state property, and the law on privatization of state-owned companies in retail trade, catering and services.

A compensation law was passed in the summer of 1991 to recompense the former owners for properties confiscated after 1949.

b. *Privatization strategy: ongoing programmes and results*

According to the Guidelines on Property Ownership issued in March 1991, the Hungarian privatization programme is aimed at increasing the share of the private sector in the competitive sector to over 50% by 1994. Initially, in response to "spontaneous" or "wild" privatization, which resulted in an appropriation of state assets by the managers of self-managed companies and the *nomenklatura*, the SPA pursued a rather centralized approach to privatization. However, this strategy proved to be too cumbersome, slowing down substantially the transfer of state assets. Action was thus taken in 1991 to accelerate privatization.

Five different types of privatization are currently in progress:

(i) Spontaneous privatization or company-initiated privatization enables the enterprise to prepare its own privatization plan by looking for a partner. The plan is submitted to the SPA, which monitors its implementation; this procedure is an extension of the transformation of state enterprises into self-managed companies that began in the second half of the 1980s.

(ii) The small-scale privatization, or pre-privatization, programme for the sale of small shops (less than 10 employees) and catering establishments (less than 15 employees) and other services was approved in September 1990. The sales take place through auctions, which are not open to foreigners. The privatization of 6,031 identified units is supposed to be completed by the end of 1992. The programme is running behind schedule: by the end of 1991 only 2,120 units, sold for Ft 5.1bn, had been privatized.

(iii) Large-scale or "active" privatization is intended for large companies with good prospects of generating profits. The SPA estimates the market value of the companies and prepares a detailed privatization plan to be submitted to local or foreign potential investors. The initial intention was to proceed with successive privatization programmes, each covering a group of about twenty companies, every three to six months. However, the asset valuation proved to be a lengthy and cumbersome exercise. In addition, the companies either were found to be less profitable than thought, or were hit by the worsening of the economic situation in 1991. As a result, the programme lost momentum. Since September 1990, two programmes have been launched, with two other sectoral programmes for vineyards and the building sector. In 1991, it was also decided to accelerate the privatization of some large companies affected by the collapse of the CMEA: following a review of 15 companies, 7 of them were finally selected for privatization. At the end of 1991, only 18 companies had been sold, for Ft 183bn, and privatization had been initiated for 107 companies.

(iv) Investor-initiated privatization, introduced in February 1991, gives the opportunity to foreign investors or small-scale entrepreneurs to make an offer to buy a company they have identified. The privatization plan is prepared by the buyer in consultation with the company. The role of the SPA is limited to checking the transparency and appropriate valuation of capital. As of end-1991, offers for 356 companies had been received from potential buyers or from enterprises, of which 180 were approved. In terms of asset value, this has been the main channel for privatization so far.

(v) In the same vein, companies have recently been permitted to organize their own privatization, with the assistance of a consultant authorized by the SPA. Unlike spontaneous privatization, this method, self-privatization, only requires the final approval of the SPA. In the first phase, self-privatization was confined to companies with less than 300 employees and less than Ft 300m annual turnover. Rather less than 400 companies were involved in self-privatization at the end of 1991: 20 companies had been transformed, and 353 were in the process of transformation.

c. *Evaluation and Prospects*

Hungary's privatization programme is very ambitious: from a state sector comprising 2,200 companies valued at Ft 1,900bn, about 900 companies will be privatized, representing a value of Ft700bn, from which the government expects revenue of about Ft380-390bn. In 1991, privatization proceeds did not exceed Ft40bn, and no increase is foreseen in 1992. All the components of the programme are behind schedule, and the Hungarian authorities are debating how to overcome the initial difficulties of the learning process, the political confusion, and the unfavourable economic conditions.

The design of the privatization programme neglected some basic legal incentives or prerequisites necessary for the emergence of a capital market. The absence of international company accounting standards, for instance, has weakened the relevance of the valuation of state assets before auctions. For pre-privatization, the fact that the premises of retail outlets could only be leased and not purchased discouraged many bidders. Such obstacles are progressively being removed through the development of a legislative framework. The Hungarian authorities are also correcting these disincentives by moving away from a centralized privatization process towards diversified privatization channels, enabling the privatization plans to be tailored to different company situations and delegating privatization initiatives to the economic agents. The self-privatization package is part of the new strategy.

The role of government institutions will also be redefined. Owing to inexperience, or even to some political opposition, the government institutions have sometimes delayed the transfer of state assets. Complications over ownership arose between the local and central governments, as in the case of the Danubius Hotels, one of the "flagship" companies of the privatization programmes. All the chain's 18 first-class hotels lie on land owned by different local authorities, which are entitled to shares in the new private sector entity, making 18 separate sets of negotiations necessary.

Conflicts of interest have also emerged. The SPA seems to have been a source of delays, being more concerned to control than to privatize the public sector, as reflected in its focus on the transformation of companies. Spontaneous privatization or self-privatization have mainly been channels for transforming state enterprises into companies, rather than for privatization. Transformation was achieved on a large scale: through company, investor or state-initiated privatization: 218 companies with a book value of Ft345bn had been transformed by December 1991, and 636 were in the process of transformation, totalling a book value of Ft305bn. However, this had only a weak impact on the development of a competitive sector. Case studies quoted by Kiss[19] suggest, that there is no evidence of improved performance after transformation. Nor has transformation systematically facilitated the restructuring of companies, which remains to be undertaken as a preliminary step to privatization. The government is envisaging limiting the power of the SPA by separating the function of managing the public sector from that of privatization. A bill will be submitted to the Parliament in spring 1992 which proposes to set up a new agency for managing state property. Another bill is in the pipeline for selecting the companies, which will remain state-owned over the next few years. Given the social cost of restructuring and privatization, pressures have been mounting to expand this "list of exceptions", to a point which might imply a downward revision of the privatization targets.

Privatization is expected to gain momentum, with the development of financial instruments and institutions. As in other East European countries, privatization is limited by the availability of savings. So far the dominant source of financing has been the massive inflow of foreign capital: foreign participation in privatized companies amounted in 1991 to about 90% of the privatization proceeds and was equally distributed between purchases of state assets in privatized companies and increases in equity capital in transformed companies. By comparison domestic savings played a minor role: the stock exchange is still in its infancy; the financial institutions, predominantly state-owned, are unable to develop an active role in the absence of a clear treatment of bad debts; in addition, the restrictive monetary policy entailed giving priority to short-term credit, rather than developing the medium-term credit policy needed for such investment. In 1992, the financial sector will be a priority of the privatization programme and its reform will accelerate following the adoption of the banking law. The government also intends to increase the

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19 Yudit Kiss - 1991 - "Privatization in Hungary - wishful thinking or economic way out?", Conference on "International Privatization: strategies and practices", St Andrews, September 1991.

availability of loans at subsidized interest rates and to relax the eligibility criteria for privatization loans, which have been underutilized so far.

Faster restructuring can also be expected. The government strategy is twofold: to take a more active hand in restructuring companies before selling them, in particular, using the proceeds of privatization to refloat companies in difficulty; and to step up the liquidation of unprofitable companies, on the basis of the new liquidation legislation. Privatization could then focus on attractive investment opportunities. However, if unemployment continues to accelerate in 1992 as it did in 1991, such a policy might generate unsustainable tensions on the labour market. 1992 will be a test year for the government's commitment to its privatization objectives.

4. Reform of the tax system

a. *Fiscal revenue*

According to statistical data available in April 1991, Hungarian total tax revenue in 1989 was Ft817.8 bn (47.9 per cent of GDP); estimated revenue for 1990 was Ft 970.1 bn and for 1991 Ft 681 bn. The share in GDP is continuously declining, as taxes are not fully indexed on inflation.

The 1989 breakdown was 7.2 per cent of GDP for enterprise income tax (which is a profit tax; see below), 1.6 per cent personal income tax (which represents 5.5 per cent of GDP, but for the remaining 3.9 per cent of GDP is transferred to the budgets of local authorities), 13.5 per cent VAT (see below) and excises, 2.6 per cent custom duties, 17.3 per cent social security contributions, 5.8 per cent other tax revenue. In the absence of a tax reform and with the gradual pace of structural reform, no major change has so far affected the composition of fiscal revenues. Subsidies, which can be regarded as a negative tax, were cut from 17-18 per cent of GDP to 9 per cent in 1990 and 7 per cent in 1991 (they will be cut further to 5 per cent in 1992 and 4 per cent in 1993; some subsidies will still remain in agriculture). According to the latest revised data available, 1989 tax revenue in the consolidated state budget was Ft 865.8 bn, rising to Ft 1,019.3 bn in 1990 and Ft 1,094.2 bn in 1991.

b. *Value added tax.*

In all centrally planned economies, including Hungary since 1947, a 'turnover tax' used to be levied (except on subsidized goods) at every stage of production at differential rates by product and by enterprise, simply to syphon off above-minimum profits into the state budget. In 1988 Hungary introduced a value added tax, but Hungarians still call it a 'general turnover tax', i.e. a term which naturally suggests a cascade tax levied on the value of turnover at each stage of production, instead of a tax on value added. This tends to generate confusion.

Already in 1968 Hungary reformed consumer and producer prices, ending up with a system of 3,000 different turnover tax rates levied in a single stage on wholesale prices (i.e. avoiding the cascade effect); in 1986 the turnover tax rates were reduced to four, still in a single stage at the wholesale outlet; work on a value added tax began in 1985, and the new VAT was introduced in January 1988, when subsidies on consumption goods were reduced and subsidized goods temporarily taxed at a zero rate. Now government services (public administration, education, health) and financial services are exempt, some basic goods and services are zero-rated (foodstuffs, most staples, water, district heating, public transport; energy and fuels, on which a large non-deductible excise tax is levied instead); other services are rated at 15 and other goods at 25 per cent.

Hungarian officials claim that Hungarian VAT is fully harmonized with EEC regulations; the 1990 law and 1991 amendments have followed EEC trends and intentions, except that the new rates are planned to be levied at 10 and 20 per cent (approaching the case of Austria, where VAT rates are 8 and 18 per cent). If, at the same time, all previously zero-rated goods are made subject to tax, the VAT burden will rise by between 1.7 and 2.5 per cent of GDP.

c. *Excise taxes*

Excise taxes are levied on a range of goods which is much wider than in the West. In 1986, when the former turnover tax was streamlined to four rates and a single stage, in order not to lose the fiscal revenue obtained from the more highly taxed goods the turnover tax on those goods was transformed into an excise tax. Today this is still substantial on products such as tobacco, alcohol, coffee, chocolate, chewing gum, peanuts, crystal, passenger vehicles, fuels, or gold (jewelry carries a 65 per cent excise tax plus VAT at 25 per cent). Over time, excise rates have been reduced and every year the excise tax on a few products is abolished. The aim is eventually to charge excise tax only on tobacco, alcohol and fuels.

d. *Tax on excess wage increases*

One of the early instruments of wage control under the New Economic Mechanism was a tax on increases in wages above statutory guidelines. In 1991 no tax was levied on wage bill increases up to 18 per cent, otherwise a 40 per cent tax rate was applied to wage bill increases between 18 and 28 per cent; over 28 per cent the tax rate applied to the whole of the increase (in addition, there is a tax on personal incomes of up to a maximum rate of 50 per cent).

Hungarian tax officials, like their Polish counterparts who levy a similar tax (the so-called Popiwek), have not regarded taxation of excess wages as a true tax, since 'in an ideal world it should yield no income' (as stated by a Hungarian official); this point is controversial, but this tax has indeed served as a form of wage control which does not raise significant income and has been suspended from the beginning of 1992.

e. *Income taxes*

Until 1988 personal income tax was paid only by private self-employed persons. In 1988, when the tax rate on wage increases above a statutory guideline was reduced, personal income tax was introduced also for employees of state enterprises, i.e. extended from 200,000 to 5.5 million taxpayers. Today the tax starts at 20 per cent and rises to a top marginal rate of 50 per cent.

The profit tax (at 35 per cent on the first 3 mn forints, then 40 per cent in 1990) is subject to sizeable rebates (50-100 per cent) for the private sector and for enterprises partially privatized or with foreign participation. This entrepreneurial profits tax originally was devised for state enterprises and cooperatives but, after transitional tax arrangements for 1988, in 1989 private entrepreneurs were given the option to choose between the profits tax and the personal income tax, which caused a substantial reduction in the tax burden of the private sector.

If there had been no further ownership changes nor progress towards a market economy Hungary might have muddled through with VAT, personal and/or enterprise income tax; with private ownership at under 5 per cent of the total, private income taxation could only have had a marginal importance. In 1988 it was expected that the private sector would begin to grow only in 1992, but events moved faster. Today the private sector represents something between 20 and 30 per cent of GDP according to various estimates; it is probably closer to 30 than to 20 per cent, and it is growing faster than the rest of the economy. Thus the tax system has to be changed accordingly, taking into account the importance of all incomes and, especially in times of inflation, capital gains.

With the transition to a market economy the administrative capacity for tax assessment and collection has become inadequate: under the old system the direct monitoring of 10,000 large enterprises allowed a relatively simple tax administration to catch at least 90 per cent of all incomes. With the growth of the private sector many additional activities and incomes become taxable, but the operation of the existing system becomes increasingly uncertain and inefficient.

According to official estimates, 50-60 bn forints of income tax revenue a year are not being collected from prospective taxpayers. The President of the Hungarian Association of Private Entrepreneurs, Mr Polotas, has argued that since 1988, when the possibility of choosing between the enterprise income tax and personal income tax was introduced, all income tax has been collected; however, the structure, logistics and audit methods of the tax administration are insufficient, and according to the Ministry of Finance tax evasion remains a large-scale phenomenon. The new Company Act lumped together new companies, cooperatives and state enterprises for tax purposes, while the administration is not able to deal with the resulting hundreds of thousands of taxpayers; hence the importance of technical assistance in tax administration under the PHARE programme. Improvements in tax administration may be more important than tax reform: even if the best tax system could be devised and introduced it would remain useless if it was not operated effectively.

The Hungarian personal income tax system is characterized by differential rates according to kind of income, nature of ownership, enterprise form. Thus, for instance, farmers' income is tax exempt if obtained from sales of up to 500,000 forints, a most generous allowance. There is a tax exemption on up to 30 per cent of taxable income for financial and some types of direct investments. Interest and dividends are taxed at 20 per cent. In the case of dividends (after a 40% profit tax), that means a 52% cumulative tax burden, which unduly favours bank deposits versus equity investment. Most fringe benefits (cars, housing, holiday facilities provided by enterprises; capital vouchers issued to employees) are tax-exempt. Cooperatives are all treated equally regardless of size. Capital gains are globalized with other income and taxed in accordance with the normal tax rate schedule. In the case of owner-occupied houses the tax can be postponed. State enterprises depreciate investment over 12-13 years, while private enterprises are allowed to depreciate it over two years.

In view of these anomalies it can be argued that the Hungarian income tax system is neither fair nor efficient; government policy and recent IMF recommendations favour a simpler system of income tax (with fewer rates), at lower rates (no more than 40 per cent), more uniform across taxpayers and levied on a broader range of incomes, with preferential treatment for small enterprises. The enterprise income tax will probably be transformed into a corporation tax, at lower rates and therefore with a lesser need for particularly generous treatment of private and foreign investment (accelerated depreciation, tax holidays and rebates).

A balance has to be struck between the need to provide effective incentives for private and especially for foreign investment on the one hand and, on the other, the need to implement a sound fiscal policy and therefore to obtain an increase in tax revenue. According to Ministry of Finance officials, a sound budgetary policy is a more important precondition for the success of reform than the artificial boosting of private and foreign investment when this is crowded out by public sector borrowing requirements, discouraged by high interest rates and handicapped by excessive taxation of dividends.

5. Trade reforms

Hungary's most significant trade reforms began with the introduction of the New Economic Mechanism (NEM) in 1968. Since then they have passed through three stages; initially, decentralization, then demonopolization which began slowly in 1981 and accelerated in 1986, and finally, liberalization, which began in 1989.

a. Decentralization

Up to 1968, a small number of specialized foreign trade companies acted as a branch of the government, ensuring that its plans regarding exports and imports were carried out. Each company had its own list of products which it could import and export, and there was no overlap among the lists. In other words, the foreign trade organizations had exclusive rights to trade in certain products. In addition, some large industrial enterprises were authorized to export their products and to import essential inputs.

In 1968, as part of the NEM, 22 more industrial enterprises were authorized to conduct foreign trade, exporting their output and importing essential inputs (extended to 5 more industrial enterprises in the 1970s). More importantly, the specialized foreign trade companies were given greater independence. Instead of just carrying out government policy, they became decentralized organizations, although acting within the parameters of government rules, subsidies, quotas and knowledge of the government's preferences. It is important to realize, however, that although this meant some decentralization of the state's monopoly over foreign trade, it entailed neither the end of that monopoly nor trade liberalization - the bulk of Hungarian producers had to go through the foreign trade organizations if they wanted to export or import any goods, or else obtain licences from the government.

Another attempt to relax the state's monopoly over foreign trade began in 1981. This combined, first, a significant increase in the number of economic organizations granted licences to engage in foreign trade (to 270 enterprises by the end of 1985, of which 38 were organizations that specialized only in foreign trade, while the others were industrial enterprises, state farms, and cooperatives) with, second, the granting to eight existing foreign trade organizations (and several entirely new ones) the right to comprehensive foreign trade - meaning that they could trade goods which other organizations were also trading. This was known as parallel licensing. For the first time, some competition between the trading organizations was being allowed, although strictly supervised and regulated by the government. It had the effect of accelerating decentralization of Hungary's foreign trade activities.

Nonetheless, the monopoly over foreign trade was not significantly weakened. Licensed organizations continued to exercise near-monopoly powers to export and import products, although, as the number of licensed trading organizations grew, each one had near-monopoly powers to trade in fewer products. Moreover, the decentralization process did not always proceed completely smoothly.

b. Demonopolization

From 1986 onwards, however, more radical foreign trade reforms were implemented which did significantly reduce the degree of monopoly in foreign trade. Instead of organizations being licensed to hold virtually exclusive rights over the imports or exports of particular products, the Hungarian government started granting parallel trade licences to all of the trading companies. In other words, individual organizations' almost exclusive rights to trade in certain products began to be dismantled. The forty enterprises specialized in foreign trade could engage in convertible-currency imports or exports of any goods other than those on lists produced by the government (the so-called lists of exceptions - goods which needed authorization in the form of a licence from the government before they could be traded) and were thus pitted against each other. Furthermore, licences for foreign trade in convertible currency were handed out automatically to any organization that wanted them, provided that the goods traded were not on the list of exceptions and that the organization had produced them itself, or needed the imports for production purposes. As the effect of these reforms seemed rather favourable, the government authorized 71 more companies to engage in general foreign trading in 1987.

Then in 1988 came a decree which further significantly demonopolized convertible currency trade by allowing any Hungarian business organization at all to carry out foreign trade in convertible currency without having first to obtain a licence (unless the goods traded were on the lists of exceptions, in which case licences still had to be obtained from the authorities). Nevertheless, although trading licences were no longer needed, business organizations were instead required to register with the Ministry of Trade before they could engage in foreign trade. Provided the organization met a number of conditions, however, registration could not be denied.

The decree also allowed individuals to sell items to the convertible-currency area (except items on the list of export exceptions). Then, from 1 April 1989, individuals were also given the right to carry out convertible-currency imports provided that they were used in the domestic production of goods or services. As a consequence of these developments, there were 3,000 firms and 1,000 private individuals registered with the Ministry of Trade by the end of 1989, and 10,000 firms registered by the end of 1990.

c. Liberalization

The most significant of all Hungary's trade reforms, however, was introduced on 1 January 1989, when a three-year programme of import liberalization was begun. This meant that the lists of exceptions began to be pruned in stages. According to official Hungarian sources (which provided all the statistics presented in this paragraph), 54% of the total value of Hungarian convertible currency exports and 40% of Hungary's total value of convertible currency imports were covered by the lists in 1988. In 1989, systematic trade liberalization reduced the figures to 36% for exports and 20% for imports. Following further legislation introduced on 1 January 1991, it was envisaged that only 8% of imports and 30% of exports would still be on the lists of exceptions. In any case, for products still on the lists of exceptions, authorization is being granted to approximately 90 % of licence requests. Nonetheless, trading in agricultural and food products, a sector for which licences are still required, remains dominated by the large, traditional foreign trade organizations. As a result of import liberalization, more and more of Hungarian industrial production has been exposed to foreign competition - whereas 15% of industrial production was affected by foreign competition in 1988, the figure had risen to 32% in 1990, and to about 90-92% in 1991.

The list of import exceptions covers coal, raw materials, telecommunications equipment, food products, motor cars, some consumer products, textiles and medicines. Import licences can relate to a single import transaction or specify a ceiling up to which imports of a commodity or group of commodities can be permitted. For those consumer goods which are subject to a global quota (and therefore require licensing), the quota is specified in US dollars and was increased by 67 % in 1989 compared with 1988, and by another 35 % in 1990.

In some cases export licences have been retained because of international obligations, such as textile agreements or COCOM. Furthermore, the Hungarian government reserves the right to introduce restrictions on the trade of any goods if it is deemed that Hungary's security would be preserved by such action, or if Hungary commits itself to international trade agreements in the future, or if such actions would help conserve supplies of staple goods, or if a trading partner engages in unfair practices.

Other important reform measures have also had an impact on foreign trade. For example, the unweighted average tariff level on an MFN basis declined from 34% in 1968 to 16 % in 1989 and to 13% in 1991. Furthermore, under new laws introduced on 1 January 1991 Hungary adopted the harmonized customs classification system. Reductions in tariff levels, however, only became significant with the recent period of trade liberalization, as, before the present government came to power, non-tariff barriers in the form of institutional controls and the prevailing influence of the Hungarian Socialist Workers' Party were much more important and effective than tariff barriers. Trade liberalization and declining non-tariff barriers have together had an impact on import volumes. For the future, Hungary has offered to reduce its average tariff level to 8% over a five-year period, as part of its commitments within the Uruguay Round.

Hungary has by now nearly completed its internal trade reform, additional improvements being expected from forthcoming changes in the economic environment (such as the removal of exchange controls or the decentralization of foreign exchange transactions). The integration of Hungary in the world economy will also accelerate beyond 1991 following the disappearance of the CMEA trade regime and the conclusion of bilateral trade agreements, mainly the European Agreement with the EC. Both changes will further expose the Hungarian economy to international competition. If, however, these trade measures have only a weak impact on exports in the short run, while Hungary continues to face the high transition costs of structural reform, the liberalization of trade might undergo some revision.

ANNEX: ECONOMIC TRANSITION AND STATISTICAL INFORMATION

(1) The role of statistics in the transition: a difficult situation

The long sequence of reforms carried out in Hungary over more than twenty years has not been without consequences for the Hungarian statistical apparatus. These reforms, in particular those of 1968, have increased the autonomy of firms and accordingly reduced the confusion between the function of statistical measurement and that of an instrument of planning - a stronger and more durable feature of the statistical information systems of the other East European economies. The statistical apparatus has seen partial emancipation from the plan-fulfilment preoccupations of those involved in the planning process - state bodies and firms alike. Given their more autonomous status, Hungarian statisticians have been able to move closer to certain international statistical standards, as in the case of national accounts. Since 1970, the main Hungarian macroeconomic aggregates have been available in a form compatible with SNA (System of National Accounts) standards, while continuing to be available in the traditional MPS (Material Product System) form.

Despite this gradual adjustment of the Hungarian system of statistics to an economy which very partially incorporates market mechanisms, serious difficulties are being experienced today in reforming the system. These difficulties are both institutional and conceptual, both aspects being inextricably linked. The former communication channels between firms and the various administrative departments involved in compiling statistics and among those departments themselves have been profoundly disrupted. How are the statistical institutions going to deal with the large firms and banks which will survive in the Hungarian economy (often under foreign influence) and with the rapidly increasing number of small and medium-sized firms? How will it be possible to create a common accounting and statistical language in an economy which combines a concentrated, multinational sector with a local sector of small firms? This difficult reshaping of the way in which the statistical apparatus fits into the institutional landscape raises problems of a more technical nature: a redefinition of the methods used to gather data on firms is necessary, given the rapid increase in the number of businesses, and the statistical nomenclatures will have gradually to be converted to international standards.

National and foreign users of Hungarian statistics must expect a fairly long period of statistical uncertainty, during which it will be difficult to provide a direct and clear-cut answer to delicate questions of major interest to economists. For example, do the available statistical measures underestimate performance in the transitional period owing to deficiencies in recording private activities? Will there be breaks in foreign trade statistics because of institutional and economic changes affecting trade formation and management? It is hardly possible today to give an accurate answer to these questions. It is only as the system of statistics is reformed and any methodological problems are clarified and solved that more satisfactory answers will emerge. These uncertainties clearly reduce the capacity of the system of statistics to make an effective contribution to managing the transition. But economists should take this fact for what it is: a high degree of imperfection in the information available to public and private decision-makers will inevitably be part and parcel of the transition. Statistical cooperation schemes undertaken with Hungary under the PHARE programme aim to overcome this situation as quickly as possible. By its very nature, this task is not easy: on the one hand, statistical indicators are supposed to help measure the intensity and speed of structural and behaviourial change in the Hungarian economy, while, on the other, the scale and structural nature of this change complicate the task of statisticians and require tailor-made methods to be developed.

(2) Rebuilding the Hungarian system of statistics

The Hungarian system of statistics should soon benefit from the introduction of a new legislative framework governing its activities. The current Statistics Act dates from 1973 and is in need of a fundamental updating if the public's perception of statistical activity is to be corrected. A new Act is scheduled for 1991. It should guarantee the independence of official statistical bodies and redefine the coordinating functions exercised by the Central Statistical Office and the conditions under which it may have access to administrative sources. Awareness that attention must be paid to the needs of a more diversified population of users has increased among those responsible for compiling statistics in Hungary. Thus, both the new parliamentary committees and the business community will become active and demanding users of statistical data.

Statistical nomenclatures and classifications are an essential focus of the reform of statistical activity. The existing nomenclatures in East European countries are heavily marked by the administrative logic which constrained that activity. A firm's dependence on a given ministry was indeed a much stronger classification criterion than its actual involvement in one type of activity or another.

Hungarian statistics officials have embarked on defining a concrete strategy for transition in the area of nomenclatures.[20] They are aware of the demands which accompany such an approach:

- It requires clear identification of the conceptual changes to be made and of the logical order in which they must be carried out, avoiding any confusion between the various statistical concepts at stake. A rigorous and operational definition of basic economic units must be established before the classifications can be applied which group these units together according to certain criteria. These basic units must be identified and recorded in exhaustive registers or lists so that they can be classified.

- Explicit coordination must be established between the various administrations involved in the introduction and use of a given nomenclature. For example, the quality of coordination between the Central Statistical Office and the Customs Administration, which since the beginning of 1991 has been responsible instead of the Ministry of International Economic Relations for the statistical monitoring of foreign trade, is particularly crucial in a context of general change in overseeing trade. The keeping of lists of firms should also be coordinated between the various departments responsible for them.

- Pragmatic solutions need to be adopted to ensure the continuity of information during the period of transition (such as the publication of data in two nomenclatures).

Hungarian statisticians are today leaning towards the following decisions:

(a) Introduction in 1992 of a new national nomenclature of activities (the 'Hungarian Uniform Classification of Activities') harmonized with (but not completely aligned on) the revised version of the Community's NACE nomenclature (NACE-REV1). The breakdown of the Hungarian nomenclature will remain less detailed than that of NACE and, in this sense, will be closer to the UN's ISIC-REV3 nomenclature.

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20 A seminar on statistical nomenclatures was organized jointly by Eurostat and the Hungarian Central Statistical Office on 15-19 April 1991 in Budapest. This paper takes account of the proceedings.

(b) Linking of the national nomenclatures of products (industrial products, agricultural products, buildings and public works, services) with the new national nomenclature of activities. In the case of the nomenclature of industrial products, an attempt will be made in the medium term at harmonization with the Community PRODCOM project, which aims to develop a homogeneous system of monitoring industrial production throughout the single European market that is compatible with the harmonized foreign trade nomenclatures. The interest shown in PRODCOM by Hungarian statisticians, as by Austrian statisticians, bears witness to the attention paid by neighbouring and geographically close countries such as Austria and Hungary to emerging Community standards.

(c) Introduction of a new nomenclature of products in foreign trade based on the UN's Harmonized System (HS). Compatibility with the Community's Combined Nomenclature (CN) will be sought, but the peculiarities of the Combined Nomenclature resulting from the nature of the links among the Community's member states require a degree of caution. Instead, the immediate priority is a 'magyarization' of the HS, to be achieved through cooperation between the Central Statistical Office and the Customs Administration. The current situation of the old and new nomenclatures existing alongside each other can only be transitional.

Operational implementation of the nomenclatures presupposes in particular the existence and regular updating of a list of economic units and firms. The existing register of economic organizations, which dates from 1978, has now been overtaken by the rapid expansion in the number of private units. Preparation of a new list is planned by the Statistical Office. It will be fed and updated through access to the data of the tax administration, with which all economic units subject to tax on their profits or to VAT must be registered. At the same time, the Ministry of Justice is implementing a project entitled 'National Firm Registration and Information System', for which finance is available from the PHARE programme. It would be desirable for statisticians to be given access to this register and for its preparation to be coordinated with their own efforts.

The introduction of suitable nomenclatures and registers is the first stage of a complete redesign of business statistics intended to lay the foundations for the launch of surveys. Hungarian statisticians are currently very busy with this first phase. Its completion should create a firmer basis for all business statistics. While the black economy will by its nature remain difficult to capture in any register, the gathering of information on new private firms, particularly small ones (less than 50 employees), will be improved: uncertainty about the extent to which these firms are taken into account in cyclical and structural surveys is considerable at present, although Hungarian statisticians play down the risk of underestimating economic performance because of such shortcomings.

(3) Macroeconomic data: market observation

(a) Incomes, employment, unemployment

Rebuilding the system of statistics also extends to statistics relating to households. Phenomena of hitherto unknown acuteness are now affecting households, such as unemployment. This is currently tracked using the administrative registration of unemployed people carried out by local employment offices. The need has been recognized for a more systematic monitoring of the integration of households in the labour market, in accordance with international standards. The Statistical Office is, to this end, testing a tentative quarterly 'labour force survey'. The results of this experiment carried out in 1991 should enable the survey to be launched in January 1992.

Hungarian statisticians are also considering the use of tax-related administrative sources as a means of compiling statistics on household incomes, either in addition to or instead of existing surveys in this area.[21]

(b) Price indices

As in other areas, Hungary is starting from a situation that is rather different from that in the other East European countries: a consumer price index covering products sold on free markets was introduced in Hungary twenty years ago. The current consumer price index is based on data covering each month 120,000 price observations in 130 towns and villages obtained by 160 survey officers. However, this survey must now undergo radical reform given the general expansion of market mechanisms. The statistical quality of the index, which is crucial in a period of high inflation, is affected by structural and circumstantial problems: the failure to take account of quality effects; shortcomings in the information available on the structure of household consumption that would enable the index weighting to be updated; and difficulties in observing prices on the unofficial markets of the secondary economy and purchases against foreign exchange. Cooperation has been established between Eurostat and the Hungarian Central Statistical Office with a view to improving measurement of the consumer price trend. It is intended to deal with all the technical questions raised by that objective. It will allow the exact purpose of the consumer price index to be defined with more accuracy and clarity: in particular, in an economy in transition in which the inflationary trend is not reflected solely in visible price movements, what component of this trend is captured by the index ?

Similar questions apply to the production and construction price indices, for which reforms are also planned. More generally, the entire range of business statistics (monthly or quarterly output, employment and wage indices) should be adapted to a situation in which public (in particular government) and private decision-makers have a growing need for information on trends in the economy.

(c) Foreign trade

A number of changes converge in this field: new responsibility of the Customs Administration for the gathering of basic statistical data; adoption of the Harmonized System as the international reference standard; use from 1 January 1992 of a customs document similar to that used within the European Community; and the changeover to generalized payment in convertible currencies. Will this combination of changes lead to statistical breaks in observed series? These might result in particular from the Customs Administration's lack of experience, with imports perhaps treated more exhaustively than exports. However, the adjustments and corrections made by statisticians should, according to officials of the Statistical Office, ensure continuity of the series. The problem remains that the redefinition of payment rules within the CMEA is making the task of dividing the value of trade between volume and price a particularly delicate one.

The Statistical Office has no intention of recalculating foreign trade statistics by using new exchange rates in order to re-evaluate trade flows, particularly within the CMEA. Such an

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21 See the paper presented by Laszlo Vita at the conference on 'Economic Statistics for Economies in Transition' organized in Washington on 14-16 February 1991 by Eurostat and the Bureau of Labour Statistics: 'On the future of household income surveys in Hungary'.

operation, which is considered useful for analytical purposes, does not seem justified to officials of the Statistical Office from a purely statistical point of view.

(d) National accounts

The SNA is nothing new to Hungarian national account experts. But introduction of the SNA into Hungarian statistical practice, while maintaining the MPS, has remained patchy and superficial. Indeed, the aggregates measured according to SNA methods were derived from MPS aggregates. The current aim is to introduce the SNA in full and independently. This means adapting data collection and coding methods to SNA concepts and a more widespread use of the latter by economic analysts. Hungarian national account experts are aiming from the outset to harmonize their accounting system with the next version of the SNA. While the adoption of international standards does not appear to present any major problems in itself, the same is not true for the adaptation of the data supply channels of the national accounts system, particularly as far as data from firms is concerned. Innovations are needed in this area, especially concerning access by national accounts experts to administrative sources and the standardization of accounting information from firms.

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