The "New Growth Path" in Hungary *

Introduction

This paper will analyze changes in economic policies in Hungary that began with the December 1978 resolution of the Central Committee of the Hungarian Socialist Workers' Party (for short, Party resolution). The impetus for policy change was provided by Hungary's growing indebtedness, with its deficit in convertible currency trade reaching $ 1.2 billion in 1978, equivalent to 6.7 percent of the gross domestic product.[1]

Changes in economic policies had the double objective of remedying the disequilibrium in Hungary's balance of payments and reestablishing the reform process that began in 1968 but was subverted in various respects after 1972. The new policies have been given the collective name 'the new growth path' that has been chosen as the title of this paper.

1. Adjustment Policies and the Debt Crisis

With its large exposure to foreign trade, the unfavorable balance-of-payments effects of external shocks through the deterioration of the terms of trade and the export shortfall associated with the slowdown of

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[1] Trade is defined to include services other than investment income; unless otherwise noted, all data originate in official Hungarian statistical sources.

economic activity abroad averaged 10.5 percent of Hungary's gross domestic product in the 1973-78 period (Balassa-Tyson, 1983).[2] Over two-thirds of this loss occurred in trade with private market economies, which will be the subject of the following discussion. This in part because Hungary's rising debt *vis-à-vis* private market economies was the principal factor motivating the stabilization measures taken following the December 1978 Party resolution and in part because of the constraint foreign exchange earnings in convertible currencies represent for economic expansion in Hungary.[3]

Hungary responded to the external shocks of the 1973-78 period by borrowing abroad. This was done in an effort to maintain earlier rates of growth of domestic consumption and investment, notwithstanding the deterioration of the external situation. Domestic investment rose particularly rapidly, doubling between 1973 and 1978, while consumption increased by one quarter.

Thus, Hungary did not make use of macroeconomic policies to reduce the imbalance in its external accounts that resulted from external shocks. And while some import substitution did occur, it was offset several times by losses in export market shares. These losses, representing an average decline of 18 percent in Hungary's share in the imports of private market economies,[4] amounted to $ 316 million in 1978. In the same year, import substitution associated with a slight decline in the income elasticity of import demand *vis-à-vis* the 1963-73 period was $ 63 million (Balassa-Tyson, 1983).

Losses in export market shares represented a reversal of trends observed in the previous period. In particular, Hungary's share in the imports of developed countries, accounting for three quarters of its exports to private market economies, increased from 0.22 percent in 1965 to 0.28 percent in 1973, but declined again to 0.22 percent in 1979 (Lakos, 1981). While Hungary was adversely affected by restrictions

[2] The terms of trade loss is measured by taking the difference between Hungary's imports and exports valued in actual prices and in the prices of the 1971-73 base period; the export shortfall is derived by taking the difference between Hungary's actual exports and its hypothetical exports, calculated on the assumption that trends observed in world trade in 1963-73 continued *and* Hungary maintained its 1971-73 export market shares in this trade.

[3] Private market economies provided markets for 39 percent of Hungary's exports and supplied 48 percent of its imports during the period under consideration, with socialist countries accounting for the remainder. About 15 percent of Hungary's trade with socialist countries was settled in convertible currencies but the volume of this trade was circumscribed by state-to-state trade agreements.

[4] Changes in Hungary's market shares have been calculated with respect to the imports of nonfuel primary products, fuels, and manufactured goods by private market economies in the years 1971-73.

imposed in 1974 on its cattle exports by the European Common Market,[5] the principal reasons for this reversal can be found in changes in the policies applied.

The introduction of the new economic mechanism of January 1, 1968 represented a break with the centralized system of economic planning, under which production targets were set and materials allocated centrally and domestic prices were divorced from world market prices. The establishment of market relationships among firms and the adoption of a single commercial exchange rate (called foreign exchange conversion ratio at the time), supplemented by export subsidies, gave considerable impetus to exports to private market economies in the years following.

In turn, the measures of recentralization applied following the November 1972 Party resolution and, especially, the attempts made to isolate the Hungarian economy from external events after 1973, reduced the incentives to export. Profits derived from exporting were lowered through decreases in export subsidies and by *ex post* transfers to the state budget. These changes, together with the buoyancy of domestic markets, tended to discourage export expansion and the transformation of the export structure in response to the changing pattern of foreign demand (Balassa, 1983a).

The December 1978 Party resolution called for a return to the principles of the 1968 reforms, including the decentralization of the system of decision-making and the linking of domestic to world market prices. At the same time, recognizing the fact that Hungary could not continue indefinitely accumulating convertible-currency debt, which increased from $ 900 million at the end of 1973 to $ 4600 at the end of 1978 in net terms *(ibid.)*, the resolution called for re-equilibrating the balance of trade in convertible currencies.

Equilibrium in the balance of trade was restored by 1981, notwithstanding the adverse effects of increases in petroleum prices in 1979-80, the world economic slowdown, and the rise in interest rates on world financial markets. The adjustment, however, was not brought about by output-increasing policies in the form of export expansion and import substitution, but through the application of restrictive macroeconomic policy measures.

[5] Between 1973 and 1978, Hungary's cattle exports to the European Common Market declined from $ 133 million to $ 43 million. But, in the same period, Hungary's meat exports to the Common Market increased from $ 84 million to $ 149 million.

In fact, in its trade with private market economies, Hungary experienced little import substitution between 1978 and 1981, and this was increasingly offset by losses in export market shares. By 1981, Hungary's average market shares in the imports of these economies declined by 15 percent, giving rise to a foreign exchange loss of $ 511 million, whereas the balance-of-payments gain from import substitution was only $ 123 million (Balassa, 1985).[6]

During this period, Hungary suffered the adverse effects of the cessation of its cattle exports to the Common Market, but this was compensated by increases in meat exports. Furthermore, while exports of pig iron to the EEC halted, this was more than offset by higher exports of iron and steel products. At the same time, limitations on the exports of textile products to the Common Market apply to most socialist and developing countries and not only to Hungary. Finally, although individual EEC member countries impose quotas on certain manufactured goods imported from Hungary, these quotas reportedly affect only 3-4 percent of Hungary's manufactured exports to the Common Market (*Financial Times*, May 1, 1984). It would thus appear that one can attribute no more than a fraction of the losses in Hungary's market shares to discrimination against its exports.

Restrictive macroeconomic policies, in turn, bore on investment rather than on consumption. Between 1978 and 1981, gross domestic investment fell by 21.3 percent in Hungary, with net investment declining by 40.7 percent. By contrast, domestic consumption increased by altogether 6.0 percent during the period. With the gross domestic product rising by a total of 4.5 percent between 1978 and 1981, the share of domestic consumption in GDP increased, partly offsetting the effects of reduced investment on Hungary's balance of payments.

The situation was aggravated in subsequent years as Hungary suffered the consequences of the events in Poland that brought into question the creditworthiness of the socialist countries for foreign private loans. There ensued the virtual cessation of commercial bank lending and the partial withdrawal of liquid funds, mostly by Middle Eastern countries, from the Hungarian National Bank.

In view of Hungary's debt payment obligations, the government's objective was changed from the re-equilibration of the balance of trade

[6] Changes in export market shares in the commodity groups listed above have been calculated with respect to the 1976-78 period; in turn, the base period for estimating changes in the income elasticity of import demand has remained 1963-73.

in convertible currencies to achieving a substantial surplus. This in fact occurred in 1984, when a $ 0.6 billion surplus in convertible currency trade was attained. The adjustment entailed the continued application of restrictive macroeconomic policies, again involving reductions in investment rather than consumption, supplemented by import restrictions while Hungary continued to lose export market shares.

Gross domestic investment fell by 13.0 percent between 1981 and 1984, with net investment declining by 31.9 percent whereas consumption increased by 2.9 percent. At the same time, increased import restrictions in convertible currency trade reduced the ratio of imports to the gross domestic product. Thus, a 6.2 percent rise in Hungary's GDP between 1981 and 1984 was accompanied by a 3.0 percent increase in its imports from private market economies. In this way, 'forced' import substitution occurred in Hungary.

Changes in Hungarian exports may be evaluated by making comparisons with the export performance of other countries at similar levels of economic development. This has been done in regard to the exports of newly-industrializing developing countries (NICs), including Argentina, Brazil, Chile, Israel, Korea, Mexico, Portugal, Singapore, Taiwan, Turkey, Uruguay, and Yugoslavia, to the developed countries.

Using import data reported by the developed countries,[7] estimates have been made of hypothetical exports, defined as the exports that would have taken place had Hungary maintained its 1981 market share in the imports of each of the developed countries from the NICs. Under this hypothesis, Hungary's exports to developed country markets would have increased from $ 2.4 billion in 1981 to $ 2.7 billion in 1984. In actual fact, exports remained at $ 2.4 billion, representing a decline in market shares of 11 percent and a loss of $ 0.3 billion in absolute terms.

The result for Hungary contrasts with that for the outward-oriented NICs, such as the Far Eastern countries, which gained export market shares during the period. This contrast represents a continuation of earlier trends, with the outward-oriented newly-industrializing countries gaining and Hungary as well as inward-oriented NICs losing export market shares in both the 1973-78 and the 1979-81 periods (Balassa-Tyson, 1983; Balassa, 1985).

[7] The data are expressed in current dollars at fob prices for the United States, Canada, Australia, and New Zealand and at cif prices for Japan and the countries of Western Europe. They originate in International Monetary Fund, *Direction of International Trade*. — Lack of information on the commodity composition of exports did not permit applying the methodology utilized in regard to the 1973-78 and 1978-81 periods.

Comparison may further be made with Turkey that used to be considered an extreme case of an inward-oriented country. This comparison is of especial interest, both because Turkey encountered debt servicing difficulties at about the same time as Hungary and because, in contradistinction with Hungary, the policies applied led to increases in Turkey's export market shares. While Turkish exports to the developed countries would have increased from $ 2.1 billion in 1981 to $ 2.5 billion in 1984 under the assumption of unchanged market shares, actual exports reached $ 3.0 billion, representing a gain of 20 percent or $ 0.5 billion.

The contrast is even greater if total exports to private market economies rather than only to the developed countries are considered, largely because of Turkey's success in entering Middle Eastern markets. Between 1981 and 1984, Turkey raised the dollar value of its exports to private market economies by 55 percent whereas the corresponding increase was 10 percent in Hungary. In the same period, Turkey's imports from private market economies rose by 15 percent and those of Hungary declined by 14 percent.

The observed increases in Turkish imports point to the fact that the rapid growth of exports permitted limiting the use of deflationary measures. Correspondingly, Turkey's gross domestic product increased at an average annual rate of 4.6 percent between 1981 and 1984, compared with 2.0 percent for Hungary. Economic growth in Turkey was also aided by the rapid rise of construction abroad whereas Hungary was largely unsuccessful with foreign construction *(Financial Times,* October 10, 1983).

The rapid growth of the exports of goods and services in Turkey can be attributed to the effects of the wide-ranging economic reform introduced in January 1980.[8] The reform included a substantial devaluation, the provision of export incentives, the liberalization of imports, as well as the freeing of the prices of a wide-range of products, followed by interest rate reform. From the point of view of export performance, the first three of these measures offer particular interest.

Changes in exchange rates have been evaluated by adjusting trade-weighted (effective) exchange rates for changes in domestic and in

[8] In fact, the dollar value of Turkish exports increased by 75 percent between 1980 and 1981, permitting increases in imports of 18 percent while simultaneously improving the balance of payments to a considerable extent. In the same year, the dollar value of exports fell by 6 percent, and that of imports by 2 percent, in Hungary.

foreign wholesale prices.[9] The real effective exchange rate thus derived, calculated on a 1976-78 basis, appreciated by 9 percent in 1979, the year before the reforms were implemented. However, the rate depreciated by 32 percent in 1980, with further devaluations occurring after 1981. By 1984, Turkey's real effective exchange rate depreciated by 41 percent compared with its 1976-78 level.

Turkey has also provided export incentives in the form of preferential credits and tax rebates, with additional rebates granted to trading companies.[10] Furthermore, exporters have been given the right to import their inputs duty free even if a domestic substitute is available. Finally, imports have been liberalized, thereby reducing the protection of domestic markets and encouraging efficient production and exports.[11]

In turn, various influences have contributed to the poor performance of Hungarian exports. They include the appreciation of the exchange rate in real terms, the introduction of the so-called competitive pricing rules, relative risks and rewards for exporting to private market economies *vis-à-vis* domestic sales and exports to socialist countries, the system of wage determination, the taxation of profits, the remuneration of managers, access to funds for export-oriented investments, the availability of labor, and the imposition of import restrictions on inputs used directly or indirectly in exporting.

2. Factors Affecting Hungary's Export Performance

After an initial depreciation, the Hungarian forint appreciated in real terms to a considerable extent. On a 1976-78 basis, the index of the real effective exchange rate rose to 110 in 1979, declining to 97 in 1980, 87 in 1981, and 85 in 1982, increasing slightly to 91 in 1983 and attaining 93 in 1984. The figure for 1984 represents a 16 percent real

[9] The data derive from International Monetary Fund, *Direction of International Trade*, and *International Financial Statistics*.

[10] In 1981, exporters received an extra amount equal to 5 percent of export value if their exports reached $ 4 million a year and 10 percent if exports attained $ 15 million. And although these rebates have subsequently been reduced, they provided a strong push for the establishment of trading companies that spearheaded the export expansion.

[11] For a detailed discussion of the situation existing in 1981, see BALASSA 1982; subsequent developments are discussed in BALASSA 1983c.

appreciation of the forint compared to 1978, the year when policy changes were introduced, even though the external shocks suffered and the objective of turning the trade deficit into a surplus would have called for a devaluation.

The cited results may appear surprising in view of the frequent references made in Hungary to the devaluation of the forint. Thus, according to an official of Foreign Trade Ministry, "after the revaluations of the years 1980 and 1981, the forint was devalued by 27 percent, compared to the average of convertible currencies, between 1981 and 1984" (Dunai, 1984, p. 94). The explanation for this apparent discrepancy may be found in the inappropriate weighting of foreign currencies in Hungary's currency basket, with a much greater weight given to the U.S. dollar than warranted by its importance in Hungary's trade.[12] Yet, from the point of view of evaluating changes in the competitive position of Hungary, the country composition of its trade is relevant.

As the dollar was rising rapidly in recent years *vis-à-vis* other major currencies, its excessive weight in the currency basket limited the extent of devaluation of the forint. Thus, the trade-weighted nominal effective devaluation in Hungary was only 7 percent between 1981 and 1984, compared with the 27 percent figure cited above.[13] The extent of the devaluation was 6 percent if changes in foreign currency values are averaged by using Hungary's exports, rather than exports and imports, as weights (Table 1). At the same time, weighting by exports will be relevant for explaining changes in Hungary's export market shares.

Compared to 1978, Hungary's nominal effective exchange rate appreciated by 14 or 16 percent by 1984, depending on whether export and import, or only export, weights are used in the calculations. The corresponding figure is 11 percent for the real effective exchange rate, irrespective of the choice of weights, reflecting the fact that wholesale prices (in effect, producer prices) rose less in Hungary than in its partner countries, on the average.

Table 1 also shows data on changes in the nominal and in the real value of the forint *vis-à-vis* Hungary's principal trading partners and,

[12] This has been the case in some developing countries as well, reflecting a confusion between the use of the dollar in denominating exports and imports and the share of trade with the United States. In turn, adjustments in the currency basket to apropriately reflect the geographical composition of trade have led to considerable devaluations in several countries in recent years.

[13] Among Hungary's principal trading partners, the forint was devalued by 9 percent *vis-à-vis* the German mark and by 11 percent *vis-à-vis* the Austrian shilling while it was revalued by 9 percent *vis-à-vis* the Italian lira; at the same time, a devaluation of 40 percent occurred *vis-à-vis* the U.S. dollar.

TABLE 1

CHANGES IN EXCHANGE RATES IN HUNGARY

	1976-78	1978	1979	1980	1981	1982	1983	1984
Trade Weighted Exchange Rates								
Nominal effective exchange rate								
(a) export and import weighted	100	103.4	103.8	95.8	82.9	80.5	87.5	88.9
(b) export weighted	100	103.0	103.6	95.5	82.0	79.4	86.1	87.0
Real effective exchange rate								
(a) export and import weighted	100	104.1	109.9	97.4	86.8	85.4	90.6	92.6
(b) export weighted	100	104.0	110.2	97.7	86.6	85.3	90.4	92.2
Nominal Exchange Rates								
Forint/U.S. Dollar	100	94.4	88.6	81.0	85.5	91.2	106.3	119.7
Forint/Deutsche Mark	100	106.8	109.8	101.3	85.9	85.4	94.6	95.5
Forint/Austrian Schilling	100	105.7	107.8	101.8	87.3	87.0	96.2	97.3
Forint/Italian Lira	100	95.0	91.1	80.8	64.2	57.6	59.8	58.2
Wholesale Price Indexes								
Hungary	100	103.1	105.4	121.5	129.2	135.2	142.8	148.8
U.S.A.	100	107.1	120.5	137.5	150.1	153.1	155.0	158.7
Germany	100	101.6	106.5	114.6	123.5	130.8	132.7	136.6
Austria	100	101.6	105.9	115.0	124.3	128.2	129.0	133.8
Italy	100	110.6	127.7	153.3	178.8	203.6	223.4	246.5
Real Exchange Rates								
Forint/U.S. Dollar	100	98.3	101.5	91.9	99.5	103.5	115.6	127.9
Forint/Deutsche Mark	100	105.3	111.0	95.5	82.2	82.6	87.9	87.7
Forint/Austrian Schilling	100	104.3	108.4	96.4	84.0	82.5	86.9	87.0
Forint/Italian Lira	100	102.4	110.9	102.4	89.3	87.2	94.0	96.9

Sources: IMF, *Direction of Trade* and *International Financial Statistics*.
Note: Nominal and real effective exchange rates have been calculated by weighting with Hungary's trade with the major partner countries among private market economies. In order of their 1976-78 trade with Hungary, these were Germany, Austria, Italy, Switzerland, United Kingdom, United States, Sweden, Belgium, Japan, Finland, and Denmark. Trade with Jugoslavia is regulated by intergovernmental agreements; its inclusion would make Hungary's exchange rate even more overvalued than indicated by the figures of the table.

for comparison, the United States. As is apparent, the forint appreciated in real terms by 21 percent *vis-à-vis* the German mark, 16 percent *vis-à-vis* the Austrian shilling, and 5 percent *vis-à-vis* the Italian lira between 1978 and 1984. And while a 30 percent depreciation occurred *vis-à-vis* the U.S. dollar, Hungary's trade with the United States represented less than 5 percent of its trade with private market economies in the base period.

The revaluation of the exchange rate in real terms adversely affected Hungarian exports by reducing their profitability and by limiting the possibility of increasing their volume through price cutting. At the same time, the introduction of so-called competitive pricing in January 1980 tended to discourage industrial firms from increasing their convertible currency exports and even encouraged them to reduce such exports. This was the case because prices on domestic sales could be raised only if export prices increased *and* export profitability improved in convertible currency trade. In eliminating exports with below-average prices and/or profitability, then, the firm could raise domestic prices under the rules. Moreover, some firms endeavored to keep their convertible currency exports below 5 percent of their total sales, in which case the competitive pricing rules did not apply to them.

There is evidence that the introduction of competitive pricing rules unfavorably affected the volume of manufactured exports in 1980 (Balassa, 1983b). Nor did attempts made in subsequent years to remedy the situation by modifying the rules suffice to remove these adverse consequences. In fact, they were reinforced by the increased overvaluation of the exchange rate, which broadened the range of products that were unprofitable for the firm but profitable for the national economy.

While the application of competitive pricing rules adversely affected the profitability of exporting firms, under conditions of excess demand existing in the domestic market firms with less than 5 percent convertible currency exports had greater possibilities to improve their profitability by raising prices or by changing their product composition towards higher-priced products.[14]

[14] In fact, industrial firms that had less than nine tenths of the average rate of profit, calculated on capital investment and wages combined, accounted for 49 percent of convertible currency exports in 1979, 53 percent in 1980, 57 percent in 1981, and 59 percent in 1982 (KEVEVÁRI, 1984, p. 486). In the latter year, in the iron and steel, machinery, chemical, and light industries, firms with profit rates of less than 5 percent on fixed capital exported 13, 24, 28, and 13 percent of their output for convertible currencies while export shares averaged 9, 11, 7, and 8 percent for firms with profit rates in excess of 20 percent (PETÖ, 1983, p. 3). Also, all firms showing losses were subject to competitive pricing rules (JUHÁSZ, 1983, p. 956) and that highly indebted firms had twice the average share of convertible currency exports in their output (DEÁK, 1983a, p. 36).

But, even if a firm could conceivably increase its profits by raising the prices, or expanding the volume, of exports to private market economies, these exports involved a considerable risk, which practically did not exist in the case of domestic sales and exports to socialist countries. There was a risk not only because of fluctuations in foreign demand and prices, but because of the possibility that the higher quality requirements of developed country markets led to the rejection of the merchandise.

Variations in profits obtained in exporting to private market economies had implications for wage setting. While in years of good profits increases in wages were limited by the highly progressive taxation of wage increments, in bad years firms could not raise wages, thus risking the departure of workers, in particular skilled workers and technicians. Nor could firms set up wage reserves with confidence, since such reserves were repatedly confiscated by the State. Also, firms feared that fluctuations in profits would meet with adverse reception on the part of the supervising authority and that high profits may be taken away from them as it happened in several instances.

At the same time, for various reasons, the prospects of profits derived from exporting might not have created sufficient encouragement for the firm to expand exports. To begin with, the firm producing for exports could not adequately remunerate its high-performing workers because of the progressivity of taxes on wage increments, with only about Ft. 4-5 of a profit increment of Ft. 100 allocable to such increases (Faluvégi, 1984, p. 1078). This fact created particular difficulties in manufacturing high-quality products that are in demand in developed countries. Furthermore, on the average, the profit tax and other taxes payable from the firm's profits amounted to about 80 percent of profits in recent years while goverment financial support accounted for 40-45 percent of profits.[15]

Nor could post-redistribution profits be freely utilized by management as they were divided between the profit-sharing and the investment funds and, apart from confiscating the reserves for wage increases derived from the profit-sharing fund, limitations were repeatedly imposed on the use of the investment fund. Finally, owing

[15] As these ratios varied from firm to firm, the profits obtained after redistribution became to a large extent divorced from the pre-distribution profits. Thus, in an empirical investigation covering all state enterprises, it has been shown that in 1979 and in 1980 the correlation between pre- and post-redistribution profits in Hungarian industry was practically nil (KORNAI-MATITS, 1983, p. 15).

to the overall limitations imposed on the payment of bonuses after 1972, the importance given to considerations other than profits in the bonus scheme, and the latitude of the supervising ministries to modify the bonus conditions, the sharing of the managers in increases in profits was limited.[16]

Also, exports were adversely affected by limited access to financing. The special fund of bank credits that had earlier been made available for investment in export activities was increasingly allocated to import-substituting projects, and the time limits set for the repayment of loans for investments in export activities were reduced to a considerable extent. While three years had earlier been allotted for implementing the investment and five years for recouping the amount invested, in 1981 the total time limit for repayment was set at four years. This regulation benefited agriculture and food processing at the expense of manufacturing industries and favored capacity-increasing investments over the introduction of new products and technological change.

More generally, manufactured exports suffered from the reduction of investments funds that was more pronounced in the industrial sector than the average decline on the national economy level. Also, in the allocation of industrial investment funds preference was given to central investments in energy and heavy industry over enterprise investments in the light and machinery industries, which give promise for exports.[17]

A further consideration is that export credits, and other export incentives, were provided to direct but not to indirect exporters. As a result, firms manufacturing intermediate products often undertook direct exports, even though from the point of view of the national economy exporting in processed form would have been desirable.

[16] According to one observer, "the incomes of the managers — within the strict limits on income differentiation — have little to do with their work, their performance, and their abilities" (HÉTHY, 1983, p. 66). Also, according to the findings of a survey of managers conducted by the Labor Research Institute as reported in *Figyelö* (Observer), October 21, 1982, the deciding role played by supervising ministries in setting bonuses, and the subjective elements involved in these decisions, meant that the managers reportedly expressed more of an interest in pleasing the *cadres* of the ministries than in improving the performance of the firm.

[17] Within the industrial total, the combined investment share of mining, electricity generation, and iron and steel increased from 32.9 percent in 1978 to 49.3 percent in 1984 whereas that of the light and machinery industries declined from 28.9 to 22.0 percent. Yet, the average age of machinery is 16 years in Hungary's manufacturing industries and product composition is far from up-to-date, with new products accounting for only 3-4 percent of output each year, which represents a deterioration compared to the situation existing earlier. Interview given by Andrea Deák, Chief Economist of the Industry Ministry, as reported in *Figyelö* (Observer), December 22, 1983, p. 11.

One half of the firms exporting to private market economies indicated that the lack of manpower limited the possibilities for increasing exports. But import restrictions were considered to be a more important source of difficulties. Thus, it happened that by the time the import license was obtained higher prices had to be paid for the input or the would-be purchaser of the final product did not accept the delay that had occurred. In general, the imposition of import restrictions discouraged exports by creating uncertainty for the firm.[18]

It was attempted to offset the inadequacies of the incentive system by the goverment reaching agreements with some large firms on export targets, providing certain advantages in return. The poor export results cited earlier indicate, however, that these attempts were far from being fully successful. At the same time, such a procedure tends to freeze the existing export pattern and does not ensure the efficient choice of export activities. It also increases the scope of *ad hoc* interventions.

The last point leads to the general observation that while the December 1978 Party resolution simultaneously aimed at re-establishing external equilibrium and returning to the principles of the 1968 reform, in practice these objectives came into conflict. More often than not, the conflicts were resolved in favor of the former objective, so that there were increasing interventions in the firms' activities.

Such interventions originated with the Economic Committee, the Ministry of Finance, the Materials and Price Board, as well as the sectoral ministries. They involved *ex ante* actions, such as instructing the firm to undertake or not to undertake certain activities as well as *ex post* actions, such as the withdrawal of investment and wage funds from the firm. Apart from creating mistrust on the part of firms, these actions induced firm managers to curry favor with the supervising authorities that often appeared to be the easiest way to pursue the firm's objectives.

The adverse consequences of the increased scope of *ad hoc* interventions were well stated by János Hoós, the Vice President of the Planning Office:

> "The overall direction of economic activities has lost its transparency; its automaticity decreased to a considerable extent and there are adverse consequences in the price system and in the regulation of incomes. As a result,

[18] These are the conclusions of a survey, the results of which are reported in *Figyelö* (Observer) January 5, 1984, p. 12; the difficulties exporters encountered because of the existence of import restrictions were also voiced in interviews by firm managers, reported in *Figyelö* (Observer) August 30, 1984, p. 5.

firms are not sensitive to costs and they do not have appropriate incentives. This is expressed in the fact that in practice every firm can obtain — if in no other way than through government support — the revenues it needs for continued operation ... The situation has been aggravated by the import limitations and export obligations resulting from short-term problems of equilibrium, which have led practically to production instructions. For all these reasons, firms cannot optimize their decisions and rationally combine their resources" (1985, p. 115).

3. The Exchange Rate, Product Prices, and Competition

According to Lajos Faluvégi, Deputy Prime Minister and President of the Planning Office, the pre-condition of renewed economic expansion in Hungary is that productive activities are increasingly oriented towards exports. Preliminary targets for the 1985-90 period call for exports to rise at an average annual rate of 3.5-4.0 percent. Faluvégi notes that reaching this target would permit the growth of national income to attain 3 percent a year during the period while imports would increase 3 to 5 percent a year (1984, p. 1029).

The export target appears rather modest. According to the World Bank's average projection, the manufactured exports of the developing countries would rise by 8 percent a year between 1985 and 1990 (1985). Also, Hungary has considerable possibilities for expanding and upgrading its food exports, provided that export markets are diversified.

Apart from the growth of foreign demand, Hungary could theoretically increase its exports to private market economies by 61 percent if it regained the market shares lost between 1971-73 and 1984 in its trade with these economies. And while regaining market shares takes time, this objective would need to be pursued through the adoption of appropriate policies.

The first condition is to adopt a realistic exchange rate. As shown above, the forint appreciated in real terms by 11 percent between 1978 and 1984. Yet, the external shocks Hungary suffered, and the objective of turning the trade deficit into a surplus, would have necessitated a devaluation.

While adjusting the exchange rate adds to inflation, in providing tax rebates to exports and imposing taxes on imports, the introduction of a value added tax would have the same effects as a devaluation without inflationary consequences, provided that the tax were to

replace profit taxes. Reducing profit taxes by one half would, however, permit but a 3.5-4.0 percent adjustment (Vicze, 1983, p. 3), which would go only part of the way to undo the appreciation of the real exchange rate.

The Hungarian authorities wish to keep the rate of inflation within a 6-7 percent range. In recent years, reductions in consumption subsidies was the principal factor contributing to price increases. In early 1985, the resulting increases reached the presumed annual limit, leading to a virtual freeze on producer prices for the rest of the year.

While reducing consumer subsidies is desirable in the long term, the rationalization of producer prices is a more immediate objective, when the process of rationalization involves, first of all, setting realistic exchange rates. At the same time, the inflationary effects of a devaluation may be mitigated by simultaneously lowering tariffs that would also lessen the bias against exports resulting from import protection. The bias against exports may be further reduced by increasing export incentives and extending the incentives received by direct exporters to indirect exporters (the manufacturing of domestic inputs for export production).

To begin with, it would be desirable to ensure the automatic and duty free importation of inputs used directly or indirectly for export production. This provision conforms to GATT rules and hence does not invoke retaliation on the part of importers. It has been used to good effect by successful exporting countries in the Far East and, more recently, Turkey.

On the example of these countries, it would further be desirable to extend the credit facilities available to direct exporters to indirect exporters as well while increasing the volume, and improving the terms, of these credits. In particular, providing longer-term credits would contribute to investment in export activities.

Hungary may also follow the example of successful exporting countries in improving the organization of foreign trade. Apart from generalizing the right of direct exportation to all industrial firms, and extending it to agricultural cooperatives, it would be desirable to encourage the establishment of trading companies. Producers, then, would be free to choose among the alternatives of direct exporting, selling through the traditional specialized exporting firms, and utilizing the services of trading companies that have played an important role in the rapid expansion of exports in Japan, subsequently in Korea, and more recently in Turkey.

The described measures would provide inducements for exports as well as for efficient import substitution, particularly in industries producing inputs for exports. At the same time, for these inducements to have the desired effects, additional measures would need to be taken to establish rational prices, to provide the carrot and the stick of competition, and to ensure the incentive effects of profits.

Note has been taken above of the use of 'constructed' prices in domestic markets that unfavorably affected industrial exports. To overcome the deficiencies of this price scheme, it was decided to introduce 'genuine' market prices in Hungary. This was to be done first for firms that undertook certain obligations in the framework of the so-called 'price club', established in 1984, subsequently extended to over one third of industrial firms in 1985, with further extensions planned in later years.

Membership in the price club required the fulfilment of three conditions: (a) supply-demand balance in domestic markets; (b) domestic prices not to exceed import prices,[19] and (c) potential for export expansion. It was further stated that the extension of the new price scheme was conditioned on equating domestic supply and demand, with domestic prices being bounded by import prices.

In practice, however, there is little domestic competition in Hungary that would ensure the establishment of genuine market prices. Also, as noted by the head of the department responsible for price control in the Materials and Price Board, in the absence of import competition, comparisons of domestic and import prices have considerable information requirements. Thus, "one needs to take account of the product's physical and chemical characteristics, its specifications, durability, the variability of product characteristics, packaging, the rate of delivery, the accepted delivery time, as well as other conditions of sale, such as the size of the order and the servicing, transportation, and financial conditions".[20]

This is a formidable set of requirements and, in his earlier review of criticisms of the so-called competitive price scheme, the then President of the Materials and Price Board, Béla Csikós-Nagy, expressed the view that a "price scheme based on import prices is a practical impossibility" (1983, p. 732). Csikós-Nagy added that "of the several millions of products manufactured in Hungary only a few ten thousand are imported. Thus, not actual but constructed foreign prices would be in the center of price determination, and the comparisons of domestic and foreign semi-manufactures and finished goods would burden price setting with problems that cannot find a solution" (Csikós-Nagy, 1983, p. 732).

[19] Import prices (or world market prices) refer to the prices prevailing in private market economies. The prices of goods sold to, or purchased from, socialist countries are adjusted by the use of compensating taxes and subsidies to approximate prices prevailing in the (capitalist) world market.

[20] Interview reported in *Figyelö* (Observer), October 4, 1984, pp. 1, 7.

At the same time, in the absence of effective domestic and import competition,[21] the freeing of prices raises the danger of monopolistic or oligopolistic price determination. This danger has in fact been invoked in rationalizing the increased role of the Materials and Price Board in setting prices in conjunction with the introduction of so-called genuine market prices.

It appears, then, that the lack of competition in Hungary has not permitted the establishment of genuine market prices and has led to increased price controls. It is further apparent that in a small country, a situation approximated by Hungary, the efficient allocation of resources would require adopting world market prices and specializing in response of these prices.

While one may adopt world market prices for standardized products, which have well-defined specifications, most manufactured goods are differentiated products where import competition would be needed to align domestic prices with world market prices. Under present conditions, this is not in the realm of possibilities for Hungary. Such being the case, one should first take measures to intensify domestic competition, with the gradual opening of the domestic market to imports.

Although in 1980-81 several trusts and large enterprises were broken up, leading to the establishment of 167 new firms, Hungary continues to have a very centralized industrial structure (Balassa, 1983b). To increase competition, it would be necessary to continue the process of deconcentration, by breaking up firms that have several factories producing identical or similar commodities. Such is the case, in particular, in the steel, machinery, textiles, clothing, and shoe industries as well as in construction and commerce.

Breaking up large firms is a necessary but not a sufficient condition for effective competition. The break-up of the food canning trust has

[21] The importance of competition is emphasized in Csikós-Nagy, 1985, p. 38.

not led to price competition in the industry, for example. Rather, the newly established firms have colluded in setting prices, which have then been reviewed by the Materials and Price Board. Central price setting, however, does not provide an appropriate solution as noneconomic considerations, such as the desire to limit price increases, affect the outcome.

A more appropriate solution would be to establish anti-trust legislation and to rely on the courts to ensure that cartels are not formed. The courts may also be given a role in breaking up large firms that have monopoly or quasi-monopoly positions in Hungary. Furthermore, domestic competition could be increased if the measures taken in 1981 and 1982 were followed by additional steps to provide inducements for the establishment of small and medium-size enterprises.

At the same time, steps would need to be taken to gradually introduce import competition. János Deák, the Director of the Institute of Market Research, suggested that this be done by liberalizing during the 1985-90 period, the imports of products and product groups, where exports are profitable at the existing exchange rate, followed by further import liberalization in cases where international competition can be established during the next five year period. Deák also suggests closing down activities that could not become internationally competitive (1983b, pp. 11-14).

The implementation of this proposal would permit the gradual liberalization of imports while limiting the cost of adjustment in the domestic economy, when an additional criterion for import liberalization may be the existence of monopoly positions. However, it should not be assumed that foreign competition would necessarily lead to the demise of domestic firms that presently produce at costs in excess of import prices. This is because of the possibilities for improving operating efficiency in Hungarian firms through improved utilization of the capital stock and through reductions in what has been called intra-plant unemployment.

In fact, increased competition from imports would elicit cost reductions through the rationalization of operations and provide inducements for technological change. It would also make exports to private markets more attractive relative to production for domestic markets by lessening the advantages that sellers have over buyers in Hungary. In turn, if particular plants or firms continue to make losses in a competitive environment, they would need to be closed down. While decisions on closing plants may be taken by firm management, the involvement of the courts in bankruptcy proceedings would provide for the orderly closing down of firms.

4. Factor Prices and Institutional Changes

Further consideration needs to be given to the pricing of productive factors. Several important measures have been taken in this regard in 1985. They include the introduction of a 10 percent tax on labor and a 3 percent tax on own capital for most manufacturing industries, compensated by a net reduction in the profit tax by 3-4 percentage points. At the same time, a number of firms have adopted new wage regulations that treat wage costs as any other cost item and make the ability of firms to pay wages dependent on its income.[22]

The tax on wages is intended to internalize the cost of some of the social policies that are presently financed from the goverment budget; the tax on own capital provides a payment to the State for the ownership of capital. Both of these changes contribute to the efficient pricing of primary factors while increasing the incentive effects of profits.

In turn, the newly-introduced wage (earnings) regulations improve rationality in firm decision-making by treating all cost items equally. They represent a break with the system of incremental wage regulations, under which increases in wages are financed from increases in profits. But, at present, the new earnings regulations apply only to a minority of firms that have accepted its introduction; in view of its advantages over the incremental wage system,[23] the application of the new regulations should be extended over a wider sphere.

Under the new earnings regulations, firms that cannot pay the competitive wage will lose labor to other firms. At same time, the

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[22] FALUVÉGI (1984), MADARASI (1984) and MEDGYESSY (1984) describe these changes and indicate the need for further improvements in the system of the incentives, some of which are taken up below. Use has further been made of the review of the system of economic decision-making edited by PULAI and VISSI (1985).

[23] Under the incremental wage system, the ability of the firm to raise wages is dependent on its original starting position and inefficiently managed firms could raise wages by effecting some improvements in their operations while highly efficient firms could do so to a lesser extent as their scope for productivity improvements was more limited. Furthermore, as noted above, the incremental wage system contributed to risk aversion and slowed the process of technological change for the sake of providing steady wage increases.

mobility of labor would need to be accompanied by the mobility of capital. This, however, would necessitate adopting appropriate tax and credit policies.

The imposition of taxes on labor and capital increases the interfirm variability of profits. But, for profits to have sufficient incentive effects, the payments made to the budget from profits would have to be reduced. The recent lowering of the profit tax rate represents the first step in this direction. It would need to be followed by a more substantial reduction in profit tax rates, say by one half, with the revenue loss offset through the introduction of the value added tax. As noted above, the introduction of the value added tax would also improve the international competitiveness of Hungarian exports.

Providing credits on the basis of profitability considerations alone would also contribute to the allocation of capital to efficient activities. This, in turn, would require placing increased reliance on commercial principles in bank lending. The recent establishment of a few small financial institutions and the separation of commercial banking functions within the Hungarian National Bank represent steps in this direction. They would need to be followed by the establishment of full-fledged commercial banks, thereby limiting the activities of the National Bank to central banking functions. Making profitability the dominant consideration for the commercial banks would further call for the establishment of a competitive banking structure.

Furthermore, the availability of investment funds to manufacturing enterprises would need to be increased, with additional funds devoted to infrastructural investment aimed in particular at improving transportation and communication facilities. This may be accomplished by devoting an increasing part of the increment in national income to new investments, encouraging private savings, promoting foreign direct investment, raising the share of the industries of transformation in total industrial investment, and reducing the scope of central investments and of central interventions in firm decision making on investment.

Hungary's recent experience with the issue of bonds indicates the responsiveness of savers to interest rates. Establishing positive real interest rates on savings deposits can be expected to attract further private savings. The same effect may be achieved by permitting private individuals to buy shares in small and medium-size firms while encouraging the establishment of such firms.

Promoting foreign direct investment would benefit Hungary through the inflow of capital as well as through the increased availability of technological and marketing know-how. Particular importance attaches to the latter factor as, more often than not, the purchase of foreign licenses has not led to continued efforts to improve technology in Hungarian firms and marketing expertise is needed to ensure the success of the export effort.

Increasing the share of the industries of transformation in total investment would involve reducing allocations to energy and to basic industries and limiting the scope of central investments. This would permit orienting investments towards high profitability uses by relying on firms to make choices on the basis of their evaluation of market possibilities domestically as well as abroad and increase the responsibility of the firm for its own actions.

At the same time, the introduction of bankruptcy proceedings would need to be accompanied by the strengthening of financial discipline, thereby replacing the 'soft' by a 'hard' budget constraint for the firm. In this way, one may reduce the presently excessive demand for investment credit on the part of firms, with interest rates used to equilibrate credit markets. Also, firms would have more incentive to make placement with banks which would again contribute to the reallocation of capital.

Distortions in product and in factor markets have been said to motivate case-by-case interventions by the supervising authorities that have taken the form of fixing prices, establishing export obligations, setting targets for domestic sales, and modifying *ex post* the firm's retained profits. Such interventions have grown in scope in recent years as 'manual guidance' has been utilized to re-establish macroeconomic equilibrium.

Reducing distortions in product and factor markets and re-establishing macroeconomic equilibrium would lessen the rationale (or the excuse) for case-by-case interventions. At the same time, the institutional changes under way aim at limiting the opportunities for interventions. Thus, following the earlier consolidation of the industrial ministries into one, sectoral departments have been abolished, the only exception being the energy sector. Furthermore, apart from about one hundred of the largest industrial firms, the ministry only retains veto power over the choice of the firm's manager who is elected by the council or the collective of the firm.

These institutional changes are to be welcomed. But, fears have been expressed that the newly-acquired responsibilities of the Material and Price Board for 'market surveillance' would mean the displacement

rather than the abolition of case-by-case interventions. And, while the new legislation provides possibilities for the firm to present its case at the courts for compensation in the event that the Board's actions adversely affect its profits, its dependence on the Board in regard to price setting may make this little more than a theoretical possibility.

The above considerations again point to the importance of freeing prices which, as noted before, is dependent on the establishment of conditions for competition. At the same time, there would be need to reduce the scope of fiscal redistribution that takes the form of *ex ante* regulations and *ex post* decisions on a case-by-case basis. Apart from actions to assist firms in difficulties, the bulk of financial support has aimed at offsetting the high production costs for firms that cannot profitably export at the existing exchange rate. The adoption of a rational exchange rate would reduce the need for such support, both by shifting upward the threshold of export profitability and by providing possibilities to replace high-cost export products through the expansion of low-cost exports.

Correspondingly, fiscal support for exports could be reduced and ultimately eliminated. Financial interventions should be limited to cases when government actions affect the firm's profits, thereby increasing the financial responsibility of the firm for its own actions.[24] This purpose would further be served by penalizing firms that delay payments to other firms.[25]

Note has been taken above of the changes in the system of appointing managers. Under the new regulations introduced in 1985, in the majority of the firms the chief executive will be chosen by an enterprise council that is, in turn, elected by the workers of the firm. In smaller enterprises, generally those having less than 500 workers, the chief executive will be elected by the general assembly of the workers' collective. Finally, in the largest one hundred industrial firms, the supervising ministry will continue to appoint the chief executive for the time being.

The following discussion will concentrate on the case of firms that have enterprise councils, which account for approximately two thirds of all industrial firms and for a similar proportion of industrial workers.

[24] The institution of a list of firms operating with low efficiency, with a view to induce these firms to improve their operations, represents a step in this direction. However, a variety of exceptions continue to be made, providing scope for bargaining (LAKY, 1985).

[25] Recent increases in firm-to-firm indebtedness and the lengthening of payment delays are reported in JÁNOSSY, 1985, p. 5.

In turn, only about 2 to 3 percent of the workers will be in firms where the general assembly elects the chief executive, representing about one sixth of industrial firms. The remaining one sixth of industrial firms, employing nearly one third of the workers, will remain under the administrative control of the supervising ministry (Deák, 1985).

Apart from selecting the chief executive, the enterprise council will define the annual plan, approve the annual financial statement, determine the utilization of profits, set up subsidiaries, and decide on the division of the firm into independent units. On the whole, the council will fulfill the function of the board of directors of capitalist firms, with the important exception that the supervising ministry will retain veto power over the choice of managers and its agreement will be necessary for closing down the firm.

At the same time, while in capitalist countries the board of directors represents the shareholders of the firm, in Hungary the council will be composed of the firm's workers. This represents a change compared with the original proposal that called for majority participation by representatives of organizations, such as the supervising ministry, the banks, the Chamber of Commerce, as well as outside experts.

The changes made in the composition of the council make them resemble the Yugoslav system of workers' management. As it is well-known, this system has involved a bias against hiring new workers who would reduce the average product of labor, which is the relevant consideration for the workers' collective that does not equate wages to the marginal product of labor. Also, Yugoslav firms have showed a preference for increasing wages and social benefits over new investment.

There is a danger that enterprise councils in Hungary will follow the Yugoslav example. This danger is enhanced by reason of the fact that the trade unions are playing an important role in selecting the members of the council. Another danger is that the chief executive would dominate the proceedings, thereby perpetuating his stewardship. Such a danger exists since the council will include members of the management team who are appointed by the chief executive.

The above considerations indicate the advantages of the original proposal to have a majority of outside members on the enterprise council. This is not to suggest to have representatives of the supervising ministry on the council, since this would mean combining ownership and regulatory functions. A more appropriate alternative would be to

establish an agency, consisting of legal, economic, and accounting experts, that would represent the State *qua* owner on the enterprise council. But, in order to avoid that such an agency assume excessive powers, its minority participation on the council would be desirable. A possible formula may be to have one third of the members represent the agency, one third the other outside organizations referred to above, and one third the firm's employees on the enterprise council.

Concluding Remarks

Following a brief review of the policies applied in response to external shocks, this paper has examined Hungary's adjustment experience in the 1978-84 period. It has been shown that Hungary succeeded in transforming a deficit in convertible currency trade into a surplus during the period. But, this involved the adoption of deflationary policies, bearing chiefly on investment activity, as well as import controls, while Hungary lost export market shares and the rate of economic growth averaged only 1.8 percent a year.

Also, the exigencies of turning a deficit into a surplus in convertible currency trade and the requirements of the reform effort repeatedly came into conflict and, more often than not, this conflict was resolved in favor of the former objective. This involved limiting the firm's freedom of actions, both through binding regulations and through case-by-case interventions.

The changes introduced in 1985, in particular the establishment of enterprise councils, changes in the tax system, the new wage regulations, and the shift away from the so-called competitive price scheme, represent important new reform efforts. But, for these measures to have their full effect, further actions would need to be taken to rationalize product and factor prices and to increase the freedom of action by the firm. More generally one should create a situation where the firm responds to market signals rather than to ever-changing regulations and interventions. This, in turn, calls for establishing the conditions for effective competition in the domestic economy and, eventually, through imports.

These changes are necessary for the structural transformation of the Hungarian economy that has been hindered by the practice of

overregulations and 'manual guidance'. Such transformation will require investments, more exactly efficient investments that conform to market conditions. In this respect, too, greater scope needs to be given to decision-making by the firm that has to take the risks and enjoy the reward of its actions. One may, then, ensure that 'the new growth path' lives up to its name as adjustment occurs through exports and efficient import substitution, thereby leading to higher rates of economic expansion.

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