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Transformational Recession
A General Phenomenon Examined through the Example of Hungary's Development [(1)]

János Kornai

All the postsocialist countries are in deep recession. This study discusses the common features of these recessions, using the Hungarian economy as an example. The author starts by considering the following general reasons for the phenomenon: 1) the shift from a sellers' to a buyers' market, 2) the transformation of the real structure of the economy, 3) the disturbances in the coordination mechanisms, 4) the macro consequences of the hardening of financial discipline, and 5) the backwardness of the financial system. The components of macrodemand-investment, personal consumption, government consumption, and exports-are then examined one by one. The most important factor here is the dwindling propensity to invest. Finally comes a summary of the conclusions to be drawn from the analysis. There are good reasons for placing the tasks of

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(1) The "Francois Perroux Lecture", delivered in Collège de France, Paris, on June 9, 1993.

The study was made as part of a broad research program on the subject of the transformation of the Hungarian economy in the period 1986–1992. An initial version of its message for economic policy was conveyed to a broad readership in an article in the Christmas 1992 issue of the newspaper *Magyar Hírlap.* Several of the ideas in the study were put forward at seminars held by the World Bank and the International Monetary Fund in Washington, and at the Political Science Faculty of the Central European University, the Transit Club of the Institute of Economics and Neumann Foundation and the Budapest University of Economics in Budapest. The contributions to the discussion on those occasions were a great help to me in clarifying my ideas. I am most grateful to Mária Kovács for her wide-ranging assistance with the research, to Álmos Kovács and György Surányi for their valuable comments, to Brian McLean and Julianna Parti for their excellent translation of the Hunganian text, and to Hungary's National Scientific Research Foundation (OTKA), the European Bank and the AustriaLotto for their financial assistance to the program.

emerging from the recession, recovery, at the top of the list of economic-"policy priorities, but without permitting an acceleration of inflation or a resumed increase in indebtedness. The study ends by analyzing the political and economic"-psychological requirements for recovery.

I would like to express my sincere gratitude for the great honor being invited to deliver this year's Francois Perroux Lecture. Perroux had a long-lasting impact on the thinking of economists. I am convinced that if he were alive, he would approve with heart and soul the great transformation of formerly centrally planned economies into market economies. Here is a quotation from his work: "To say it with a few words that would need extended comments, the market, even the most imperfect one, is worth more than the most perfect system of planification. A system of compromise where all participants are entitled to an only limited freedom of expression and action is better than a regime where by definition the State has unlimited power over its citizens." (F. Perroux, 1962, p. 91.)

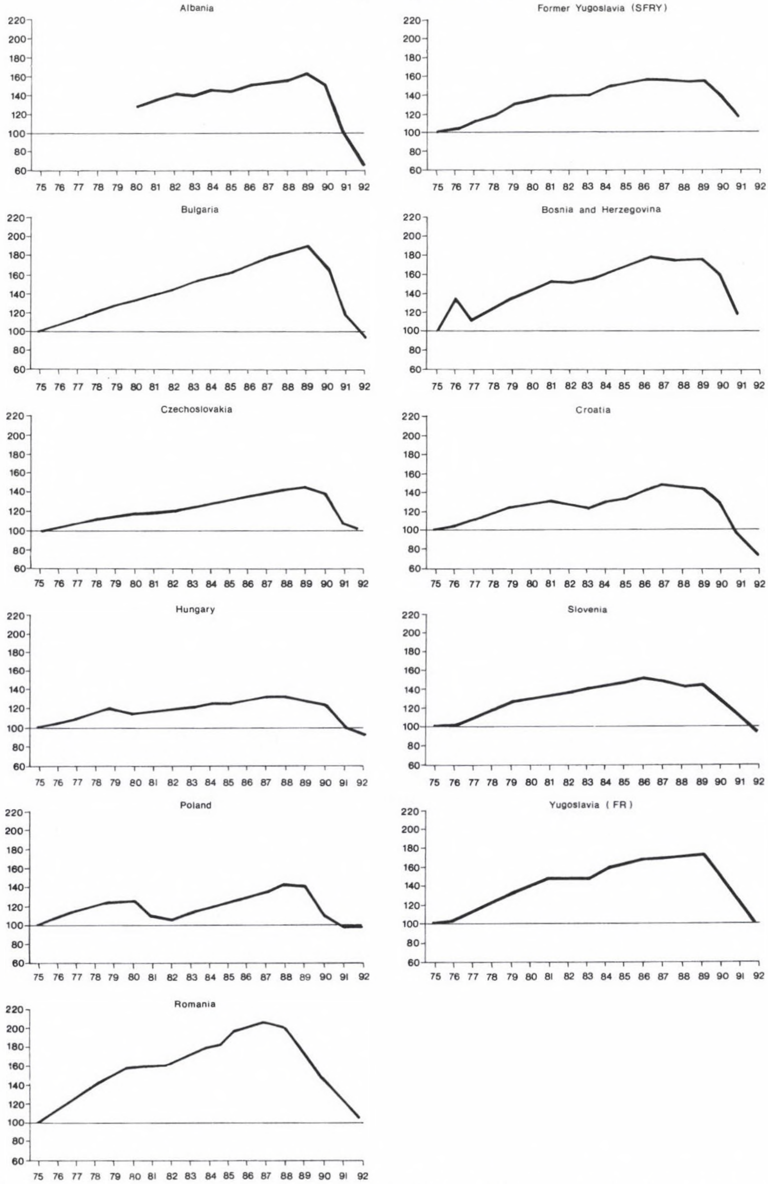
Not only this quotation, but his whole life-time work shows that he was not an uncritical observer of capitalism, but was well aware of its weaknesses and deficiencies. Permit me one more quotation which could well be the motto of my paper today: "If the fluctuations are too marked and, especially, if depressions persist and are followed by massive unemployment, there is no power in the world capable of safeguarding the trust in the virtues of market economy and free enterprise. Oscillations around a rising trend are accepted but oscillations of shortage and misery appear for all as useless". (F. Perroux, 1962, p. 86.)

In the spirit of these ideas let me turn to the subject of the paper.

All the postsocialist countries without exception are suffering from a grave economic recession. This is made clear by *Figure 1*. The course of the recession is conspicuously similar in every case, even though these are countries whose starting points and specific circumstances differ substantially. The history of the production decline in Poland, the prime example of "shock therapy", is similar to the one in Hungary, where the transition has been gradual. Production has fallen sharply in countries which started with high international debts, and done the same in Romania and Czechoslovakia (or the Czech Republic and Slovakia), which were untroubled by this problem at the beginning of the transition. Production has fallen where there was no reform before the political turning point, and also where there was a process of reform taking place over many years.

Figure 1

Gross industrial output (Indices, 1975 = 100)



Source: Economic Bulletin for Europe, 1992, Vol. 44, p. 29, on the basis of national statistics and ECE secretariat Common Data Base.

Note: Industrial output changes for 1992 estimated by the ECE secretariat.

This strong similarity has prompted me to concentrate in this study onthe factors that are common to the histories of this group of countries. Although the discussion throughout this study is about Hungary, I hope that the analytical approaches in it will prove useful when examining other postsocialist countries as well.

Since the phenomenon differs substantially from the cases discussed hitherto in the theories of economic fluctuation, there is justification for giving it a separate name. To distinguish it from them, I have called it *transformational recession.*

The figures for Hungary are shown in *Tables 1, 2* and *3*. These make it clear that the fall in production, which followed a long period of stagnation, is deeper than the one that took place in the Great Depression of the early 1930s. Total production has fallen by 19% instead of 7% then, and industrial production by 36% instead of 12%. Yet the recession in Hungary so far has been relatively milder than in most other countries in the region (2).

It was generally expected that the transition would be accompanied by a range of difficulties, but to my knowledge, very few economists predicted this large-scale decline in production (3). A growing number of economists have been dealing with the question since then, but the profession has failed to arrive at a consensus about how to explain the phenomenon. Some ascribe it to a single cause (or at least a single main cause) like the collapse of Comecon trade, including the Soviet market. Such simple theories do not seem convincing to me. In my opinion, this is a complex, compound phenomenon that requires a *multi-causal explanation* (4), and my research is aimed at contributing to a synthesis of various explanations.

The first chapter of the study points out a few *general* factors inducing the recession. The second chapter examines the *special* factors that cause the contraction of the main elements of macrodemand (investment,

(2) It can be assumed that the share of the informal sector (the "shadow economy") in total production grew in the same period. If this was really so, the fall in the total GDP including both the formal and informal sectors was smaller than the official statistics show.

(3) The public in the postsocialist region was not prepared for this eventuality by the new parties and leading politicians, or by the new democratic governments. Nor can any forecast of the serious recession be found in the early theoretical writings to outline the program for the transition. So it is absent, for instance, from my own book, *The Road to a Free Economy* (1990 [1989]), and from the oft-cited study written by O. Blanchard and other famous Western macroeconomists (1991). Among the very few exceptional early warnings was the writing of K. Laski (1990).

(4) Efforts to provide one are apparent in the articles by T. Erdös (1992), S. Commander and F. Coricelli (1992), S. Gomulka (1991a), (1991b), and G. W. Kolodko (1992). I have taken over several important ideas from these in this study.

Table 1
Indices of GDP and industrial production in Hungary, 1980-1992

Year	GDP	Industrial Production
	(1989 = 100)	
1980	86.5	98.8
1981	89.0	94.3
1982	91.5	98.7
1983	92.1	100.4
1984	94.6	103.0
1985	94.4	100.9
1986	95.8	100.4
1987	99.7	103.6
1988	99.6	102.1
1989	100.0	100.0
1990	96.7	92.3
1991	85.2	74.8
1992[a]	80.9	63.8

Source: GDP, period 1980 –1990: Központi Statisztikai Hivatal (1992a, p. 94). Industrial production, period 1980–1984: Központi Statisztikai Hivatal (1991, p. 56). Period 1985–1990: Központi Statisztikai Hivatal (1992a, p.94). Data for 1991 and 1992 were given by the Central Statistical Office of Hungary.
Note: [a] The data for 1992 are based on the preliminary calculations of the Central Statistical Office of Hungary.

consumption, government spending, and exports). Both chapters discuss causal factors that can be traced back to a common ultimate cause: the postsocialist transformation itself. I am not arguing that no part of any kind is played by factors other than the group of factors associated with the process of transformation. A contribution to the decline in the postsocialist region has certainly been made, for instance, by the fact that the outside world, including the developed capitalist countries, is going through a recession as well. Apart from the direct economic drawbacks of this (tougher export conditions, a smaller influx of capital), it has an unfavorable social-psychological effect. It is unfortunate that the former socialist world should have begun to move towards capitalism just at a time when this system was not in its best form. This factor, however, is not covered in my study, which deals solely with *internal* effects rooted in the transformation itself.

Table 2
Vacancies and unemployment

	Number of registered vacancies	Number of registered unemployed	Unemployment rate (percent)
1990/03	34,048	33,682	0.7
06	37,859	43,506	0.9
09	26,969	56,113	1.2
12	16,815	79,521	1.7
1991/03	13,583	144,840	3.0
06	14,860	185,554	3.9
09	15,351	292,756	6.1
12	11,529	406,124	8.5
1992/03	15,124	477,987	8.9
06	25,346	546,676	10.1
09	25,634	616,782	11.4
12	24,097	663,027	12.3
1993/01	26,471	693,983	13.3
02	32,432	705,032	13.6

Source : Reports of the National Labor Center, Budapest, 1991–1993.
Note: The statistical definition of the unemployment rate has been adjusted beginning in January 1992 to the definition used in Western labor statistics. The data for 1990 and 1991 are calculated according to the old definition, since no recalculation was made. The unemployment rate would be somewhat lower in this period on the basis of the new definition.

The third and final chapter draws conclusions from the causal examination described in the previous two chapters. The emphasis in all three chapters is on positive description and analysis, but normative proposals also appear in them, in most cases simply as illustrative examples.

It is worth saying what the study does *not* set out to do. It does not provide a numerical forecast, and it does not put forward a detailed program of government action. Instead of contributing to the debate on the current situation of the Hungarian economy, I would like to analyze a few major tendencies in the last and next few years, and comment on some strategic problems that arose.

Table 3

Output, investment and employment indices in Hungary under the great depression

Year	Net national product	Industrial production	Capital formation	Industrial employment
1929	100.0	100.0	100.0	100.0
1930	103.3	94.6	75.6	91.3
1931	101.0	87.4	59.1	82.9
1932	96.2	81.9	54.5	73.0
1933	93.6	88.2	43.5	73.6
1934	102.0	99.2	34.9	79.9
1935	102.7	106.8	34.5	85.9
1936	107.8	118.4	41.8	94.7
1937	115.1	129.5	54.3	104.0
1938	112.5	125.3	60.7	112.3

Source : Net national product and capital formation: B.R. Mitchell, (1976, p. 786); Industrial production and employment: League of Nations, (1939, p. 67, 181).

THE GENERAL FACTORS INDUCING THE RECESSION

Not even in the recessions in a mature capitalist economy does the production of each and every firm and product decline. Even near the trough, successful, expanding enterprises are found at least sporadically. In a transformational recession, this is not exceptional at all; this duality is one of its characteristic features. Contraction and expansion, failure and success, mass exit and mass entry can be observed side by side. To use the phrase of Schumpeter's so often quoted these days, "creative destruction" takes place at tempestuous speed. But it is still possible to refer to a recession in the macro sense because the balance of the two processes is negative; for the time being, the pace of the contraction process is greater than the pace of the parallel process of expansion.

This recognition dictates that the examination should not be confined exclusively to the factors that explain the *absolute* decline. The final balance between the expansion and contraction processes with their opposite signs is affected by everything that promotes or impedes either growth or decline.

Each and every trade cycle under capitalism has specific features. Even so, I will attempt a measure of abstraction, by comparing the individual features of the transformational recession with an "ideal type", the typical recession that occurs in a mature capitalist economy.

1) From a sellers' market towards a buyers' market

In the normal state of capitalist economy taken here as a basis for comparison, macro-level monetary equilibrium applies as the long-term trend : macrosupply and macrodemand are in balance at the prevailing level of prices. The usual attendant phenomena are unemployment corresponding to the natural rate, excess capacities accompanying imperfect competition that governs the bulk of the market, and a constant process of entries and exits. The balance of power between the producer-cum-seller and the buyer in this kind of economy is tipped in the buyer's favor. There is a buyers' market, in which the sellers compete for the buyers' money, and precisely this is one of capitalism's greatest advantages, because it encourages adaptation to the demand, respect for consumer sovereignty, improvement in quality, and the introduction of new products (5).

Compare this with the normal state of classical socialism, a chronic shortage economy, in which macrosupply and macrodemand are not in equilibrium at the prevailing level of prices. The attendant phenomena are a shortage of labor, unsatisfied demand for many products and services, wide-spread queuing, and forced substitution. The expansion of production regularly runs up against bottlenecks and constraints on physical resources (6). The balance of power between the producer-cum-seller and the buyer in this kind of economy is tipped towards the seller. This is a sellers' market, in which the buyers compete for the products for sale.

Not even at the peak of the trade cycle in mature capitalism does the state of the market switch over to a general, intensive and chronic shortage economy. The ball remains in the same half-court, *i.e.* the buyers' market basically continues to prevail, and at most the balance of power shifts slightly in the direction favorable to the seller. At the trough, there is an increase of unemployment and under-utilization of resources, which intensifies the competition even more.

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(5) On the advantages of a buyers' market, see the articles by T. Scitovsky [1951] (1971), (1985) and E. Domar (1989). A detailed comparative discussion of the buyers' and sellers' markets appears in Chapters 11 and 12 of my book (1992a).

(6) In an open socialist economy the desire to increase production often runs up against constraints on the availability of hard foreign currencies.

Transformational recession, on the other hand, is combined with a profound and *unique* change. The game moves to the other half-court, so that the economy changes from a sellers' into a buyers' market-from a supply-constrained economy into a demand-constrained economy. This is a process that is to some extent consciously controlled by economic policy (monetary and fiscal policy, as well as pricing policy), out of a desire to bring the shortage economy to an end. But its course is influenced by several uncontrolled, spontaneous circumstances as well. There is a complex mutual influence between recession and the switch of "market regime" (the change from a sellers' to a buyers' market), so that neither process can be plainly said to have *caused* the other.

In the countries that were moving away from the classical form of socialism before the political turning point, Hungary at the first place, the transition to a buyers' market began earlier. *Table 4* is instructive in this respect, because it shows how the supply constraints (shortages of labor, materials, semi-finished products and components, for instance) eased steadily over a period of six years. Already it is rare for physical resource constraints to constitute a direct obstacle to production growth. The kind of low frequency with which production in Hungary runs up against input constraints can be found in any mature market economy as well. It can be established from this table (and from numerous other facts) that the shortage economy in Hungary has ceased; there is no longer a general, intensive and chronic shortage. Parallel with this very substantial change, the role of the demand constraint increases. The table shows clearly how this is now the obstacle that the desire to raise production encounters most often. (A very important role is additionally played by the financing constraints, which are discussed later.)

To simplify somewhat, this long period of transition in Hungary can be divided into two stages (*Table 5*). In the first, repressed inflation that constituted one feature of the shortage economy turned into a moderate rate of open inflation. The gradual, increasingly widespread freeing of prices worked in this direction; a price level developed at which macro-supply and demand could reach equilibrium. This was also helped by supply factors: the emergence of the private sector, the easing of the conditions for entry into production, and the partial liberalization of imports. The rate of inflation speeded up, reaching a peak in June 1991, when prices were 38.6% higher than a year before. These processes presumably soaked up the unspent purchasing power or "monetary overhang". In other words, there was an end to the macroeconomic situation that some economists characterize as a general excess demand.

Table 4

Impediments to production
Hungarian survey data (in percent)

Quarter	Insufficient demand	Shortage of labor	Insufficient Supply of row materials and spare parts: Domestic origin	Imported from ruble area	Imported from dollar area	Financing problems
1987/1	26.0	22.2	41.2	42.6		31.2
2	27.4	23.7	42.3	46.7		24.3
3	21.3	24.1	46.6	50.4		22.1
4	24.1	15.8	39.4	41.8		20.4
1988/1	28.0	15.7	50.0	16.6	32.8	32.7
2	28.3	24.7	44.1	17.2	35.3	36.4
3	27.3	23.0	45.3	18.2	64.0	35.0
4	30.7	19.3	38.5	14.9	22.4	40.1
1989/1	38.0	21.5	37.6	14.4	17.9	49.6
2	40.1	22.0	28.7	11.0	11.8	46.1
3	40.4	21.9	27.5	10.3	8.9	46.8
4	51.2	13.4	21.4	8.0	6.3	49.4
1990/1	51.3	12.1	13.8	5.8	3.9	57.8
2	56.1	13.9	13.0	3.4	2.2	45.2
3	51.0	10.3	15.3	4.6	5.2	51.9
4	54.5	4.3	11.3	3.2	3.7	48.7
1991/1	60.6	4.3	9.4	2.3	2.6	53.2
2	70.1	4.0	7.1	1.5	2.4	54.1
3	66.8	3.3	6.2	1.2	2.0	52.7
4	65.9	3.0	7.2	0.5	1.0	47.3
1992/1	65.1	3.3	5.8	0.3	1.0	51.0
2	62.2	7.4	5.9	0.7	1.5	45.9
3	56.1	4.4	10.6	1.7	3.1	47.8
4	54.5	4.8	8.7	0.7	2.3	42.9
1993/1	57.7	2.2	6.1	1.3		45.5

Source : Kopint-Datorg (1993).
Note: The survey applies the methodology elaborated by the German research institute IFO and used in several other countries as well. Respondents are asked to mention "impediments of production". Each respondent can mention as many impediments as he likes. The figures refer to relative frequencies in percentage. (E.g. in 1987/1 out of 100 respondents 26 mentioned insufficient demand, beside mentioning other factors as well.) There are other impediments mentioned by the respondents but not included in this table. "Ruble area" refers to the former member countries of COMECON. The survey did not separate the "ruble area" and the "dollar area" in 1987 and in 1993; the data refer to the lack of imported raw materials and spare parts.

Table 5

Consumer price indexes in Hungary, 1980-1993

Year	Average annual rate of change (in percent)
1980	9.1
1981	4.6
1982	6.9
1983	7.3
1984	8.3
1985	7.0
1986	5.3
1987	8.6
1988	15.5
1989	17.0
1990	28.9
1991	35.0
1992	23.0
1993 January	25.9
1993 March	23.4

Source : Period 1980 –1990, Központi Statisztikai Hivatal (1991, p. 218); 1991: Központi Statisztikai Hivatal (1992b, p. 62-63); 1992 : Központi Statisztikai Hivatal (1192c, p. 63); 1993 : The data were given by the central statistical office of Hungary.

The *disinflationary* efforts of the financial administration commenced in 1991 and became more perceptible in 1992. The rate of inflation reached its lowest level so far in July 1992, when the price level was 20.1% higher than twelve months before. Since then it has fluctuated within the range of 20-26% on yearly level. To some extent demand had actually been held in check even earlier by monetary policy. Though no orthodox monetarist economist would call the financial policy of the late 1980s and early 1990s "restrictive", as scope constantly remained for a very sizeable inflationary growth in the money supply, demand clearly did not "run away" (7). In fact it fell appreciably in volume terms, and the gap between demand and the earlier maximum supply, *i.e.* the potential GDP, steadily widened. Ultimately, the economy on the macro level tipped from the state of excess demand to insufficient demand.

The "market regime" can be graphically demonstrated by using a synthetic index that shows the composition of stocks. In a shortage

(7) A part was played in curbing demand by the institutional reforms and the changes that took place in the behavior of the economic actors as well. To some extent the budget constraint became harder, and that was accompanied by a lessening of the investment hunger; firms, and even the state budget, became less prodigal in their spending.

economy, firms mainly accumulate stocks of inputs, while outputs are soon taken up by the buyers. When the shortage economy ends, the proportions change; there is no more need to hoard inputs, but output stocks build up due to sales difficulties. This change is shown in *Table 6*. The index in Hungary stood earlier at around 6–input stocks were six times as big as output stocks. This compares with a value of around 1 in the mature and developed market economies. The present value of the index shows a dramatic fall to below 3, but it has yet to reach the figure typical of a mature market economy.

Table 6
Ratio of input and output stocks

Countries periods	Input stocks/output stocks
Capitalist countries, 1981–1985	
Austria	1.06
Canada	0.92
Finland	1.92
Japan	1.09
Portugal	1.66
United States	1.02
West Germany	0.71
Hungary	
1981–1985	6.10
1988	5.16
1990	3.50
1991	2.67

Source : Data compiled by A. Chikán.

From all this can be drawn a range of conclusions important to our subject, recession.

The recession cannot be explained solely in terms of insufficient demand. Even now, only half the firms consider the insufficiency of demand as the obstacle to production (8). We currently face a "half-Keynesian" situation, for whose treatment a doctrinaire Keynesian therapy is not suitable *in itself*. But the other half of the comment must be added immediately:

(8) Nor does inadequate demand become the sole obstacle to production in a mature, developed capitalist economy, even during the downward phase of the trade cycle. The frequency there is at most 70-80%. See J.-J. Laffont (1985, p. 354).

precisely because the situation is already half-Keynesian, demand plays a very marked role in determining output. So the second chapter of the study analyzes this in detail. In a postsocialist transformational recession, the "brake" has not been applied by central controls on supply, as was the case when investment and production were curbed in the socialist economy. Although we are not faced with a recession produced *exclusively* on the demand side, the demand side has assumed the primary role.

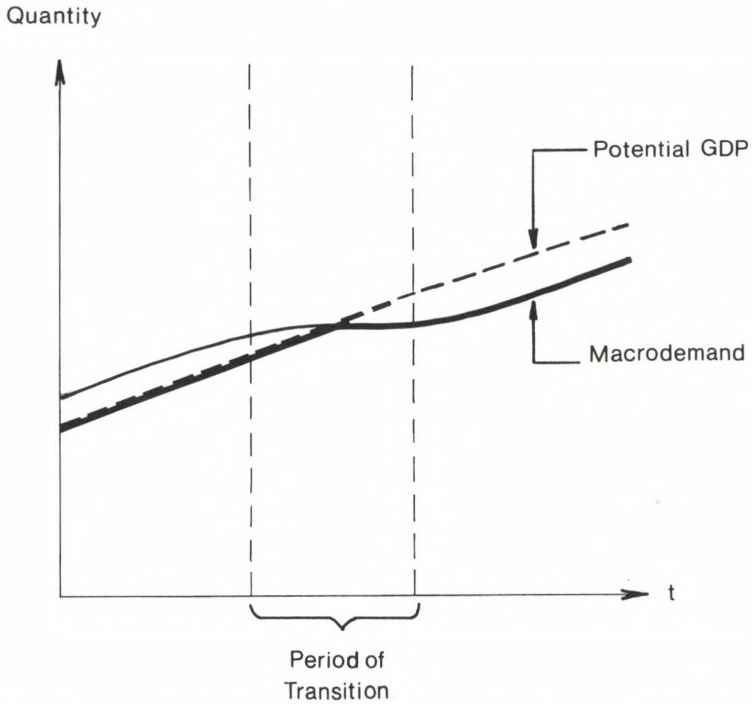
When I first asked myself, 23 years ago, how a supply-constrained sellers' market would turn into a demand-constrained buyers' market, I hoped this could be accomplished without a fall in production (9). I thought the supply would continue to grow, while the growth in demand would decelerate (but still remain positive) to an extent that finally tipped the situation from excess demand to excess supply. The idea, or rather hope, that I had at that time is shown in *Figure 2a*, taken from my 1971 book. Unfortunately the transition takes place differently in practice, for a number of reasons. Well before the change of system in Hungary, the growth of production had decelerated and been followed by a long period of stagnation. To transfer from excess supply to excess demand under such circumstances, the curbing of the growth of demand and (in volume terms) its absolute reduction inevitably drags down the supply as well, and these interact with each other in a vicious circle to deepen the recession. When the postsocialist economy transfers from one secular market regime, a sellers' market, to the other secular market regime, a buyers' market, it *tips over too far*, instead of arriving at an ideal state of equilibrium. The actual trend of supply and demand appears in a stylized form in *Figure 2b*. The actual volume of production falls back steeply from its previous peak; the state of the economy resembles in this respect the trough in the customary fluctuation of the capitalist trade cycle (10).

In fact I have a bad conscience about using the expressions *general* excess demand and excess supply, because they simplify the description of the situation. I have been campaigning for a long time against rash use of aggregate macro categories in this subject-area. Unsold goods also existed under the conditions of the shortage economy. Occurrences of excess demand and excess supply can coexist at the micro level.

(9) See *Anti-Equilibrium* (1971, p. 325). At that time I used other terminology ("suction" and "pressure"), but in later works, and in this study, I adopted the more widespread expressions.

(10) The 1992 annual report of the UN Economic Commission for Europe considers it a mistake not to recognize the alteration in the macroeconomic conditions in Eastern Europe. "Emerging unemployment, the elimination of shortages and restoration of the basic monetary equilibrium are all symptoms of transforming the Kornai-type, supply-constrained economies into Keynesian-type, demand-constrained ones." (p. 51.)

Figure 2a
The concept put forward in 1971



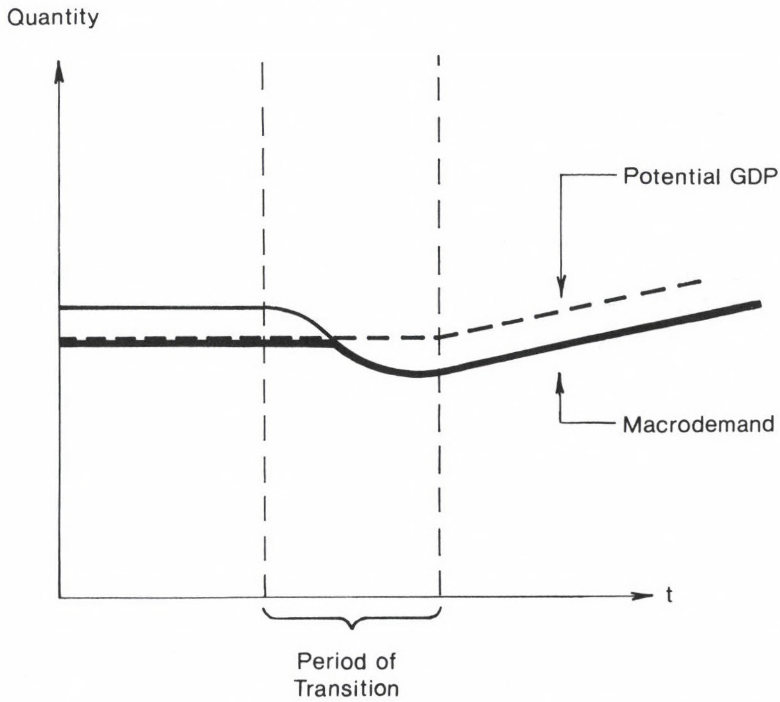
Some producer run up against supply constraints, while others meet with demand constraints. This caution is now more apposite than ever before, but it leads on to the next factor, the transformation of the real structure of the economy.

2) The transformation of the real structure of the economy

When we were looking at the restoration of macro monetary equilibrium just now, one question was left open: why does the change of market regime, the development of the sellers' market into a buyers' market, have recessionary effects?

Prices are gradually (or in some other countries suddenly) freed, which brings about a new system of relative prices. The greater the extent to which this is accompanied by liberalization of foreign trade (which in Hungary took place in parallel to a substantial extent), the more strongly

Figure 2b
The reality of the 1990s



Note : The bold line represents the actual GDP. The actual GDP is the smaller of potential GDP and macrodemand. The curves in Figure 2a coincide with those of Figure 22.2 in *Anti-Equilibrium* (1971); I modified only the denominations of the variables as to follow the generally used terminology.

and immediately the effects of foreign relative prices are felt. It suddenly emerges that there is no sufficient demand for a range of products and services at the earlier high prices or at slightly lower ones; but if the prices plummet, the firms producing them make a loss. If the firms are deprived (either gradually or suddenly) of their financial subsidies at the same time, they are forced to cut or completely cease their production. Meanwhile the prices of other products rise due to the appearance of hitherto suppressed demand, therefore it becomes profitable to produce or import them. So the new relative prices and the concurrent new product composition of demand generate an adjustment in the supply, *i.e.* a transformation of the real structure of production. But the adjustment of the quantities to the new prices always takes time, and for several reasons it is particularly sluggish during the period of the postsocialist transition. (Some of these reasons will be returned to later.)

The strategy of forced growth under socialism gave rise to a production structure unadjusted to user requirements, including domestic consumption, but utilization of these products was imposed on buyers by central allocation and shortages. In the reform period a gradual change in the product composition of output took place. This transformation has accelerated in the last few years. At branch level, this primarily consists of a fall in the share and absolute volume of industrial production and a rise in the share and absolute volume of services (*Table 7*). Within this process, thousands of alterations, great and small, take place on the micro level in the specific product composition of output.

Table 7
Composition of GDP in Hungary

branches	Sources of GDP by economic branches (in percent)			
	1986	1988	1990	1991
Industry	36.7	34.1	31.8	30.7
Construction	6.6	7.7	6.6	6.3
Agriculture and forestry	20.7	16.6	16.2	14.8
Transportation, post and telecommunication	8.9	8.0	8.2	8.8
Commerce	9.4	10.1	11.5	11.1
Water management	1.4	1.4	1.3	1.3
Other material activities	1.2	1.1	1.3	1.4
Material activities	**84.9**	**79.0**	**76.9**	**74.4**
Personal and economic services	4.6	5.0	5.6	–
Services by financial institutions	–	1.5	2.0	–
Health, social and cultural services	6.2	8.7	9.4	–
Community, public administration and other services	4.3	5.8	6.1	–
Non-material activities	**15.1**	**21.0**	**23.1**	**25.6**

Source : 1986: Központi Statisztikai Hivatal (1989, p. 57); 1988 and 1990: Központi Statisztikai Hivatal (1992a, p. 95); 1991: Központi Statisztikai Hivatal (1992d, p.61).

In this respect the transformational recession has characteristics that are far more Schumpeterian than Keynesian. It is not simply that aggregate demand is insufficient. The demand for the output of some sectors of the economy fell dramatically, while the demand for that of other sectors did not fall at all, but may actually have grown. Let me give just two examples. Long-postponed demand led to an almost explosive development of businesses concerned with personal computers, electronics, modern information systems and telecommunications, so that for a long time this broad sector experienced a positive boom in the midst of the recession. The new relative prices and the new structure of demand caused the catering industry and services connected with tourism to flourish.

The change in the product composition and branch structure is connected with two other processes of change:

Property relations alter. There is a fall in the proportion of the sector in purely state ownership and a rise in those of the purely privately owned sector and the mixed-ownership sector that covers various combinations of state and private ownership. This occurs in such a way that the production of the purely state-owned sector decreases in absolute terms, while that of the private and mixed-ownership sectors increases.

A change takes place in the size distribution of firms. The small and medium-sized enterprises were almost totally eliminated under the classical socialist system. Small and medium-sized firms began to return during the period of reform socialism between 1968 and 1989, but they have only begun to multiply rapidly since the change of political system. The proportion and absolute production volume of the large-firm segment are falling, while those of the segment of small and medium-sized firms are rising.

These three kinds of restructuring do not overlap completely, but they coincide to a significant degree. It is not far wrong to say that the two most characteristic actors in a postsocialist economy are the large, contracting, state-owned industrial firm and the small, expanding, privately owned service firm. A more general and accurate way of putting it is to refer to contracting and expanding segments of the economy, without specifying their ownership, scale and product classifications. The desirable state would be if the expansion were faster than the contraction, so that the balance between them yielded a positive increment. The opposite is unfortunately the case: the contraction of the first segment is faster than the expansion of the second, not because anyone intended it should be, but because there are a number of factors retarding the expansion of the growing sector. More will be said about these retarding factors later.

A painful process of "natural selection" takes place, but the trauma has a healthy, cleansing effect. In fact a similar process occurs during the normal capitalist trade cycle; the idea features large in the cycle theories of A. Spiethoff and J. Schumpeter [(11)]. In the transformational recession, this process is far more intense and comprehensive. At the end of a capitalist trade cycle, the real structure of the economy has changed comparatively little since the beginning of the cycle, whereas it can be assumed (or rather hoped) that the situation after the transformational recession will be drastically altered.

3) Disruptions in coordination

Many people had the naive idea that the elimination of central planning and bureaucratic coordination would be followed immediately and automatically by the appearance and operation of market coordination. In fact there is a curious "no-man's land", where bureaucratic coordination *no longer* applies and market coordination does *not yet* apply, and economic activity is impeded by disintegration, lack of coordination, and anarchy [(12)].

The lack of coordination assumes various forms, of which I will pick out a few:

• The old behavioral norms of the economic actors have ceased, but they have not yet learnt the new behavior to suit the new situation.

• Certain earlier institutions of bureaucratic coordination (organizations and legal regulations) have ended, but the erection of the new market institutions has either not begun yet, or is progressing very slowly. The network of market connections is still very loose, and it will take time before a dense network has been woven.

• The information structure of bureaucratic coordination has gone, but the new system of signals has not yet developed, or the economic actors are not yet sufficiently capable of assessing and processing the new kind of information.

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(11) See A. Spiethoff's (1902) and J. Schumpeter's (1934), (1939) works. An excellent account of these two cycle theories can be found in A. Hansen's well-known summarizing work (1964).

(12) G. A. Calvo and F. Coricelli refer in their study (1992) to a trade "implosion". The trade relations are destroyed by the absence of market institutions.

The phenomenon they describe is an important constituent of the wider group of phenomena referred to above as the yawning gap and lack of coordination between the two kinds of coordination mechanism.

• Bureaucratic coordination, especially in its more consolidated periods before the final disintegration, supplied a kind of order and predictability. The market by its nature involves its participants in a lot of uncertainty and risk. This, however, is multiplied in the present unsettled situation. Most of the actors are at a loss, anxious, and hesitant about their decisions.

This phenomenon takes its ultimate form in many of the republics that have replaced the Soviet Union, but it also plays a major part in other countries like Albania and Bulgaria. This in my view is one of the main causes (possibly *the* main cause) behind the recession in these countries.

In Hungary the supplanting of bureaucratic coordination began much earlier, in 1968, after which gradual progress was made, with successive relapses. So the phenomenon just described appears in less dramatic forms than in countries which jumped almost directly from classical socialism to postsocialism. But it is worth recalling that there were areas of "no-man's land" even throughout the period of partial reforms implemented under the socialist system, a state described at the time by Tamás Bauer as one that was "neither plan nor market" (13).

The process of transformation has not been completed in Hungary either. The confusions of coordination and the phenomena of "no-man's land" still appear from time to time, at least in certain branches, and they contribute greatly to the recession. Let us look at two examples of this.

One is agriculture, where production has taken a real nosedive. Cooperative production based on collective ownership complemented by private farming on dwarf household plots holdings was not efficient in many respects, but nonetheless it worked and scored some successes. All the elements of coordination were adjusted to these property forms at the time: the central administration, the allocation of investments, the credit and tax system, the setting of prices, the commercial relations between producers and users etc. The old property forms have been shaken, but mature new property forms have not arisen in their place. Everything is in a fluid state. The old institutions and organizations of coordination cease to function under these conditions. But the requisite new system of coordinative institutions–an up-to-date new wholesale and retail network to link the smallholders with the consumers, a new credit system for smallholders, and a stability-enhancing price and subsidy system in line with European practice–have still not developed. All these factors gravely impede production. They are compounded by a succession of big government mistakes, above all over the compensation of formerly expropriated land-owners and the reorganization of the cooperatives.

(13) See T. Bauer (1983).

The other example is the building industry, and in connection with it, housing construction and urban planning. Although this sphere was relegated and neglected under the socialist system, it still had an established organization and system of institutions. There were periods when the performance was relatively great, at least in terms of the number of housing completions, even though the quality of the housing completed was poor. Now the sphere is in a state of collapse as well, even though there is a great demand for housing. The market institutions have not yet developed, a credit system to suit the specific features of the housing market still hardly operates, the network of real-estate agencies is rudimentary, developers able to undertake the development of whole neighborhoods have not yet appeared, and there is confusion in the system of rents and social subsidies. There is an undoubted need for state supervision over the market processes in this field, and in certain respects for state regulation as well (for instance in applying urban-planning and social-policy criteria). Instead of a harmonious combination of bureaucratic and market coordination, one encounters repeated confused conflicts between them. As a result of all this, housing construction has fallen back seriously, whereas it might have been one of the leading sectors in the postsocialist transition.

The development of market coordination takes time, which is one reason why the recession is protracted in many fields. But the period of development can be shortened by appropriate legal regulations and state initiatives. The government has committed many sins of omission in this respect: it dawdled over drafting and implementing the legislation to support market coordination, over organizing supervisory agencies in conformity with the market economy, and over supplying a system of state guarantees in certain areas requiring it.

4) Financial discipline and enforcement of efficiency

A hardening of the firms' budget constraint can be observed in the Hungarian economy [(14)]. The most tangible manifestation of this is the forceful implementation of the bankruptcy legislation, even if some mitigation of this originally very strict piece of law has come onto the agenda since. A large number of insolvent firms are undergoing reorganization through bankruptcy proceedings, and many of them are being liquidated.

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(14) This process is analyzed in greater detail in my article (1993).

A private firm is under a hard budget constraint from the outset. Although there are attempts to soften it here as well, the growth of the private sector entails the spread of a hard budget constraint.

What effect do these changes have on recession, the phenomenon discussed in this study? Some of the firms go bankrupt and exit, which means lay-offs and an end to the firm's demand for inputs. The survivors, which from now on are truly profit-maximizing firms that use market instruments to fight for their survival, economize in their expenditure better than they did, which means that their demand for inputs is decreasing. They try to use up their swollen stocks from the past. This too has a demand-reducing effect. They dismiss workers who have become superfluous. The unemployed usually generate less consumer demand than the employed.

Even if the managers of state-owned firms bring themselves to dismiss workers, they remain somewhat disinclined to undertake a radical reduction of their excess labor. *Table 8* shows that employment in industry falls far slower than production, so that the productivity of labor is deteriorating. Presumably there is still a great deal of "unemployment on the job". Once state-owned property is privatized, the situation changes. Experience in many cases confirms what would be expected in theory: the first thing the new owners do is to dismiss the workers they judge to be superfluous.

Privatization is widely considered to be the main means of overcoming the recession and inducing growth, but this is a simplified misconception of the real relationship. *In the long term*, efficiency really will be increased by the spread of private ownership, the privatization of assets previously owned by the state, and the enforcement of financial discipline, a hard budget constraint, in all sectors of the economy, and that will make the growth trend steeper. *In the short term*, however, privatization has a different effect, because as we have described already, it raises unemployment, reduces demand and so contributes to the recession. Choosing between a short-term, anti-recessionary goal and a long-term growth goal is one of the gravest dilemmas to be faced during the postsocialist transition.

5) The backwardness of the financial sector

The problem to be discussed now is in fact part of the previous two, but it deserves separate treatment because of its special importance. Only now, when the financial sector's backwardness has become one of the obstacles to growth, can the full significance of the difference between

Table 8

Gross production, employment and labor productivity in Hungarian industry[a], 1980-1992

Year	Output	Average number of employed	Gross production per employee
	(1989 = 100)		
1980	87.0	116.1	74.9
1981	89.4	113.7	78.6
1982	91.6	111.4	82.2
1983	92.3	109.2	84.5
1984	94.8	108.6	87.3
1985	95.5	107.9	88.5
1986	97.3	107.1	90.9
1987	101.0	104.4	96.8
1988	101.0	101.7	99.3
1989	100.0	100.0	100.0
1990	90.8	94.5	96.0
1991	71.3	82.2	86.7
1992[b]	55.0	68.0	81.0

Source : Period 1980 –1991: Központi Statisztikai Hivatal (1192a, p. 122); 1992: Kopint-Datorg: (1992, p. 193).

Notes: [a] The output data for the period of 1980-1989 are based on the gross production of economic organizations belonging to the category of industry. The output indices for 1990 and 1991 are calculated on the basis of industrial production. Data from 1990 refer to firms with legal entity employing more than 50 persons. The table does not cover the construction sector. [b] January-June, 1992.

a wholly monetized capitalist economy and a semi-monetized socialist economy be appreciated.

Let me return to the column in *Table 4* showing the proportion of firms that consider insufficient financing to be one of the obstacles to growth. It is worth noting that while this factor was mentioned by 20-30% of the respondents in 1987, the frequency is 45-50% nowadays.

The banking system under classical socialism did not operate as a real bank. Its actual function was to provide a nationwide bookkeeping and cashier service, coupled with some aspects of the supervision of producer firms. Its guiding principle was that if a real action was declared necessary by the plan or the state bureaucracy, it would provide the money for carrying it out. Where a start was made to reforming the economy before the change of political system, as it was in Hungary, transformation of the banking system also began, so that it came somewhat to resemble its counterpart in a true market economy, although the development can certainly not be taken as complete.

This study does not set out to make a comprehensive analysis of the financial sector, and so only a few problems directly related to the subject of recession and growth will be dealt with here.

One problem is the rash and irresponsible way in which credit risks are assumed when they are motivated by non-commercial considerations. This problem that ties in with the question discussed in the previous section, *i.e.*, financial discipline, still appears very sharply in the successor states of the Soviet Union. There thousands of loss-making firms are being kept alive with bank credits, this way fueling inflation and impeding the enforcement of financial discipline. This phenomenon does not occur on a mass scale in Hungary, since we are past that stage. But not even in Hungary has the special relation of the state-owned commercial banks and the large state-owned firms ceased altogether. The owner of both is the state, and in a sense a "personal union" applies. The banks are at times more indulgent with their old customers than they are with their new customers, the private entrepreneurs, when it comes to pressing their claims. Sometimes a similar partiality can be seen in the extension of new credit as well (15). Settlement of the situation with unrecoverable loans was a very long time coming. This "soft" behavior by the banks towards the state-owned firms' sector hinders the process of natural selection described earlier. The situation is further exacerbated by the fact that from time to time a high-ranking figure in the government and political life will intervene, usually in an informal way, in the activity of the commercial banks in state ownership, exerting pressure on their credit-extension decisions.

In some credit relationships there is a disregard for risks, and in others there is excessive caution and real cowardice about extending credits, particularly when the applicant is a small or medium-sized private firm or a household. It must be admitted that there is a real dilemma here. The banks are just beginning to get used to the idea that they must pursue *commercial* activity, which taken as a whole will yield a profit. They should learn that a bank is not an institution for distributing money on orders from above or friendly recommendations from politicians. That may be so, but they now apply the lesson they have learnt with eager zeal and are inordinately averse to risks. They have yet to master the second part of the lesson: a bank, as a commercial undertaking, must live and

(15) The bias is not shown exclusively to state-owned firms. The banks have also rashly extended vast credits to a good many large private firms, and find it hard to bring themselves to take harsher measures to force repayment.

prosper by extending credit. No venture in a market economy can make lasting profits by "holding goods back".

So a paradoxical situation has developed. A huge stock of liquidity has accumulated in the banking system, but got stuck there. On the one hand the commercial banks are shy of lending it on a broad scale, but on the other, entrepreneurs are shy of drawing credit, because they think it is too risky as well.

For a long time the nominal rate of interest was very high, and it only began to fall quite recently. The real interest rate was less alarming because of the steep rate of inflation, but still high enough to deter many entrepreneurs from borrowing. There is a debate taking place about the role played in decisions about borrowing under current Hungarian conditions by the magnitude of the interest rate. For want of a strong enough argument to support a decided opinion on this, I can only give my impression. It seems that at the real rate of interest prevalent at the time of writing even a moderately successful business could service a loan on such terms. I tend to agree with those who say the *main* cause of the reluctance to borrow is the uncertainty [(16)]. There are too many unpredictable aspects of the future legal situation, property relations, taxation and other public levies, the future trend in relative prices and inflation, and not least the forecasts about the general state of the economy. On the creditors' side, the interest rate has probably come down enough to make the banks even less inclined to lend, precisely because of the uncertainty about the economic conditions.

To follow up the line of argument begun in the previous section, I can point to the continued absence of a whole range of institutions and organizations very necessary in general for the operation of a market economy, and especially important for stimulating Hungary's transitional economy. Let me give just a few examples. There has not yet emerged a system of collaterals and guarantees that does not just copy the rules and conventions in the mature market economies, but allows for the immaturity typical of the Hungarian economy and the initial problems of the entrepreneurial stratum. There has not yet developed fully one of the elementary tools of all modern financial systems: a system of current (checking) accounts. Transfers and payments of claims through the banking system are still very slow and expensive. Credit cards are not widespread. The network of various kinds of investment funds, venture-capital companies, pension funds and other financial intermediaries has

(16) See, for instance, the article by Á. Valentinyi (1992).

still not consolidated. The development of the capital market is at its early stage [17].

Mention must again be made of the two branches referred to earlier: agriculture and housing construction. Throughout the world, both of these employ special credit and investment schemes. In Hungary, the development of these proceeds very sluggishly, which has greatly contributed to the grave recession in these two branches.

Development of the financial sector inevitably takes a long time, of course, but a great many omissions by the government can be blamed for the fact that progress has not been faster. This applies to all the phenomena used to demonstrate the backwardness. Yet another typical example of government neglect was the delay and procrastination before conditions for the so-called "E-credits" available to entrepreneurs were eased, thus widening access to them. (This is a specific credit-scheme, which grants loans to private entrepreneurs for investment at favorable terms with the help of governmental assistance.) Hesitation and a lack of imagination have been shown in a field where there is a real need for constructive governmental initiative.

Calvo and Coricelli, in the study mentioned earlier [18], take the disturbances in the credit system and the scarcity of credit to be one of the main causes of the recession. This statement seems to be correct, but at least in Hungary's case it needs some refinement. I do not think the main problem is the tightness of the total credit supply permitted by central monetary policy. There is even some redundancy here. In my view the problem lies in the excessive friction and low efficiency with which the financial system operates as an intermediary between the possessor of money–the depositor-saver–and the borrower of loans.

To sum up the first chapter of the study, it can be stated that the postsocialist transformation necessarily gives rise to processes that tend towards a reduction in aggregate production. This painful consequence of the transformation has been examined in five "dimensions". These five processes, intertwined with and reinforcing each other, hinder growth and

(17) It is particularly worth noting that the country is facing problems of immaturity not only in the banking sector in a narrow sense, but in the broader financial sector. It would be a mistake for credit to play an excessive role in financing the firms, and so relegate their own capital into the background. Difficulties appear in assembling initial capital and obtaining investments needed for capital injections. A very high degree of uncertainty about the chances of value-preserving, profitable investments, furthermore the underdevelopment of the organizations managing investments is deterring many possessors of money from bringing their savings to the capital market.

(18) G. A. Calvo and F. Coricelli (1992).

retard production. Their negative effects are compounded by mistakes on the government's part.

ON THE FOUR COMPONENTS OF MACRODEMAND

Attention was drawn in Section 1 of the previous chapter to the conspicuous and constantly expanding role played by the demand side in determining output during the period of the postsocialist transition. So let us consider the principal components of demand one by one, employing the categories customarily used in macroeconomics. (A summary of the changes in these is provided by *Table 9*) [(19)]. But I would like to stress in advance that I do not confine myself exclusively to examining the demand (utilization) side; mention will also be made of some aspects of the supply (production) side. Although in each case I take a macro approach as the point of departure for examining the phenomenon, I will also refer several times to the microeconomic and institutional aspects.

1) Investment

Let us begin with the most important category from the point of view of medium and long-term growth: investment. The volume of investment has seriously declined (*Table 10*), in fact to 29% below its peak. The proportion of investment in the utilization of the steadily declining GDP has fallen (*Table 11*).

There was a constant insatiable investment hunger apparent under the classical socialist system. The investment stimulus of what Keynes called "animal spirits" never flagged. The decision-makers at every level from the works manager to the prime minister were driven by expansion drive. The fact that the bill for the investment was always paid in the end out of public funds, so that the financial failure of the investment was overcome, guaranteed permanent optimism about growth.

This attitude, already dulled by the quasi-reforms, was completely eradicated by the political turn and the institutional changes that followed

[(19)] The text of this study uses the customary categories of macroeconomics: investment, private consumption, government consumption, and export surplus or net exports. The classification of the official statistics for the utilization of GDP differ somewhat from this, which can be seen in Table 9, for instance. The macroeconomic categories can each be made to correspond more or less with a statistical category. Since I am not at this point making a quantitative analysis, it can be hoped that the deviations between the two kinds of classification will not cause confusion.

Table 9
Gross domestic product or expenditure

Components	GDP on comparable (1988) prices, HUF mn.				Volume indices, %		
	1988	1989	1990	1991	1989/ 1988	1990/ 1989	1991/ 1990
Private consumption	873,814	893,586	861,112	811,591	102.3	96.4	94.2
Collective consumption	175,000	164,000	168,300	163,755	93.7	102.6	97.3
Final consumption	*1,048,814*	*1,057,586*	*1,029,412*	*975,346*	*100.8*	*97.3*	*94.7*
Gross fixed capital formation	310,801	332,529	308,800	272,925	107.0	92.9	88.4
Changes in stocks	49,941	32,685	40,947	−1,136	–	–	–
Gross capital formation	*360,742*	*365,214*	*349,747*	*271,789*	*101.2*	*95.8*	*77.7*
Total domestic use	*1,409,556*	*1,422,800*	*1,379,159*	*1,247,135*	*100.9*	*96.9*	*90.4*
Exports	530,395	536,815	508,132	430,345	101.2	94.7	84.7
Imports	491,738	500,737	479,425	437,038	101.8	95.7	91.2
Net exports	*38,657*	*36,078*	*28,707*	*−6,693*	–	–	–
Total GDP	**1,448,213**	**1,458,878**	**1,407,866**	**1,240,442**	**100.7**	**96.5**	**88.1**

Source : Központi Statisztikai Hivatal (1993, Table 1.3.2).

it. The investment hunger came to an end, to be replaced by caution, and even cowardly fear in many people (20). Let us take the various spheres of investment decisions in turn.

(20) Looking at the behavioral motives, this phenomenon relates to the one described earlier in connection with credit. A strong aversion to risk is apparent in both spheres.

The two spheres are not identical, although they overlap. Some investment is not financed from credits, and some credits are not extended for investment purposes.

Table 10
Fixed capital formation in Hungary, 1980-1992

Year	Fixed capital formation 1980 = 100 (on the basis of comparable prices)
1981	95.6
1982	94.2
1983	90.9
1984	87.7
1985	85.1
1986	90.6
1987	99.4
1988	90.3
1989	95.0
1990	86.8
1991	76.8
1992[a]	71.0

Source : The data were given by the Central Statistical Office of Hungary.
Note : [a] Preliminary calculation by the Central Statistical Office.

Table 11
Fixed capital formation in Hungary, 1980-1991

Year	Fixed capital formation as a percentage of GDP (at current prices)
1980	28.8
1981	26.5
1982	25.2
1983	24.5
1984	23.0
1985	22.5
1986	24.0
1987	24.7
1988	20.6
1989	20.3
1990	17.8
1991	19.1

Sources : Period 1980 –1987: Magyar Nemzeti Bank: (1990, p. 97); period 1988 –1990: National Bank of Hungary : (1991, p. 129); 1991: J. Vígh, (1993, p. 22).

1) In the government sector, in which I am not including state owned firms on this occasion, investment activity has declined. This is connected, of course, with the troubled fiscal situation. Similar tension under the socialist system would not have deterred the top leadership from undertaking great investment expenses, as the decision could be taken behind closed doors. However great the investment expenditure was, it could be covered by taxes levied indirectly on the public. There can be no question of this now, because Parliament decides how the taxpayers' money will be spent, in the full glare of publicity.

In order to overcome the recession, it would be desirable for the investment proportion of government spending to increase. The state needs to play a bigger part, especially in infrastructural investment.

2) The state-owned firms in the category likely to remain in long-term or permanent state ownership need investment to secure their survival and to modernize. The trouble is that also many of these firms are up against serious financial difficulties and not sufficiently creditworthy. If an investment project shows a loss, they cannot count on automatic assistance. So their old self-confidence has been lost; their managers are hesitant and do not dare to invest. This must change. The decision-makers, of course, owe a responsibility for these investment decisions, which they cover out of public money after all. But this should not stop such decisions being made at all; public opinion of the business community should also encourage the state sector to invest.

3) The situation is even worse with firms that are still in state ownership but known to be destined for privatization in the future. Here almost all investment activity has been paralyzed; no one dares to initiate anything while waiting for the new owners. In fact there is quiet disinvestment–depletion of the assets invested earlier. Several practical conclusions can be drawn from these observations :

• An acceleration of the change of ownership is also urgent from the investment point of view. The immediate proceeds of the sale should not be the main criterion. Consideration should be given, alongside the general objectives of social transformation, to the likely results of the investment and job-creation program promised by the new owners.

• Before the privatization takes place, it must be ensured at least that the assets will reach the new private owners in the best possible condition. A fundamental element of this is the conservation and careful maintenance of assets. Many firms need reorganizing, which usually entails larger or smaller amounts of investment as well.

• The firms' managers must be given a far bigger incentive to carry out the tasks just described, so that the assets privatized are as valuable as possible, not in a run-down condition.

4) In the private firms, in fact, the "animal spirits" referred to by Keynes are alive, as the large number of entries and firms being founded shows. They are alive, or rather would be if the propensity to invest were not cooled by several unfavorable circumstances. Two have already been mentioned when the financial sector was discussed: the uncertainty, which in fact is much greater than is usual in a market economy, and the financial sector's backwardness and reluctance to lend to private firms. Coupled with these are the weakness of the capital market and the fact that the tax system is not friendly enough towards investment. Many would also include among the factors curbing the propensity to invest the high level of interest rates. (This question has been mentioned already.)

Overcoming these unfavorable circumstances is the key factor in recovering from the recession.

5) A major figure in the investment sphere is the household, which can finance the construction of an owner-occupied apartment or house from its own savings and from credit. For the sake of completeness, let me repeat that housing construction in general, including housing construction financed by households, has seriously declined. Stimulation of this activity, for instance with more easily accessible credits and with tax concessions, could play an important part in overcoming the recession.

2) Consumption

As Table 9 showed, the volume of private, personal consumption has fallen, but to a smaller extent than GDP and total real income.

Under the mechanism of central planning, the predominant part of household incomes was regulated by the state, and the savings proportion was fairly stable, so that the central management of the economy could accurately forecast the consumer demand from the general public. There is no question of this now. Let us take the determinants of the demand in turn:

1) A smaller part of incomes derives from the budget, while the greater part depends on agreement between employers and employees. Although this is influenced by collective bargaining and interest reconciliation taking place at the highest level, on which the government has a great, though not exclusive influence, the actual wage agreements are decentralized. The central agreement is at most taken into consideration as a suggestion.

2) Once households possess a cash income and some stock of previously accumulated savings, the decision on how much to spend and how much to save is in their own hands. This may be influenced by government action (for instance a monetary and fiscal policy that tries to affect the interest rate), but the strength of this influence is doubtful.

Although the future spending intentions, *i.e.*, aggregate demand of households will have a great effect on the recession, they remain hard to predict. Households themselves are just getting acquainted with the new situation and learning to make savings decisions of a new kind. No economist can yet know the result of that learning process or yet recognize what the regularity in it is, and what represents a one-off departure from some future regularity (21). Let me pick out a few hypotheses that seem not merely to apply to the present situation in Hungary, but to have a more general validity (22):

• Citizens who can rely less and less on the assistance of the state build up a safety reserve against illness or unemployment, and for their old age.

• Also appearing as "household savings" is the accumulation of the operating business capital for new private ventures (including unregistered, gray or black businesses).

• The savings-to-earnings ratio of the higher-income strata is generally higher than that of the lower-income strata. So it can be assumed that the income differentiation that took place in recent years tended to raise the average savings rate. All these tendencies can be expected to continue.

What can be concluded from this in terms of an economic policy aimed at overcoming the recession? It would be a mistake to work for a growth in consumer demand through unbridled wage rises. Though perhaps popular initially, it is a dangerous weapon that can easily overshoot the target.

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(21) Household savings can be described by a variety of stock and flow indices. Let us take here just one stock indicator, used in Hungarian financial statistics: the "net financial position" of the general public, *i.e.*, the household sector. The indicator is calculated by subtracting total debt from accumulated gross savings (whose main components are cash, savings deposits and securities). This index suddenly grew in 1991 and in the first part of 1992; a contribution was certainly made by the strong incentive given to pay back housing loans immediately.

Even after the easing of the sharp rise, the net position of the general public in real terms shows a great increase since three years ago: it was 71% higher at the end of 1992 than at the end of 1989. (Source: communication with the National Bank of Hungary and Magyar Nemzeti Bank, 1993, p. 122.)

(22) Some hypotheses that seem convincing are advanced in this respect in an article by J. Király (1992), and I also make use of these in what follows.

There could also be an unexpected change in the spending-saving ratio, so that a still greater volume of intended spending spills onto the market from the excessive surplus of income. This would not only boost production, but price rises as well, leading to a big inflationary push. There is still a great need in the future for moderation and sobriety on the part of employees and organizations representing them. But if excessive wage pressure should appear after all, let us hope the employers (including the biggest, the state) will put up resistance.

Rash handling of wages would affect employment unfavorably as well. There is a generally recognized macroeconomic connection here. Very many firms would be obliged to dismiss workers if they were burdened by too high a wage bill under the present cost and labor productivity conditions.

Although there is still a need for caution and discipline over wages, there are some well-aimed measures that could help households as well to contribute by their economic decisions to overcoming the recession. The government and the financial sector, which is still mainly in state hands, have not shown enough initiative in this respect either. Let me give just a few examples.

- More should be done to ensure that the banking system is not the exclusive route by which private savings can turn into investment. Households should be involved to a greater extent in the capital market, primarily through the mediation of investment funds, insurance companies and decentralized pension funds. This would tie down and so stabilize a high proportion of savings.
- Here let me repeat something mentioned before: it is desirable for a sizeable part of the savings by households to be used for financing housing construction.
- As a legacy from the socialist economy, too little scope is left in all the postsocialist countries, including Hungary, for consumer credit, which is far more limited than it is in the mature market economies. The spread of consumer credit can provide an easily controllable increase in demand, with favorable effects on production.

3) Government consumption[23]

The state budget, from which government consumption is financed, has become a constant topic in day-to-day politics. This study is not a contribution to these debates. I remain within the bounds of my subject by dealing exclusively with the relationship between the budget and the recession. Looking beyond the immediate situation, I examine a few more general problems concerned with this relationship.

Hungary is in a vicious circle. Declining production is necessarily joined by declining state revenue, while most state expenditure is not related directly to the quantity of production. So a recession may produce a budget deficit in all economies. But once the deficit is there, it becomes hard for a government to bring itself to inject into the economy a fiscal stimulus, which is the most obvious method of overcoming the recession quickly.

It has been a truism since Keynes's day to suggest that it is advisable in times of recession to take fiscal measures to raise macrodemand, even at the cost of a budget deficit. The policy of governments that raised taxes and cut spending during the contraction phase of the trade cycle were described subsequently in the works of economic history written in a Keynesian spirit as gravely mistaken, because these measures reduced total demand.

This line of thinking suggests the following statement. If the deficit had been lower in past periods (if spending had been less and revenue more) and all other circumstances had been equal, the fall in production would have been greater than it actually was. The budget deficit acted as an anti-cyclical stabilizer.

The same line of thinking gives rise in the short term to the following conclusion: it would be dangerous now to reduce the deficit quickly and to a large extent (assuming the administration were capable of doing so at all). A rapid and drastic cut (for instance by a sharp increase in

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[23] The "government consumption" category (*i.e.*, total government spending, minus governmental investment expenditures) does not coincide exactly with the statistical category "collective consumption" (see Table 9), although there is quite a large overlap between them. There is a third category, "total budgetary expenditure", which differs from both, for one reason because it includes the investment financed from the budget as well.

It is not the task of this study to compare these categories in detail or work out the numerical deviations between them. What I have to say is confined to presenting qualitative tendencies. These appear most of all in the part *common* to all three expenditure aggregates, *i.e.* the collective consumption financed out of the budget.

taxes) would suddenly reduce the macrodemand and abruptly push the already very deep recession even deeper. In saying all this, I do not want to ignore all the well-founded arguments about the seriously damaging nature of the budget deficit. It entails an inflationary risk; moreover the financing of it squeezes out the investment so necessary for recovery and growth. I merely want to draw emphatic attention to the existence of a direct connection between these two grave diseases in the Hungarian economy: the recession and the budget deficit. Treating one problem without sufficient circumspection will have harmful side-effects and may hinder recovery from the other disease.

It is far from my intention to encourage a deficit increase. On the contrary, the goal must be to take concerted measures to whittle down the main totals in the budget, *i.e.* to reduce expenditure, revenue and the deficit concurrently. But an eye must be kept on the following: the reduction must happen in such a way that the demand lost from government consumption is replaced, if possible in full, by investment demand. The hope is that this desirable reallocation of resources will be ensured from a future reduction in the credit demand for financing the budget, in other words the mitigation of the crowding-out effect. This must be combined with a rise in the proportion of investment spending within total budgetary spending at any time. In this case there will be a favorable rearrangement of the composition of aggregate demand. Total investment demand of all sectors (governmental, business and household) will have more beneficial multiplicator effects than the demand from government consumption.

4) Exports and imports

The logic of the discussion has left foreign trade until last, although there is no doubt that of all the events inducing the recession, the serious decline in trade with the former Comecon countries, including the breakdown of the former Soviet market has caused the greatest upheaval [(24)].

Some of the authors dealing with the question have described this occurrence as an "external shock". In my view this is not an apt name for it. It is certainly true that the shock from foreign trade is external to each country concerned in a geographical sense, but all the characteristics of Comecon trade can be traced back to the fundamental features of the socialist economic order; its effect is deeply imbedded in the regularities

(24) An attempt to quantify this effect numerically was made in a study by D. Rodrik (1992).

of the system. The sellers' market was able to work because there was a Comecon buyer even for the articles least desired at home; if all else failed, the sale could be forced by a tie-in. The expression "external shock" is normally applied to an event that suddenly appears and then vanishes again, so that the economy, after some adjustment, gets over it and continues from where it left off before the shock. The collapse of Comecon trade, however, has lasting, definitive effects. The structure of these economies must be altered once and for all before they can prosper without it.

Table 9 shows plainly that of the main components of macrodemand, exports fell back the most, even more than investment. The Hungarian economy successfully took the first steps of adjustment, proving capable of redirecting a very high share of its export potential to the OECD markets (*Table 12*). This made sure that the Hungarian economy stayed on its feet, that the fall in production did not assume catastrophic proportions and the country's international payments position consolidated.

Table 12

Destination of Hungary's exports

	EC	(Former) Comecon	Other
	Share of total exports (%)		
1987	19.8	50.2	30.0
1988	22.5	44.8	32.7
1989	24.7	40.8	34.5
1990	33.5	30.2	36.3
1991	40.3	25.7	34.0

Sources : K. Dervis and T. Condon : (1993). Data based on IMF Direction of Trade Statistics.
Note: Figures for 1991 through to the third quarter. According to the export data of the Hungarian National Bank, which are calculated on the forint value of Hungary's exports, the share of EC countries in the total Hungarian exports was 49.7 percent in 1992. (Magyar Nemzeti Bank, 1993, p. 71.)

Unfortunately this cavalry attack cannot be sustained; the growth rate of exports has already slowed down, and the first warning signs of a decline can be discerned. We are unlucky, because a recession (far milder than ours) appeared in the Western world just at the time when we had the greatest need to expand onto their markets.

Another problem is that the first great advance was made according to the old formula : "export at any costs". Many firms, particularly in the state sector, shouldered great losses in forint terms just to be able to export and not have to shut down production. But this cannot continue in the future, as the budget constraint hardens. Instead the struggle now must be for all possible additional exports that are really profitable without a state subsidy. On the other hand, the restriction of domestic demand has eased somewhat, so that firms sense to a lesser extent that they have to export or perish.

On top of all this are the serious problems with agricultural exports, which have been caused by several factors: not merely the unfavorable weather, but the growing tendency to protectionism shown by importing countries, and the crisis in agricultural production discussed earlier in the study.

I agree with those who say that exports constitute one of the growth-inducing branches for small open countries in the long term. But it is another matter to decide to what extent exports can contribute under the present circumstances to the urgent short-term task of overcoming the recession as soon as possible. Some of the means mentioned earlier in connection with the stimulation of investment can self-evidently be applied to exports as well. Particular attention should be paid to the private investments aimed at producing for export as well.

Detailed analyses do not support the proposition that imports always squeeze the domestic producers out of the domestic market. There are examples of this, but it is far from general. A whole range of firms without an import rival have sunk into deep crisis, and on the other hand, many firms manage to carry on producing and selling successfully in spite of competition from imports. None of this is an argument against giving temporary protection to some domestic product or group of products on a considered basis of economic rationality, not under pressure from lobbies. This can contribute to curbing the recession. But the protection must only be temporary, until the necessary adjustment has been made, and in line with the prescriptions of GATT, the international tariff agreement, so that it does not lead to protectionist retaliation by foreign trading partners.

The concerns about both imports and exports make it necessary once again to rethink the exchange-rate policy. If the present policy of allowing real appreciation of the Hungarian currency is continued, the chances for exports and domestic production facing import competition may deteriorate further, which will tend to deepen the recession. The campaign against recession must include a revision of the exchange-rate policy [(25)].

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(25) This idea is argued in detail in a study by G. Oblath (1993); I agree with its conclusions.

Devaluation is known to give a boost to inflation [(26)]. Whichever way Hungary goes, either one problem (recession) or the other (inflation) will get worse. This dilemma arises in connection with most of the measures to be considered, and so it must be faced also in its more general form, which the final chapter of the study will do.

To sum up the second chapter, it can be established that the contraction observable in all four components of macrodemand is largely the result of the transformation process itself. But a role in the development of macrodemand is also played by the economic policy of the state; the severity of the recession is partly attributable to errors and mistakes on the part of the government.

CONCLUSION

1) Priorities

In my view there are now grounds for reorganizing the priorities. Two or three years ago, there were very strong political and economic arguments in favor of the following priorities:

1) The increase in indebtedness had to be halted; the country's international liquidity position had to be improved.

2) Inflation had to be slowed down as much as possible.

3) Unemployment had to be "handled" from the point of view of welfare policy.

Neither the political statements and government programs nor the writings of economists included among the urgent priorities the need to guard against recession, or later the need to halt or combat the recession.

I now propose the following new priorities:

1) We must forestall any further recession. Recovery from the recession must be promoted. The economy must be diverted onto a growth path. As a likely by-product of this, perhaps after some delay, unemployment will cease to increase, after which employment will start to grow.

2) We must prevent a renewed acceleration of inflation. The inflation rate must be gradually brought down to the 12-18% band known as the

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(26) The inflationary effect is particularly serious if nominal wages are allowed to rise to compensate for the devaluation. So a condition for the success of the exchange-rate policy is that it should be based on a social consensus.

range of "moderate inflation" (27). The attainment of single-figure inflation must be taken off the agenda for the time being. Preparation for this will become opportune once the economy is on a growth path again.

3) We need not work for a further sharp reduction in the total stock of foreign debt or rise in the foreign-exchange reserves (28). A slight deficit on the current account is tolerable temporarily, although any marked deterioration on the balance of payment must be prevented, and we must not enter a new spiral of debt accumulation.

I have tried to phrase these new priorities as accurately as possible. On the basis of bad experience in the past, I would like to protest in advance against the eventuality of any opponent of mine in debate twisting one or other of these a little and leaving out some qualification, in order to take issue with my proposals presented in a distorted form (29).

There is no justification for relaxing attention to inflation and the balance of payments. In fact the danger of inflation and accumulation of debt will be greater than ever before, precisely because measures are being taken against recession. Countries that only have to cope with one of these three painful problems–only with inflation, for example, or only with recession and the accompanying unemployment–are in an enviable situation. The Hungarian economy is suffering from several grave problems at once, which makes it extremely difficult to decide what to do, because whichever way we take, the desired beneficial effect will be accompanied by undesired side-effects. It is impossible to find a solution satisfactory in every respect. The only choice before us is to decide which disease to devote most attention to treating in the immediate future, which disease we consider most acute.

I would like to say a separate word about the problem of inflation, where some disquieting phenomena are appearing. There is a danger of inflationary pressure entailed in the rapid rise in the money supply

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(27) Experience in many countries shows that an economy can remain within this band for several years without reaching single-figure inflation, but still avoiding the danger of a renewed acceleration of inflation. See the study by R. Dornbusch and S. Fisher (1993) on this.

(28) This last proposal should be understood as follows. The yardstick is not the absolute size of the exchange reserves, but the ratio between them and the volume of imports. Point 3 embraces the suggestion that it is not worth increasing this ratio further.

(29) Inaccurate interpretations have not been confined to my opponents in debate. When I presented this line of argument in public in Budapest, one daily paper in a short report interpreted the priorities I put forward as a *temporal sequence*. According to the report, I was proposing that growth should be achieved first, then after that had happened, we should defend ourselves against inflation, and when that had been done, we should tackle the balance of payments. In fact these are simultaneous tasks.

(notably the high-powered money, *i.e.*, "monetary base") and the accompanying "surplus" of money building up in the banking system. The rate of inflation is easing more slowly than expected and promised by the government. So the emphasis throughout this study is on "growth-friendly" measures that might give a boost to production *without* causing a general rise in aggregate demand, *i.e* ones less prone to have side-effects that speed up inflation.

My proposal is a *half-turn* towards growth, not a U-turn in which our backs are turned to the earlier priority tasks of tackling inflation and the growth of indebtedness. This cannot be confined to adopting "half-turn" as a slogan. To make it will require a convincing, detailed, practical program whose implementation must begin at once.

What justification is there for rearranging the priorities? It would be a shame to commit the big mistake of rigid thinking. These economic-policy tasks, whether expressed in the earlier or the present set of priorities, are not among the *ultimate* goals and primary values of economic activity that must be stuck to at all times. They are *intermediate* goals and instrumental values that need choosing in a way appropriate to a specific situation and rearranging if the situation alters. No universally, eternally valid order of priority can be established between production growth, reduction of unemployment, curbing of inflation, or improvement of the international payments position. So the question at the beginning of the paragraph could be put more specifically like this: what alterations in the *situation* justify reappraising the priorities? Let me pick out a few circumstances.

First, as I pointed out in the introduction, the recession has proved much deeper than anyone expected two or three years ago, and protraction of it cannot be ruled out. This is causing very serious damage. The country is suffering from a variety of problems: technical backwardness, widespread poverty, with the threat of further worsening of the financial position of the poor, neglect of the health service, education and infrastructure, and so on. None of these problems can be solved satisfactorily by redistribution, by transferring from elsewhere resources to carry out tasks that have been put off or neglected. Only a growing economy can slowly but surely resolve these and other problems not mentioned here.

Secondly, while the private sector is the force for overcoming the recession on which we can most rely, insufficient demand is already holding back private-sector development as well. It is increasingly hard for many private firms coping with the difficulties of start-up to keep their heads above water [30]. If the total volume of the private sector's production should start to decline, the prospects for recovery would become almost hopeless.

The third (and possibly weightiest) factor is that the reduction in the real income of a sizeable proportion of the population and the previously unknown phenomenon of mass unemployment have produced broad economic discontent. If the strength and extent of this discontent reaches a critical threshold, it will pose serious dangers for the young Hungarian democracy. Politicians have several times warned that there could be a "Weimarization" of the postsocialist region, including Hungary [31]. It should be remembered that they were mass unemployment and waves of inflation in Weimar Germany that led to mass disillusionment and rejection of the institutions of democracy and the parliamentary system. This economically-induced disillusionment provides a fertile breeding ground for demagogy, cheap promises and desires for iron-handed leadership.

We must guard against Weimarization in the political and ideological sphere. Not as a substitute for political action, but as a parallel effort conclusions need to be drawn in terms of economic policy. This is what half-turn proposed in this study sets out to do.

2) Confidence and credibility

There are political and social-psychological requirements for an economic recovery. This is not an assumption suggested only by politicians or experts outside the economists' profession, like psychologists or sociologists. The truth in this realization has penetrated fully into modern economics as well. It is worth drawing attention to the following connections:

• Study of expectations has come to the fore in modern macroeconomics. In the first wave of studies concerning the Phillips Curve, it was thought that all disinflation was plainly accompanied by a specific rise in unemployment. Since then, however, a modification of the theory has been devised. There is already general acceptance for the view that the

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(30) This concern was voiced by the heads of the biggest private companies in Hungary, who referred to "the private sphere contracting because of the recession" and drew attention to the fact that the economic decline was making it impossible to attain the turnover required to finance the debt stock of the large firms which had rapidly expanded. (See Sz. Hámor, 1993.)

(31) In my reading, I first encountered this expression in an article by G. M. Tamás (1990).

Phillips Curve can shift depending on the inflationary expectations [32]. The more the actors in the economy expect the inflation to continue, the greater the unemployment sacrifice required to overcome that expectation. The more they believe that inflation will decelerate, the smaller the sacrifice required. Applying this line of thinking to our case, the following can be established: parallel progress in both growth and the macro equilibrium can only be made if the government program to achieve this has credibility in the eyes ofthe actors in the economy. [33]. But if people expect that the recession and the inflation will continue whatever the government may promise, the expectation will be self-fulfilling.

• Keynes and other economists underlined that optimism–confidence that the economy will pick up–is required to reinforce the propensity to invest. In this connection it can be said that either optimism or pessimism will be self-fulfilling.

• A feeling of stability, a knowledge that the existing laws and institutions are lastingly stable, not fickle or arbitrarily changeable is needed to strengthen the propensity to invest, and beyond that for business activity on a private-ownership basis.

Unfortunately there are great troubles with these socio-psychological phenomena. For the sake of illustration, I mention only one study. From *Table 13*, showing some results of an international opinion poll organized by Western researchers, the Hungarians emerge as the most pessimistic group of respondents.

Can this public attitude be reversed? Could a convincing government program backed by a broad political consensus emerge? This study was written in June 1993, nine months before the next parliamentary elections are due. It would be self-deceptive to count on this consensus in the months ahead, when political divisions and rivalries are likely to become sharper than before. It would be much more sound to expect (and even this is far from certain) that the situation will at least not deteriorate further, and that the political configuration after the elections will provide conditions more favorable to implementing a credible, confidence-inspiring program.

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[32] This theory was first expounded in articles by M. Friedman (1968) and E.S. Phelps (1968). New impetus to the examination of the connection between inflation and unemployment has been given since then primarily by the theory of rational expectations.

[33] The statement that the credibility of a stabilization program plays a decisive part in its success has been proved not only theoretically, but historically. This was proved with a force that swept all counter-arguments aside in a famous study by T. Sargent (1982) entitled "The Ends of Four Big Inflations".

3) The role of the state[34]

In theory there are two ways out of the recession: forward or back. *Back* means to restore the old structure of the economy with subsidies, support inefficient exports, sustain state-owned firms in financial crisis artificially and many jobs along with them, defend all domestic producers from import competition by protectionist means, and maintain unemployment on the job in the surviving firms and the low productivity that goes with it. This constitutes overcoming the recession by abandoning further transformation and partially restoring the old economic system. If we now ignore the political conditions, this is certainly a program that in economic sense can be realized by a combination of "hyper-Keynesian" demand-inflating monetary and fiscal policy with bureaucratic interventionism. Ideas of this kind appear in several places, tinged with the various colors of the Hungarian political spectrum.

The way *forward* out of the recession is to try and get over the gravest difficulties, in other words to eliminate the loss-making jobs and concentrate our energies on ensuring that the private sector expands, new, efficient jobs are created, the necessary structural adjustment takes place, and profitable exports develop.

But even among those who agree with the progressive line that requires a consistent transformation, two views can be found on the strategy to be followed. In one, the confidence in the spontaneous force of the market and private initiative is very strong. It is a matter of waiting before the internal forces of the economy lift the economy out of the trough. These forces are so strong that they can prevail even against an incompetent government that makes repeated mistakes. I must admit that I myself inclined to this view for a good while, all the more because I share the attitude of those whose past experience leaves them with little confidence in governmental wisdom.

But I am now obliged to adjust this perhaps too doctrinaire position somewhat. I am induced to do so by awareness of the political danger of "Weimarization", mentioned in the previous section. Another argument

(34) Here and elsewhere in the study, I mean by the "state" the ensemble of all the branches of state power (the legislature, government and judiciary). I underline this because many readers will follow ingrained habits and immediately identify the "state" with the government of the day, not taking into account the roles of Parliament, the head of state and the courts, including the Constitutional Court, as "checks and balances" on the government. These have great powers, and share responsibility for the development of the country with the government.

Table 13
Sense of personal optimism/pessimism in western and eastern european nations in 1991[a]

Countries	Personal optimism or pessimism					
	Progress[b] %	Neither %	Decline %	Optimism[c] %	Neither %	Pessimism %
United Kingdom	43	28	29	51	37	12
France	36	34	30	42	39	19
Italy	41	34	25	51	32	17
Spain	34	43	23	39	48	13
West Germany	45	38	17	42	46	12
Bulgaria	16	24	60	56	20	24
Czechoslovakia	29	22	49	41	33	26
East Germany	34	33	33	62	29	9
Hungary	18	25	57	26	40	34
Poland	27	21	52	36	40	24
European Russia	21	22	57	40	36	24

Sources : M. Kaase (1992, p. 23.), on the basis of Times-Mirror (1991, 21-23, tabular appendix). Missing data for the past and present averaged one to two percent. The future was not assessed by an average of 20 percent. Cases with missing data were excluded from this calculation.

Notes: [a] "Row percentages", Cantril-type, 0–10 ladder scale. [b] Progress/Decline is based on a comparison of five years ago/today. [c] Optimism/Pessimism is based on a comparison of today/five years from now.

for adjusting it is a recognition that simply to await a spontaneous, self-engendered movement in the present political and economic situation in Hungary could set what is known in economics as a "low-level equilibrium trap". This state in Hungary's case would bear the following characteristics:

There would be a prolonged slackness of the propensity to invest. Mass unemployment would stabilize at a high level and the utilization of the other resources would also be low. The growth of the private sector would stick at its present level for lack of enterpreneurial spirit. Foreign capital would lose interest in investing in Hungary. The fiscal crisis would be perpetuated; there would be insufficient money for infrastructural development, education, medical care and welfare services. The budget deficit could not be overcome without production growth, but production would be unable to grow because of the high taxes and the crowding-out effect of the budget deficit. There would be repeated surges of inflation, followed by repeated painful measures to slow it down. Although the slump in the economy would halt, but it would be unable to climb out of the trough.

This is no mere nightmare. There are countries in the Third World where this slow stagnation has been typical for a long time. Whatever happens we must climb out of the trough, and economic activity by the state is essential for doing so.

I am no advocate of superabundant state intervention and bureaucratic micro regulation. This would lead to the very endeavour from which I strongly dissociated myself just now: combatting the recession by partially restoring the old system.

It is worth referring, in my view, to two grades of justified and desirable state engagement. The first grade, in fact, is no more than what the state should do in a modern market economy even according to a libertarian concept: introduce laws and ensure they are enforced, pursue a fiscal and monetary policy, and exert supervision where this is essential (for instance over the financial sector or the natural monopolies). It must do all these things in such a way that they serve the priorities of the present day.

The second grade expects more than this from the state during the post-socialist transition. It must *initiate and actively assist* the development of the new institutions required by a market economy, the establishment of certain new organizations and abolition of others, and the transformation of property relations. The study has put forward plenty of examples of these as well.

So I do not support those who propose that the state should do nothing. That would relieve of responsibility both the legislative and executive branches of power. Within a well-defined field, the state should certainly do its job. If the recession accompanying the transformation proves too protracted and involves too great a loss, the government is also responsible for this.

4) The responsibility of the economists' profession

In a time of sharpening political struggles, there is a danger that politicians in government may opt for measures which are harmful in the long term but popular in the short term. There is similarly a danger that opposition politicians may try to turn public opinion against the government by making extravagant promises. At times like this, an even greater responsibility devolves on research economists, who have a professional duty to speak out against both these threats.

During the public debates taking place on the recession and the country's economic situation in general, many politicians and political journalists, along with some researchers as well, have "dug themselves into ideological trenches," as Tibor Erdös graphically put it [(35)]. An atmosphere of mutual suspicion prevails. Those who talk about "stimulation" are suspected of supporting the government, while those who mention "restriction" are classed as liberal oppositionists. Erdös emphasizes that researchers should not climb into any ideological trenches, but retain their objectiveness and express views in accordance with their convictions. A similar opinion is expressed by Rudolf Andorka as well, who points out that "there is no single redeeming economic-policy recipe. Pragmatism is required; ideologies and dogmas cannot be allowed to determine economic policy [(36)]."

I fully agree with this position. Many of us feel fed up to the back teeth with the "labelling" that has become prevalent in economic debates. The dogmatic application of half–digested economic theories and in addition the habit of classifying various theoretical schools around the present party structure in Hungary (this party is Keynesian, that party is Friedmanite), has a toxic effect on objective research.

The problems that have to be solved are extremely difficult and unprecedented. We can all make mistakes. That means there is all the more need for composure and rational argument.

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(35) See T. Erdös (1992, p. 1000).

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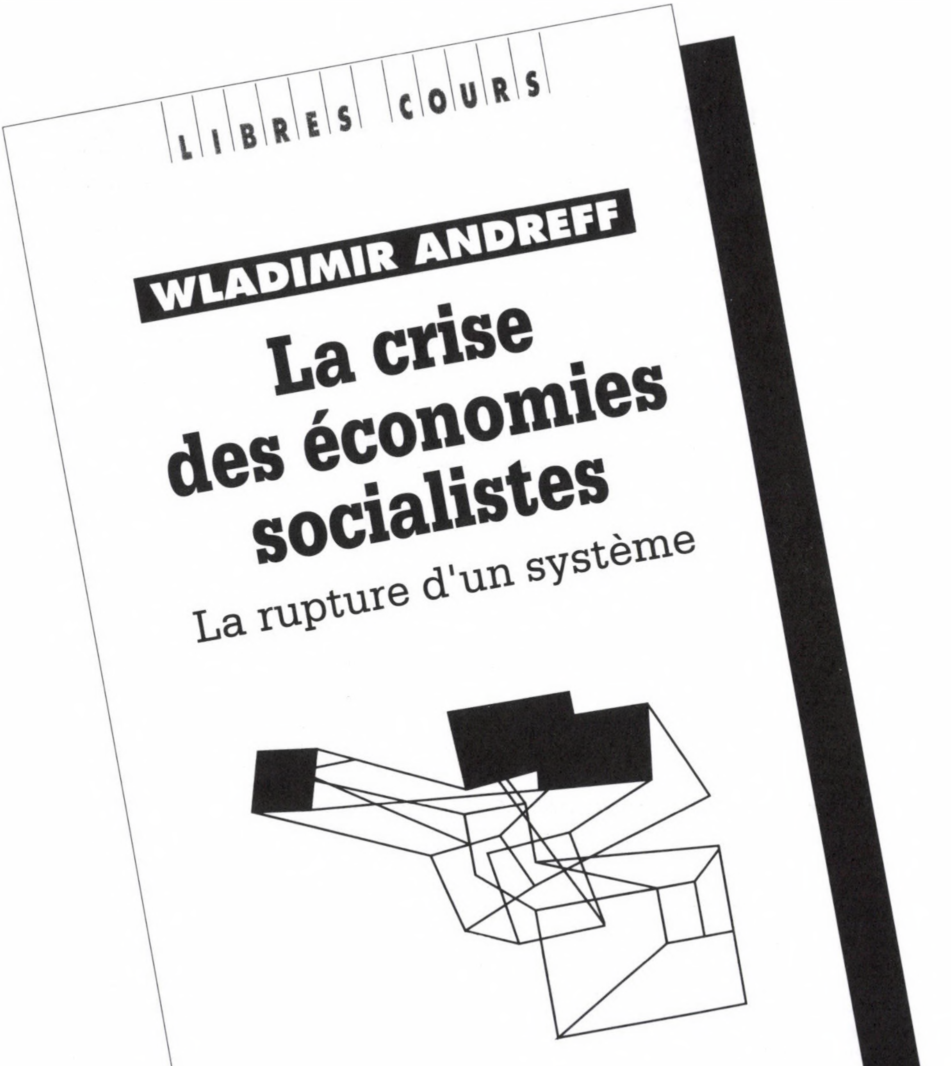

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