中央研究院經濟研究所

I E
A S

經濟論文

臺灣　臺北

第二十四卷　第一期（中華民國八十五年三月）

專 著

稿約

一、「經濟論文」為季刊，每年三月、六月、九月及十二月各出版一期。

二、投交本刊之中、英文稿件一經接受，作者應依「經濟論文規格說明」修改論文格式。該「規格說明」函索即寄。

三、本刊每期印刷時，將抽印當期發表之論文各五十份，連同當期本刊五本致送作者。

四、經本刊發表之論文，作者應對其中表示之意見單獨負責。

五、來稿請寄台北市南港區（11529）中央研究院經濟研究所「期刊編輯委員會」收。

中央研究院經濟研究所

經濟論文

第二十四卷　第一期

中華民國八十五年三月

中央研究院經濟研究所

經　濟　論　文

第二十四卷　第一期　（中華民國八十五年三月）

目　　次

ACADEMIA ECONOMIC PAPERS
24 : 1 (March 1996), 1–44

GROWTH AND MACROECONOMIC DISEQUILIBRIA IN HUNGARY*

János Kornai

ABSTRACT

This study examines five macroeconomic tensions – the problems of inflation, unemployment, budget deficit, balance-of-payments deficit, and falling production. However, it does not cover all the essential questions of the Hungarian macro economy; monetary policy, for instance, is ignored. The article's leitmotif is that a resolution of all these disequilibria will be aided if production steadily grows, and so each problem is analyzed principally from this point of view. 1/ Hungary's inflation is basically inertial in nature, which makes it especially important to end automatic wage indexation and to curb wage increases. A steady change must be made in the ratio of consumption to investment, to the benefit of the latter. 2/ Reduction of unemployment is being impeded by high labor costs, with wages paid attracting very high taxation. 3/ Consistent efforts must be made to reduce and then eliminate the budget deficit, one requirement here being steady growth. The central problem in Hungarian fiscal policy is the unrealistic scale of the state's welfare commitments. Hungary is a premature welfare state. Redressing this disproportion entails major political difficulties. 4/ The balance-of-payments deficit causes a grave problem. To overcome it calls for a better exchange-rate policy, coupled with a structural alteration of production that helps to promote exports and reduce the import demands of production. 5/ This study takes issue with the strategy of first seeking to remedy the disequilibria and only aiming for growth at a later stage. These are concurrent tasks: measures to stimulate growth must not be postponed.

---

* I am grateful to András Malatinszky and Brian McLean for the translation, and to Mária Kovács for her assistance in the editorial work.

1. INTRODUCTION

This study looks at the problems of five macroeconomic tensions: inflation, unemployment, the budget deficit, the balance-of-payments deficit, and the decline in production. Although it is quite lengthy, it still does not offer a full picture, since it does not address a number of important issues (among others, the question of monetary policy). Analyzing these five macroeconomic tensions provides a chance for me to comment on the Hungarian government's economic policy.

2. INFLATION, UNEMPLOYMENT AND WAGES

There is a well-known close connection between the rate of inflation and the extent of unemployment. Assuming other factors (including inflationary expectations) to be constant, inflation can be slowed at the cost of increasing unemployment, and conversely there are means of reducing unemployment associated with an acceleration of inflation as a side effect. Unfortunately, our economy has both these significant indicators stuck in a bad position. Inflation has slowed since its peak of a 38.6% annual rate in June 1991, but has become stuck in the 17-25% band of moderate inflation, see *Table 1*. The unemployment rate rose steadily from 1990 until February 1993. Although it has fallen slightly since then, it still stood at 11% in June 1994, see *Table 2*.

The emphasis here is not just on the regrettably high values of the two indicators at this moment, but on the fact they are *stuck* at these high levels. There is a danger these high values may become habitual, shaping the behavior of the actors in the economy.

Let us consider inflation first. Hungary became affected by this unfortunate process for a great many reasons which I will not attempt to analyze here. I will not examine comprehensively all the conditions for curbing and slowing inflation, but concentrate instead on a single, though very important problem.

Table 1. Consumer Price Indices in Hungary, 1980–1994

Year	Annual average 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	22.5
1994	
January	17.0
February	16.6
March	16.8
April	17.3
May	18.3
June	19.2
July	20.0
August	19.5

Source: *Magyar statisztikai évkönyv* 1990 (Hungarian Statistical Yearbook 1990), p.218. and *Statisztikai Havi Közlemények* (Monthly Statistical Reports), 1994, No.6, p.103; communication by the Central Statistical Office, Budapest.

Note: The 1994 monthly data shows the change since the same month of the previous year.

Table 2. Vacancies and unemployment, 1990–1994

Month		No. of Vacancies	No. of Registered Unemployed	Unemployment rate (%)
1990				
	March	34048	33682	0.7
	June	37859	43506	0.9
	September	26969	56113	1.2
	December	16815	79521	1.7
1991				
	March	13583	144840	3.0
	June	14860	185554	3.9
	September	15351	292756	6.1
	December	11529	406124	8.5
1992				
	March	15124	477987	8.9
	June	25346	546676	10.1
	September	25634	616782	11.4
	December	24097	663027	12.3
1993				
	March	26471	693983	13.3
	June	30771	657331	12.6
	September	35784	669761	12.9
	December	28089	632050	12.1
1994				
	March	33341	610994	12.2
	June	38141	549882	11.0
	August	39500	550800	11.0

Source: Reports from Hungary's National Labour Center, 1990–1994.

The type of inflation we are dealing with in Hungary can already be described as "inertial", since it is propelled by the inertia of the trend in wages and prices. Practically speaking, wages are indexed: earlier inflation is projected forward into the future and full, or almost full, compensation is made for it in advance. In fact, there has been a case of over-compensation, in the first half of 1994, when the year-on increase in consumer prices in May 1994 was 18%, while nominal average earnings had risen by almost 21% in the same period, and nominal earnings net of tax had increased even more. The increase in wages is exerting upward pressure on prices, turning on the wage-price spiral, and making inflationary expectations self-fulfilling.

Connected with this are the currency devaluations. If they are not radical enough, the HUF will appreciate in real terms (with harmful effects considered later on in the study). If there is a real devaluation, on the other hand, and this spills over into wage increases to compensate for price increases, it becomes an impetus behind inflation again. The spiral of mutually induced inflation and repeated devaluations turns round and round.

It must be said categorically that the key to the situation lies in the trend in wages, where two separate questions – the issue of nominal and real wages – need to be distinguished. (Unfortunately, these have been confused both in official statements and in debates ensuing from them.)

Taking nominal wages first, let us imagine an ideal case in which all sides concerned agree there will be no price and wage increases at all for six months from a set point in time, say January 1. Let us assume in this mental experiment that there is no delayed effect from earlier price and wage measures and other economic factors remain the same. In that case, if everybody trusted each other, believing all the other actors in the economy would keep their sides of the bargain and keeping theirs themselves, inflation would duly halt without any fall in real wages or real consumption. But a word of caution: the most critical item in this mental experiment is not the existence of zero change, the freeze in wages and prices, but the *credibility* of the sides taking part in the bargain. If one group or another tries to take advantage of the good faith of the rest, the agreement will collapse, and everything will start all over again.

I do not believe any such far-reaching agreement could be affained in the present situation. However, the closer we get to such a point of agreement, the more we will manage to slow down inflation.

Unfortunately, under Hungarian conditions, the problem of *nominal wages* ties up with another phenomenon: the fact that *real wages* and ultimately *real consumption* are higher than they are justified from an economic point of view. I realize this remark may elicit resistance or even outrage in many people's minds: how dare anyone, in a Hungary racked by poverty, call real wages and real consumption "too high"? Nonetheless, I must put up with the outcry and stick by my statement.

Consider the following simple, fundamentally important economic relation. The GDP can be used for two main purposes: consumption or investment. (Exports and imports ultimately serve to raise consumption and investment as well.) The share of investment in Hungary, and that of fixed capital formation as a part of it, has shrunk. It is much smaller than in countries that have enjoyed fast and persistent growth, the statement is backed by the international comparison in *Figure 1*. While the share of investment in rapidly developing Asian countries is persistently high, it steadily falls in Hungary. Unless we want to rely solely on foreign resources (I will return to the problems of this later), the ratio of investment to consumption must be altered in favor of investment and to the detriment of consumption.

The growth of the Hungarian economy is being jeopardized by the proportions of investment and consumption which have applied for so long and become deeply imprinted in the behavior of the actors in the economy and the mechanisms coordinating them. These proportions must be changed consistently and permanently, and the downward trend of the share of investment reversed.

Frequent mention is made in the debates about the "crowding-out" effect, whereby public spending deprives productive investment of resources. Without belittling this problem, I would like to emphasize that its importance is only secondary. Even conceptually, the distinction between the following three items should not be blurred: 1. investment by the state (fixed capital formation and increase of inventories), 2. "transfers" through the budget, does this mean "in addition to" or "more" wages and salaries paid out of state budget and 3. the material costs of public administration and the armed forces. In this context Item 1. must be added to the other types of investment and Item 2. to the rest of household consumption, while Item 3., though substantial, is not too significant by comparison with the vital problem of the ratio between investment to consumption. Investment is crowded out primarily by consumption, and only to a secondary extent by material expenditure of the state bureaucracy and the armed forces.

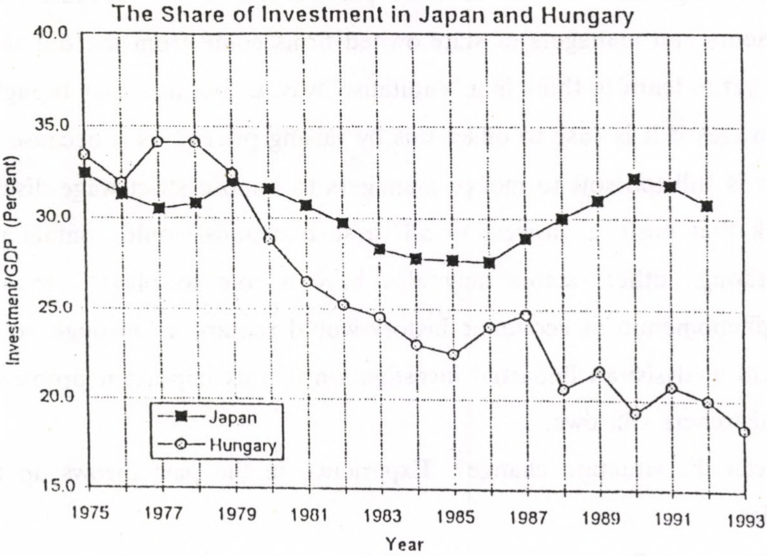

Figure 1

Source: *International Financial Statistics,* IMF, New York; issues of *Magyar statisztikai évkönyv* (Hungarian Statistical Yearbook) and *Magyar statisztikai zsebkönyv* (Hungarian Statistical Pocket Book), *Magyarország nemzeti számlái* (Hungary's National Accounts) by the Central Statistical Office, Budapest; and annual reports, National Bank of Hungary.

In fact, it is not easy to see why the present situation has arisen in connection with both nominal and real wages. Every economics textbook and all the experience of the market economies suggest that a recession as severe as the one which took place in Hungary, coupled with mass unemployment, should push wages down; in the presence of inflation, it should curb the rise in nominal wages and push down real wages. So why has this trivial connection had a merely dampening effect on real wages in some years, no effect at all in others, and actually let them move in the opposite direction, upwards, in yet others? Is it because the government, still the biggest employer, was scared by the taxidrivers' blockade of 1990 and did not dare to oppose the wage pressure for fear of losing popularity? Is it because the trade unions gained exceptional power after their success in the elections for social security boards and they pushed for ever higher nominal wages rather than for a compromise required from an economic point of view? Is it because many private entrepreneurs and managers of state-owned firms come from the old socialist elite and have yet to learn to think in a "capitalist" way, or because they thought, why not increase wages if it is easy to offset this by raising prices? Is it because the budget constraint is still too soft to induce managers to impose strict wage discipline?

I think that positive answers to all these questions would contain part of the truth (although other factors may also have a role to play). To explain this unusual phenomenon of economic history would require a thorough economic and sociological analysis; an impartial investigation of this important problem is a debt which researchers still owe.

How can the situation change? Experience in the past throws up three main possibilities.

The *first possibility* is a still deeper recession. Unemployment keeps growing in a rampant fashion, reaching a rate of 20 or even 30%. This untenable situation on the labor market eventually blocks the rise in wages, breaks the wage pressure, and restores the proportions required for production to recover. This is the most brutal version, which would be better to avoid, but it may be forced upon us by the market if the actors in the economy fail to act more wisely.

The *second possibility* is for the rise in wages to be curbed by administrative means. This was always the practice under the socialist system, and it went on for a while after the political change of 1990, although rather more loosely, in the form of punitive taxes on excessive wage increases. Later, state controls over wages were abolished completely, and in this respect Hungary goes further than quite a few capitalist countries, where from time to time administrative wage controls goes applied too to curb inflation. Although it is not unthinkable to use administrative means in today's Hungarian economy, there are several considerations that speak against it. We live in an economy that is only just starting to recover from the crippling effects of bureaucratic control; businessmen and politicians would presumably object to administrative curbs as a sign of "regression".

However, if neither the first nor the second course looks attractive, that only leaves the *third possibility*: voluntary restraint. There have been many examples of this in economic history: the self-restraining wage policy of the trade unions in post-war West Germany, the oft-cited example of post-Franco Spain, and the case of Mexico.

It is not my purpose in this study to analyze to what extent Hungary's current possession of a Socialist majority in Parliament and government is an advantage and to what extent it is a drawback from the point of view of postsocialist transformation. It would certainly seem, however, to have advantages in terms of wage and income policy. Hungary has a new government – after the second free election – based on the parliamentary majority of the Socialist Party. There is a chance that a government which has been elected to a large extent by workers and employees and with the help of the unions can expect more political support and can muster more moral capital for embarking on such restrictive measures. Much of the "government-employer-employee" conflict must be resolved "in house", within the Socialist Party leadership and among Socialist MPs.

The wage question will be a test of maturity for Hungarian society in the coming period. Will the government have the stamina to stand by its declared policy? What role will the unions play? Will they understand and be fully aware of their governmental responsibilities and recognize the imperativeness of economic circumstances, or will they come up with irresponsible demands?

The opposition parties will be put to the test, too. As far as the former government parties are concerned, having missed the chance to face the tide when they were in power, will they be strong enough to refrain from going for cheap popularity at least now when it is not their responsibility to carry out unpopular measures?

In the long-term, the trend in wages will ultimately depend most of all, of course, on the growth of production and productivity. Lasting growth is a fundamental requirement for any economic process to occur in a healthy manner. This idea, to use musical terminology, will reappear as a leitmotif throughout this study in connection with each macroeconomic problem considered. This is the point at which to sound this leitmotif for the first time: the tough self-restraint that holds back an improvement in living standards can only end once production and labor productivity are growing steadily, so that the expansion of real wages and real consumption can be covered out of this with a clear conscience, to avoid any misunderstanding, let me add that a restraint on the growth of nominal wages in order to slow the inflation and the wage-price spiral may be required as well even under circumstances of growth. An alteration of the investment-consumption ratio can be born much more easily if consumption also rises, but more slowly than investment.

Let us now consider unemployment. There are several reasons for it, but macroeconomics definitely teaches that one of the most important factors is the wage level. Wages (and as will be explained later, taxes linked to wages) greatly influence the level of costs and so the profits of firms. There is a critical threshold for profitability, and unless this can be reached at the prevailing level of costs, it ceases to be worth a firm's while to produce, regardless of who owns it, and it will lay off its employees instead. Wages and taxes linked to wages significantly affect the competitiveness of Hungarian production on domestic and international markets. They affect exports as well, and also thereby the expansion of the economy. To some extent there is a conflict of interest between the employed and the unemployed. The higher the wages are extracted for the employed have been extracted, the more people risk losing their jobs.

Here the leitmotif needs playing again: the main question is growth. So long as the economy continues to stagnate in terms of its aggregate production figures, the insider-outsider conflict, the job-destroying effect of relatively too high wages, will intensify. The reassuring solution is the creation of more and more jobs at a high and steady rate, and in greater numbers than existing jobs that are being eliminated by transformation of the economic structure.

3. THE BUDGET DEFICIT

Postsocialist economies are suffering from a series of chronic fiscal troubles.[1] I would like to focus in this paper on those most relevant in the Hungarian context, and especially on problems related to the decline of output.

I fully endorse the government's efforts to cut expenditure. I recognize the moral importance of this, as a demonstration that the state is starting its campaign of savings on itself. However the question after all is not one of moral lessons, but of acute economic problems to be solved, and from this point of view, cuts in expenditure, however commendable, are not in themselves going to relieve the major strains in the budget.

It is obvious from macroeconomic theory and from plain common sense that there is a strong, almost arithmetical relation between the budgetary balance and GDP. Most of the *expenditure* is not dependent on GDP, while part is, but with a negative sign in front of it. The more GDP contracts, the more expenditure must be allocated from the budget or financially related funds for unemployment benefits and other welfare benefits. On the other hand, the vast majority of *revenue* is related almost directly to GDP, and with a positive sign in front of it. The more GDP grows, the higher the revenue (even at unchanged tax rates) from personal income tax, general value-added tax, excise duties, corporate tax, social-security contributions, customs duties and so on. In the opposite case, if GDP decreases, these revenues will inevitably decline. It can therefore be said that in the short run, the budgetary balance is a function of the increase or decrease in GDP, and other factors have only a secondary effect.

As long as GDP contracts, a budget deficit will inevitably be reproduced. It is worth recalling the seldom mentioned fact that the real value of budgetary expenditure in Hungary has been falling steadily since 1989, so that by 1993 it was about 20% lower than it had been four years earlier, and yet the deficit has continued

[1] See, for example, R. I. McKinnon (1991), J. Kornai (1992), and S. Gomulka (1994).

to grow steadily. Here, let me repeat the leitmotif in my train of thought again: the budget deficit can only be eliminated permanently in an expanding economy. Growth is a necessary, though not sufficient condition for overcoming this tension. Unfortunately, the government program lost sight of this important connection.

The same reasoning can be applied in understanding government debt. It is impossible to decide whether the burden of debt on the budget, in terms of its absolute size, is great or small per se, in relation to a static moment in time. Like any debt, it represents a characteristically dynamic problem. If GDP increases and the main budget totals grow along with it, the same absolute amount of debt servicing will absorb a shrinking portion of budgetary revenue. On the other hand, if GDP is contracting and budgetary revenues shrink along with it, the same absolute amount of debt servicing will require an ever-increasing proportion of budgetary revenue. Thus, the main question is not whether the debt is high or low, but what the loans are being used for. If they promote GDP growth efficiently, they create their own resources for repayment and may even contribute to additional growth beyond that, but if they are used unwisely, they form an ever-heavier ballast for the taxpayers to carry.

The stock of debt will be self-proliferating while the real interest rate paid on government securities remains higher than the growth rate of the economy. In this case, the increasing debt servicing alone continually generates a budgetary deficit, the financing requirement for which increases the demand for credit and so drives up interest rates, which in turn curb investment, and along with it, growth. This line of reasoning explains the strong mutual relations between a budget deficit, government debt, rates of interest and growth, and the fiscal whirlpool that can pull the economy down deeper and deeper. Of course, efforts must be made to curb the growth of government debt and decrease the interest burden, but, ultimately, only an acceleration of growth can reverse the direction of spin, so that the economy escapes from the whirlpool instead of sinking deeper into it.[2]

The relation between GDP and state revenue applies almost automatically, but it is supplemented by a far from automatic relationship: the consistency and rigor with

[2] This line of argument is elaborated and supported by a quantitative model in G. Oblath and A. Valentinyi (1993).

which taxes are collected. The government program, very correctly, addresses this issue, promising to be more rigorous. Public opinion, let us face it, is ambivalent.

There are many ways to evade taxes. A common case is where firms, including major businesses, are seriously in arrears on their taxes, customs-duty and social-security payments. It is justified to call for strict enforcement, but it must be realized that this will have unwanted side-effects. It encourages price increases, because the firm wants to earn the money it owes, or if this is not possible, it may cause the firm to go bankrupt or into liquidation. This in turn causes jobs and production to be lost. These consequences are not welcome to those who call for speedy collection of taxes and other fiscal obligations.

The other common case is where small- or medium-sized businesses increase their income by various ruses such as failing to give receipts or register employees. The gain from the state may then be shared between the entrepreneur and the customer or unregistered employee. Thus, strict and consistent tax collection takes extra income not only from entrepreneurs who cheat on their taxes, but from hundreds of thousands of others who become accomplices by being customers in the grey economy and not demanding a receipt, or by working illegally and not insisting on registering their employment. The majority of those concerned are not among the poorest, at the bottom of the income scale, but much more commonly in the middle or even higher. The previous government did not set about a forceful action in detriment of these broad strata in society. Will the present government have the strength and the resolve to do so?

While on the subject of the budget, I would like to address two more issues. The first is the highly controversial one of the income received by roughly a million people employed by the state (about one-fourth of total employment). There are several factors to consider here, not least the stipulations of the law and the welfare position of those affected. Looking at the "employer's side", the problem is understandably tied up with the budget deficit, since it forms one of the largest items of public spending. It is also worth considering that the issue from a macroeconomic point of view boils down to two decisions. The first is the basic decision of how GDP should be divided between consumption and investment, for after all, the wages of employees paid out of the central budget are also sources of consumer spending. If the intended ratio has been attained in this respect, the second question, one of *redistribution*, presents itself. How much of total consumption should be allocated to employees paid out of the central budget, and how much should the rest receive ? The only way any group in society can obtain more from a given total of consumption is for others to receive less. Therefore, those who demand higher wages for employees of the state are not, in fact, arguing with the Finance Minister about the budget, but with the rest of the population about distribution of total consumption.

The other major set of budget-related problems is usually referred to in Hungarian parlance as "reform of the major distributive systems". It is easily understood by any seasoned political analyst why all politicians talk about this issue in general or veiled terms, as if their style were being cramped by the censors. This is one of the painful points in Hungarian society, where there is nothing like a real consensus. From my point, I have no ambition to enter Parliament or serve as a minister: I am not after votes, and so I can speak freely.

Nobody, not even an economist with rather strong laissez-faire principles, would go so far as to propose that the state abandon all its welfare functions. For the sake of clarity, strong simplification is applied; I compare two "pure" models.[3]

In one, the state only tries to assist those in need out of taxpayers' money. Although this condition cannot be applied with full consistency, the principle of need could be a guiding criterion when formulating the institutions of welfare, making laws and decrees, and allocating public expenditure. The principle is an attempt to carry into effect society's solidarity with the poor, the weak and the needy. The drawback is that means-tests have to be applied in some way, which in many cases is humiliating. Of course, the state assists other sections of society in helping themselves. It takes an active part in building up and in endowing with initial capital a broad network of decentralized insurance companies, health associations

[3] There is a growing literature and an ongoing debate on social policy in postsocialist economies. See for example R. Andorka, A. Kondratas and I. Gy. Tóth, eds. (1994), A. B. Atkinson and J. Micklewright (1992), A. G. Esping and J. Micklewright (1991), C. Kessides et al (1991), G. Kopits et al (1990), and I. Gy. Tóth (1994).

and pension funds (operating for the most part as non-profit institutions or as market-type businesses). The state retains responsibility for creating the legal framework under which these institutions operate and for arranging for their supervision. The division of the costs of welfare and social insurance spending between employers and employees still awaits legislative resolution.

The other pure model goes much further than this, and according to various other entitlement criteria, uses taxpayers' money on welfare benefits for citizens who are not dependent on them. Such entitlement criteria may include motherhood, multiple parenthood, a desire to study at a university, sickness, or simply the status of being a Hungarian citizen.

Current Hungarian practice is very close to the second model, in which the state plays an extremely paternalistic role, allocating taxpayers' money to welfare according to much broader and more comprehensive entitlement criteria than those of most other countries in the world. I used a phrase in an earlier paper of mine, which I would like to repeat here. Hungary under the Kádár regime (1956–1989) became a "premature welfare state".[4] Although this country was much less developed than the Scandinavian countries, the welfare commitments made by the state before the change of the system were equal and in some respects greater than theirs, see *Figure* 2. This trend the first freely elected Antall-Boross government did not change, and in fact it assumed further welfare commitments. So, far from approaching the first model, Hungary has been more and more moving in the opposite direction. A hitherto unprecedented degree of centralization took place in the pension and health-care systems, where almost no movement occurred towards decentralization and privatization. "Extra-budgetary", but centralized funds were created whose self-governing body is under dominantly trade-union control, however, any deficits in them must be automatically covered by the state out of taxpayers' money. The consequent system is unique in the world: nowhere else has so institutionalized and grandiose a "soft budget constraint".

[4] See J. Kornai (1992).

Per Capita GDP and the Proportion of GDP Spent on Welfare by OECD Countries and Hungary as a Proportion of the OECD Average (1990)

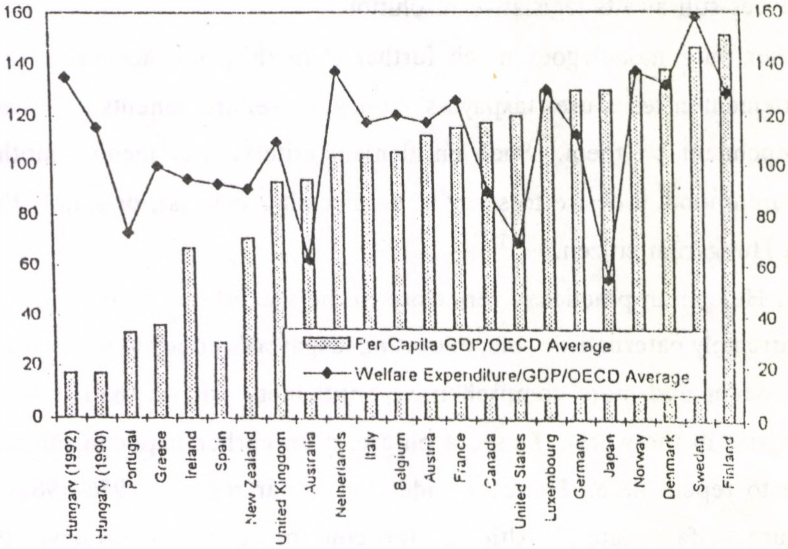

Figure 2

Source: István György Tóth, "A jóléti rendszer az átmenet idöszakában" (The Welfare System in the Period of Transition), *Közgazdasági Szemle*, April 1994, p. 322. The author's data is based on figures from the OECD and Hungary's Central Statistical Office.

Note: The calculations are based on figures for 1990, except in the first column, where 1992 figures are given for Hungary alone. The increasing height of the bars reflects economic development, Hungary being the least developed country on the chart. In its proportion of welfare spending, however, it is only exceeded substantially by Sweden, while Norway and the Netherlands are on about the same level. The comparison between the first and second columns shows how the gap opened further between 1990 and 1992.

The present situation offends many people's moral standards: why should taxpayers support those not dependent on it? However, the really serious loss concerns economic development, not ethics. This is the main reason why tax rates are high, especially rates of taxes and levies related and proportional to wages and other income, which are perhaps the highest in the world! This grave barrier to production growth, investment and job creation gives entrepreneurs a strong motive for keeping employment secret even at the risk of detection.

Of course, the advocates of the first model, of which I am one, do not believe it could be introduced all at once. It will take a long time to organize, and consideration must also be given to the ability of various groups in society to adjust. To give just one example, a different response to pensions can be expected from a young person at the beginning of a career who can really choose between various pension schemes, and from an older person who has no choice but to rely on the pension provided by the state. The reforms should certainly be carried out with patience, humanity and tact. Far be it from me to press for undue haste, but I must ask the new government nonetheless: at what pace does it intend to proceed with changes?

What I explained earlier in the study in connection with wage policy applies to this sphere of problems as well. The current political scenario actually offers a unique chance of resolving within the governing socialist party the conflicts of interest over discontinuing the "premature welfare state" and the excesses of the second model, and of waging "in house" the political battles concerned.

It would be a mistake, however, to consider this conflict simply as a power struggle between different trends. An approach to the first model, with a more consistent application of the principle of need, really conflicts with the momentary interests of broad sections of society. The needy would welcome the change. The really rich, I believe, would not protest against it, because relative to their income the loss would be negligible. The problem would arise primarily in the middle-ranking families which cannot be called needy, but would suffer appreciable harm from the loss of a few hundred or a few thousand forints. Will the new government be brave enough to make the change nonetheless? Will it begin, if not quickly, then gradually and tactfully, to move resolutely and consistently in this direction? Moreover, what will the former governing parties have to say? Will they become more socialist than the Socialists?

Here again, reference must be made to the leitmotif, the role of growth. There is the closest interaction between the reduction of the state's welfare expenditure and the growth of the economy. In one direction, excessive welfare levies and contributions act as a curb on enterprise. Like runaway wages, excessive welfare levies make it hard to reach the critical profitability threshold for viability, and still more hard for expansion and job creation. Ultimately, they postpone and curb growth. The more that welfare spending financed through taxes can be reduced, the greater the fall in employment-related production costs, and consequently, the greater the stimulus to job creation, the expansion of production, and in the end, the acceleration of growth. Of course, the force in the opposite direction is no less important: only growth can enable change to occur with less vehement opposition. As the standard of living increases, it becomes easier to surrender certain hand-outs from the state and to switch, at least partially, to voluntary insurance. While the standard of living of the middle strata is sinking due to stagnation or recession, they will understandably cling to their acquired rights to the bitter end.

Also worth mentioning here is yet another macroeconomic relation. Much has been said about how savings in Hungary do not cover investment and need encouraging more intensively. Most expert observers emphasize the role of higher deposit rates here. I would like to mention an additional factor: the very strong incentive to save that would come from partial decentralization, "marketization" and privatization of health care, pensions and other social benefits. People would understand it was they themselves, to a large extent, who had to set reserves aside for sickness, old age or unforeseen expenses. Some formation of reserves of this kind takes place through the accumulation of money in bank accounts or liquid securities. The rest is done through intermediaries. Citizens buy insurance and join decentralized pension funds and medical insurance schemes, so that these institutions perform the saving and investment functions at their behest. In a mature market economy, the demand and need to form security reserves is one of the main incentives for saving. Unfortunately, this type of saving was curbed by the paternalistic practices of the past.

Getting back to the budget, the really great opportunity for cuts on the expenditure side is the switch from the *paternalistic model* to a consistent application of the *principle of need*. However, this is not likely to contribute to easing the budget deficit. This it cannot do in the short run, as I have mentioned, since the change will certainly take a long time to occur, and it cannot do so in the long run because one of its aims is precisely to allow lower tax rates by reducing the welfare spending that they fund. Those who refer to "reform of the major distributive systems" as a panacea for eliminating the deficit are only clouding the issues for a responsible assessment of the fiscal problems.

4. THE BALANCE-OF-PAYMENTS DEFICIT

There were unsettling signs in the balance of trade and the balance of payments in 1993 and in the first half of 1994. Domestic consumption grew faster than production. The growth of exports ceased, while imports jumped positively. The result was a substantial increase in the current-account deficit, and a consequent rise in Hungary's net debt after a decreasing trend lasting several years.

A responsible government cannot pretend nothing has happened. It certainly has to react to that, which the last government unfortunately neglected to do. To reiterate what I said in connection with wages, the courage with which the new government has faced up to the situation is commendable. Its vigor and speed of action are impressive. Nevertheless, I am not sure it is taking the right course in every respect.

It will be noticed that I phrase myself carefully here, not for any tactical reasons, but because I am not quite sure in my assessment of the situation and the immediate tasks it sets, when it comes to longer-term tasks I will risk a more decided opinion. One problem I see is precisely that there has been no thorough analysis of the causes behind the disquieting phenomena or full exploration and debate on the alternative paths to a solution. The old reflex reaction has occurred instead: trouble with the balance of payments means it is time for some tight restriction. Here let me add that "restriction" is the term that has gained currency in Hungarian professional parlance, but this is not just a case of restraint, but of a decisive reduction in several economic processes, for instance, in macro-demand, production and investment, and a *contraction* in economic activity. (For the sake of emphasis I prefer the latter term in this study.) As an emergency measure, the contraction will probably work, since a drastic repression of domestic consumption will reduce imports and probably force domestic producers to export. There is a high price to pay for this, and it is not certain that such drastic means alone can achieve the purpose.

Before attempting to assess the radical cure being applied, let us return to a diagnosis of the problems. Without being exhaustive, let us look at the reasons for the deterioration in the balance of payments, not in order of importance, but in an order that makes it easiest to see the problems.

4.1 A part has been played by factors beyond Hungary's control, of which I will mention just two. One has been the fall in import demand in Western Europe, particularly Germany, and the other is the loss in the agricultural export supply due to the weather. Mentioning factors like these serves as a reminder: it is not worth blaming fiscal and monetary policy measures for the export losses explained by external, material factors.

4.2 Many export activities used to be sustained by state subsidies. Abolition of these, along with stricter enforcement of profitability and bankruptcy and liquidation proceedings, has eliminated several firms or sharply cut back their production. While having a healthy effect of natural selection in the long term, in the short term this has contributed to the fall in exports.

4.3 Mounting damage was caused by the incorrect exchange rate. A big part was played in the deterioration of Hungary's trade performance in 1993 and early 1994 by the fact that the exchange rate policy had been mistaken earlier on, because the effects always appear after a considerable lag. It took time before the exports, imports and production adjusted themselves to the exchange rate, in this case adjusting in a harmful way to a faulty exchange rate.

I therefore fully support the devaluation of the forint, and along with some other economists, I have been among those calling for this for a long time. It was negligent of the previous government not to make up its mind to devalue. It was high time it happened. It will stimulate exports, help to curb imports, make Hungarian goods more competitive at home and abroad, and so presumably help to improve the trade balance and balance of payments. Of course, the benefits will not be immediate, for as I mentioned just now, international experience suggests that several months will elapse before the effects filter through. Apart from endorsing the government's move, I would like to make some additional remarks:

– Devaluation is bound to push up the price level. If this is followed automatically by full compensation in the wage level, the benefits of the move will be eroded. This brings us back to the same questions discussed in connection with inflation. Hence the question that crosses every economist's mind is what the wage reaction will be to the devaluation. If it is followed by full indexation, we will fall into the same devaluation whirlpool as a number of developing countries, with a destructive cycle of successive devaluations, waves of price increases, wage indexing and restrictions.

– Devaluation is an important means of raising competitiveness, but not the only one. I think we should be making greater use than hitherto, with careful, objective selectiveness, of the system of tariffs and subsidies, in order to promote exports and protect domestic production. This is not what I was saying five years ago, when there was a great need for a forceful campaign of trade liberalization. That helped the Hungarian economy to build up a system of relative prices which is in conformity with world market prices, and contributed substantially to ending the shortage economy. It coerced the Hungarian economy into competing with its foreign rivals and winding up its least viable production. Today, however, we do not have to follow such an extreme free-trade policy in this respect. There is no need to strive officiously to exceed the mature market economies in eliminating all kinds of tariffs and subsidies. Care must be taken, of course, that new subsidies and tariffs do not breach GATT rules, the association agreement with the European Union, or other agreements. The question is whether the government has a concept in this respect, and if so, how it wants to prevent a scenario in which ad hoc tariffs and subsidies are determined by the struggle of lobbies and political clients, instead of economic rationalism.

Again, the deterioration in trade performance due to the faulty exchange rate and some overshooting in liberalization cannot be blamed on the expansion of production or consumption.

4.4 The balance of payments has presumably been worsened by the fact that many firms have built up vast inventories. Unfortunately the statistics on this are not reliable enough, and the figures may be exaggerated. Even if one allows for this, it would seem that a large accumulation of inventories has taken place.

What induced firms to do this? After all, the shortage economy, with its associated fears of problems with supplies of raw materials and semi-finished products, has been, on the whole, eliminated. The main reason, in my view, has been expectations of devaluation. If producers are sure the forint is going to be devalued sooner or later, they plainly have an interest in buying more and more imports at a lower forint price while they can. This attacked the stability of the balance of payments at its most sensitive point, stimulating imports without increasing production.

Ultimately, this occurred because firms were wiser than the government, realizing the forint would have to be devalued sharply in the end. The lesson to draw, as with Points 4.1 and 4.2, is that this negative event was not the result of expansion of production. To avoid such an occurrence in the future, care must be taken not to leave the economy with expectations of devaluation, but to adjust the exchange rate *continually*, even daily, if need be.

4.5 Pharmaceutical imports have surged, not because the income of consumers of medicines has increased, but for reasons outside the economic sphere, which it would not be appropriate to analyze here.

4.6 It is questionable whether the export and import figures are actually correct. Lying behind the widening gap between exports and imports, is there not the phenomenon known rather loosely as capital flight, or at least a more moderate version of this, with partial withdrawal of capital operating in Hungary and a transfer abroad?

This occurrence cannot be detected by ordinary statistical means. Nothing could be simpler for a Hungarian firm with relations abroad or a foreign partner (individual or corporate) than to submit to the authorities undervalued invoices on the export side and/or overvalued invoices on the import side, so that some of the capital of the firm functioning in Hungary is immediately transferred abroad, without the movement of capital officially going through the banking system or coming before the foreign exchange authorities. It need not completely cease its operations in

Hungary. It may simply reduce them, and gain some liquid capital abroad in exchange. This kind of relocation of capital can be performed by any economic unit from a self-employed entrepreneur or a small private company to a vast multinational corporation. My guess is that this may have had an important impact on the deterioration in the balance of trade. There is indirect evidence for this also in the fact that this deterioration appears to have coincided with some slowing of the spectacular growth of foreign direct investment. The economic motivation is presumably the same. Entrepreneurs, investors or proprietors, Hungarian or foreign – or the managers appointed by them – ask themselves where it is better to invest their capital: in Hungary or some other country? Let me stress that in spite of all administrative controls, Hungarian entrepreneurs – as well as foreign ones – will also find a way of investing their capital abroad if their interests so dictate.

Many economists, including some experts working in the government apparatus or the banking system, share the concern that this withdrawal of capital (or in a worse case, capital flight) has an appreciable effect on the trends in foreign trade, payments and lending. If so, this cannot be altered by simple restriction, which may even exacerbate the problem instead, nor does an attempt to hinder the capital transfers administratively look promising. The only thing that can help is to regain the confidence of capital, so that entrepreneurs are inclined to keep their money, their capital here, and bring more in as well. I will return to the question of what this confidence and propensity to invest depends on.

4.7 Finally, the balance of payments has been adversely affected, apart from the previous six factors, by the following: a) the rise in investment and production in certain sectors of the economy, creating extra demand for imports, and b) the surge in consumption (discussed earlier in the study), which also stimulated imports, and crowded out exports. I would certainly not like to omit these relations from my analysis. One problem is that no one knows exactly how much of the trouble is explained by Factors 4.1-4.6, which are unrelated to expansion, and how much by Factor 4.7, which is certainly related to it. It is also not accurately known how much of Factor 4.7 is explained by the a) phenomenon, i.e. the effect of production and investment growth, and how much by the b) phenomenon, i.e. the effect of consumption growth. Yet, that is exactly what needs to be known to decide on suitable proportions between the measures in order to improve the balance of payments.

All I have been able to do is to provide a longer list of the main causes of the deterioration in the balance of payments, and thereby take issue with the misleading simplification that the problem has simply been generated by a single cause, namely "artificial" growth. A single research economist cannot be expected to provide a full quantitative diagnosis to determine how much of the payments deficit is explained by each factor (or possibly, what other, unmentioned factors may have contributed). To draw up a convincing diagnosis would require an apparatus, the involvement of numerous experts, and thorough professional debates.

I made it clear earlier that I understand and endorse the measures taken by the government to brake consumption running away and reduce the bureaucratic expenses of government. However, I cannot support a policy that deliberately or not, may perhaps lead not only to the restriction, but to an excessive absolute decline of production, and especially investment, so causing the economy to contract dramatically once again.

The hardest theoretical and practical problems come when we try to clarify the relationship between the growth of the economy on the one hand and the balance-of-payments deficit and foreign debt on the other. (Here I must ask readers to excuse me for touching on the same question twice: once now in relation to the balance of payments, and again later in connection with growth.)

Some people think that to borrow, to contract a debt, must be an evil, reprehensible thing. They applaud the advice of Polonius to Laertes in Hamlet:

Neither a borrower nor a lender be;
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.

Such views are quite common in people's thinking not only about personal debt, but about corporate or national debt as well. They find it frightening that Hungary, having accumulated such big debts in the past, should now go on to increase its debt even more. This, they say, is a process that must be stopped at all cost.

In my opinion, such a stance is quite indefensible from an economic point of view. Let us embark on refuting it by considering a well-known macro-relation: total investment in the economy (investment in fixed assets plus increment in inventories) minus total new savings generated in the economy equals the inflow of net external real resources, in the case when investment is greater than savings. (In the opposite case, where investment is less than savings, the difference equals the sum of domestic real resources flowing abroad. This case we will disregard now.) I use here the generic term "external resources" to include credit raised abroad and direct investment by foreigners in this country, and also non-repayable aid. Let me draw attention to the fact that this is a relationship known in professional parlance as identity. It is not a matter of decision or economic behavior whether this equilibrium relation applies, for it does so all the time.

If, as in this case, there is a situation in which investment exceeds savings, economic policy-makers can try to influence the economic processes in three ways, by encouraging 4.1 a reduction of investment, 4.2 an increase of savings, or 4.3 an inflow of foreign resources. These do not preclude each other, of course. Within Option 4.1, it is certainly worth encouraging a growth of fixed assets rather than inventories, as I have said already. I will deal with Option 4.2, increasing savings, later on. Now let us look at the relation of Options 4.1 and 4.3: the relation between investment and the inflow of foreign resources.

The most important issue is to compare medium- and long-term benefits and costs. This reintroduces the leitmotif of the study, the problem of lasting growth. On the one hand, it must be clarified what additional production will be possible in future years and decades due to the inflow of foreign resources now, and on the other hand, what processes of resource-outflow will be started by the repayment obligation in the same period. If the former is larger, it speaks for implementation; otherwise, it speaks against. There are thousands of examples of both cases in economic history. The fast-growing economies of South-East Asia, the states of post-war Europe, and the experience of many developing countries prove that success is quite possible, though not certain. Of course, there is certainly no justification for saying in advance there is no hope of using foreign resources well! (To illustrate

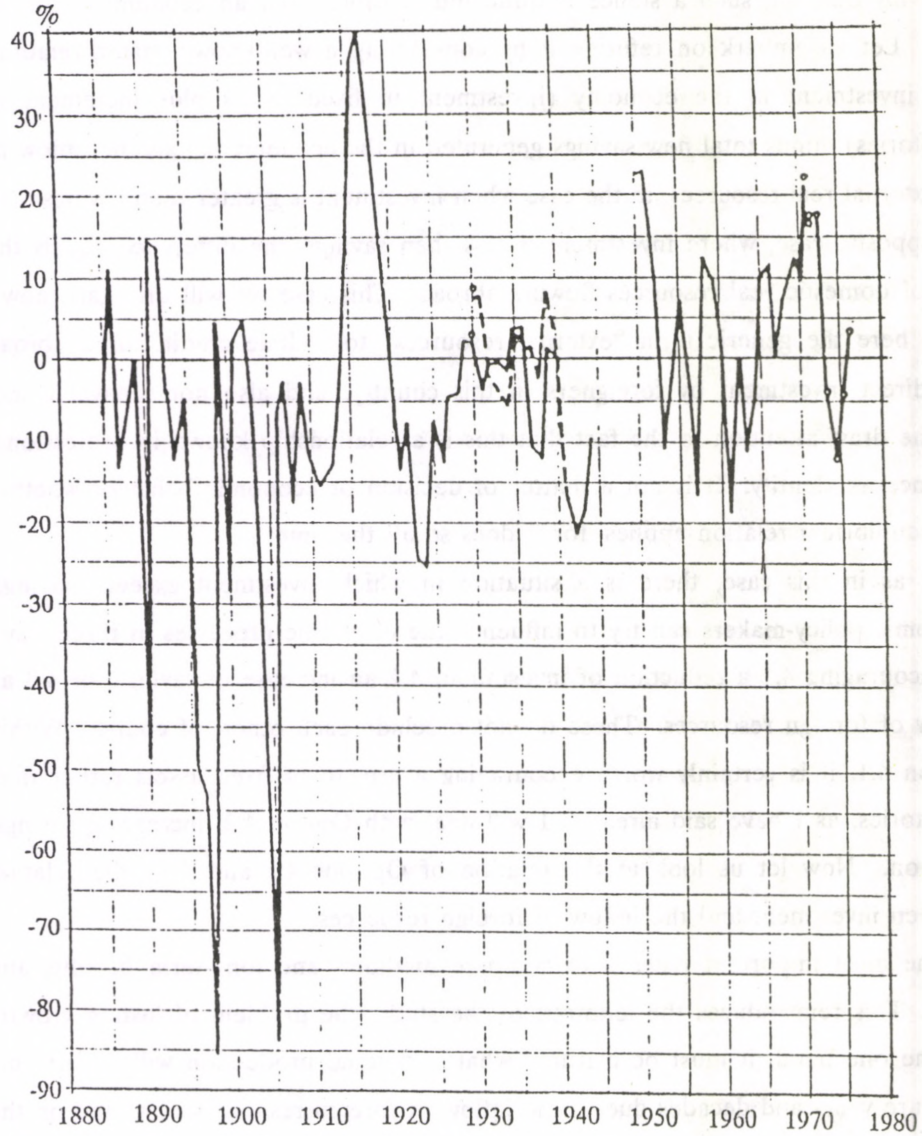

Figure 3

Source: Éva Ehrlich: Japán, a felzárkózás anatómiája (Japan – The Anatomy of Catching Up), Budapest: Közgazdasági és Jogi Könyvkiadó, 1979, p. 201.

this, I give a single example in *Figure 3*, the history of Japan's current-account balance.)

Here let us return to the situation in 1993–94. Investment seems to have received a boost in the past ten or twelve months. According to the Department of Economic Analysis and Modelling at the Finance Ministry, the value of investment at current prices in the first quarter of 1994 was 59% up on the same period of last year, so that the volume of investment has grown substantially, even if price increases are taken into account. This acceleration of investment is also indicated indirectly by a rise of 34% in the real volume of construction between the same two periods. It is remarkable that according to the report of the National Bank of Hungary, the proportion of machinery and equipment within imports rose very substantiallym in 1993, from 20.7% to 26.6%, which also shows that investment activity was livening up, and that imports are increasingly for investment purposes.

I have yet to see a study analyzing investment projects individually and more closely. I cannot state that all of them are necessarily efficient, but I have no grounds for assuming the opposite, in other words, that all or the majority of them are inefficient. For only in the latter case would the curious situation arise in which the part of the foreign resources drawn into the economy for investment purposes was doomed from the start. Since no careful analysis of the investment projects has been carried out, my doubts remain: maybe the contraction about to hit the economy will set back investment processes that were promising to be useful.

Another thought-provoking approach is a closer analysis of production figures. For my part, I consider it welcome that according to the Finance Ministry report just quoted, the growth of industrial production now apparent for some time is taking place mainly in firms with fewer than fifty employees. It is to be feared that this will be the very sector, having revived since the change of political system, which will decline due to the contraction.

A further important question closely connected with the long-term cost-benefit calculation mentioned just now is to know in what form and on what terms the foreign resources are drawn into the economy. This will clearly have an effect on the additional commitments that are opposed to the additional production arising out of the investment. Here again, care must be taken to avoid any excessively simplified formula. The idea has become implanted in the public mind that further credits are "bad", but foreign direct investments are "good". In fact, both of these

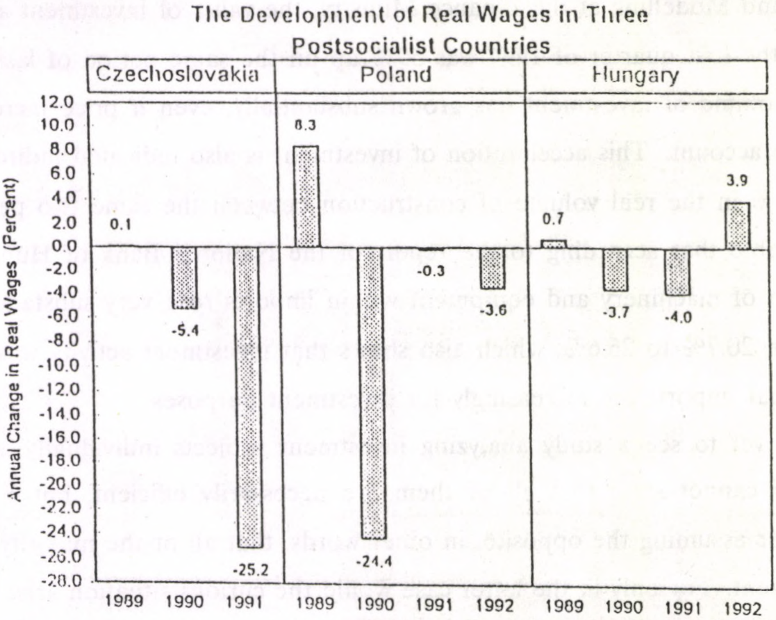

Figure 4

Source: A. H. Amsden, J. Kochanowicz and L. Taylor, *The Market Meets Its Match*, Harvard University Press, 1994.

represent an inflow of foreign resources, which must be compensated for sooner or later by an outflow abroad of domestic resources. Neither is good or bad as such; the advantages and drawbacks depend on the specific payment terms, their allocation in time, and in the case of foreign direct investment, tax and other concessions granted, restrictions on the repatriation of profits and any other conditions.

From this point of view it is desirable also, if foreign resources are drawn into the economy, that as much as possible is carried out by banks and firms (Hungarian and foreign) on their own responsibility and at their own risk, without guarantees from the government or the National Bank of Hungary. If the transaction proves profitable in the long term, it will then be primarily the firm that raised the loan, the creditor or the foreign investor who sees the profit, while the economy as a whole does well from of it. If it fails, they are mainly the ones who pay. This strong incentive encourages the participants to consider their decisions very carefully. Since the change of political system, there has been a favorable shift within the total inflow of foreign resources towards direct borrowing by Hungarian banks and companies and direct foreign investment, i.e. an increase in the portion of the debt for which responsibility is borne by the business sector rather than the government or the central bank. It would be very harmful for the economy if a general contraction set back the process of truly *decentralized* borrowing and capital inflow as well.

I give priority to medium- and long-term considerations, but, of course, one cannot ignore the *short-term* effects. Clearly the solvency of the National Bank of Hungary and the commercial banking system must be seriously considered. I am convinced there is no threat of unsurmountable short-term financing difficulties, and this conviction has been confirmed in me by studying the figures for debt servicing and foreign-exchange reserves, and by consultations with experts. Given a resolute government policy, Hungary can maintain and even improve its creditworthiness and reputation for reliability of Hungary.

To sum it up, a well-considered strategy and thorough implementation of such a strategy are required to promote the growth of exports, curb the rise in imports, and improve the trade balance and the balance of payments. This is one of the key economic-policy requirements. We must make sure that these proportions undergo a lasting improvement, or else the heightened tensions of today will reproduce themselves. Emergency measures and the most drastic of them – improving the balance of payments by way of decreasing production – will solve none of Hungary's long-term problems and may even exacerbate them.

Here I would like to return to a problem left open earlier: *domestic savings*. It is clear from the identity presented earlier that the higher domestic savings are at a given level of investment, the smaller the inflow of foreign resources. One of the serious mistakes in recent economic policy was to cut interest rates drastically when domestic savings started to rise. This presumably contributed greatly to the spectacular fall in household savings. The figures show that in 1993, for instance, it was not a case of the income of households running away, but of a jump in the proportion of income spent on consumption and a dive in the savings rate.

Table 3. Nominal and Real Interest Rates (Percent)

	Month	Nominal Interest Rates	Inflation	Real Interest Rates
1991	January	23.3	34.1	– 8.7
1991	February	23.3	33.2	– 8.0
1991	March	24.5	34.3	– 7.9
1991	April	25.7	35.4	– 7.7
1991	May	23.6	36.9	–10.9
1991	June	23.2	38.6	–12.5
1991	July	23.2	38.2	–12.2
1991	August	23.5	34.2	– 8.7
1991	September	26.2	34.0	– 6.2
1991	October	25.7	33.9	– 6.5
1991	November	26.0	32.8	– 5.3
1991	December	25.9	32.2	– 5.0
1992	January	24.8	28.2	– 2.7
1992	February	26.1	25.8	0.2
1992	March	22.5	24.7	– 1.8
1992	April	23.8	23.3	0.4
1992	May	21.1	22.6	– 1.2
1992	June	20.7	20.6	0.1
1992	July	17.8	20.1	2.0
1992	August	14.3	20.7	– 5.5
1992	September	13.4	21.7	– 7.3
1992	October	13.1	23.4	– 9.1
1992	November	13.7	22.7	– 7.9
1992	December	11.5	21.6	– 9.1
1993	January	12.4	25.9	–12.0
1993	February	12.6	24.7	–10.7
1993	March	11.4	23.4	–10.8

(continued)

1993	April	10.3	22.8	–11.3
1993	May	12.1	21.3	– 8.2
1993	June	12.4	20.9	– 7.6
1993	July	12.1	21.3	– 8.2
1993	August	12.8	22.3	– 8.4
1993	September	13.3	23.0	– 8.6
1993	October	14.1	22.0	– 7.0
1993	November	16.0	21.0	– 4.3
1993	December	16.0	21.1	– 4.3
1994	January	17.1	17.0	0.1
1994	February	15.3	16.6	– 1.1
1994	March	17.0	16.8	0.2

Source: *Havi Jelentések* (Monthly Report), National Bank of Hungary.
Note: The second column indicates the price indices concurrent with the nominal interest rate. This reflects the assumption that the saver expects inflation experienced earlier to continue when making a decision on savings.

Correction of the mistake has commenced. The figures for recent months indicate that there may again be an increase in the propensity of households to save. I would like to make a few comments on that.

It is time we changed the situation in which interest rates fluctuate spasmodically. A reasonable monetary policy uses its influence over interest rates very cautiously; that leads to changes by a half of a percentage point from time to time. In the Hungarian economy, interest rates jump wildly about, (see Table 3) which makes savers feel insecure.

Propensity to save is weakened not only by the unpredictable interest rate policy but by the other uncertainties prevailing in the economy. The more confidence households have in the future of the Hungarian economy, the more they are ready to keep their money there. (This was already mentioned in connection with withdrawal of capital, and will be returned to at the end of the study when discussing the macroeconomic role of confidence.)

It can be said in general that although interest rates have a profound influence on the trend in savings, they are not the only influence on it. Another important factor mentioned already is the strength of the motive to build up a reserve. Let me now add another: the transparency of the market for financial investments and securities, particularly state securities. Unfortunately, the market for state securities is still in a very rudimentary state. Much of the population has no access to them at all, particularly not to the ones that are really lucrative, which remain with the financial intermediaries instead. I am convinced that a high proportion of households would be happy to invest in government bonds that provided a defence against inflation, even if the real positive rate of interest was tiny, so long as the bonds were easily accessible without the hustle and bustle of standing in lines. If they did buy them, the problems of public finance would be greatly alleviated, and so indirectly would the pressure on the balance of payments.

5. STAGNATION AND DECLINE IN PRODUCTION

I am convinced (as the main title of this study suggests) that the most important task in economic policy is to promote the lasting growth of the economy. This is not a self-evident requirement. The situation would be different, for instance, if there was overheating in the economy, and a dampening of growth would have to be considered. There was a time, in fact, when this was one of the fundamental problems in the socialist economy.

Unfortunately, growth in Hungary decelerated even before the Great Recession of the 1990s. For the ten years between 1977 and 1986, the average annual growth rate was a mere 1.6%. Since 1987–88, the situation has become even worse: stagnation, decline, and then stagnation again at an even lower level! According to the latest report from the Central Statistical Office, revising earlier estimates, the downward trend has continued. A 4.3% fall in GDP in 1992 was followed by another fall of 2.3% in 1993.

It is an especially bitter feeling to compare Hungary's stagnation and contraction in production with the performance in so many other countries. Hungary's GDP in 1993 was back at its level in 1976–77, or more precisely, slightly above the 1976 level and slightly below the 1977 level. Thus, there has been zero average annual growth for a period of 17 years, while many Asian countries have had annual average growth rates of 4–9%, so that their production has increased two to three-and-a-half times over. There has also been growth to a lesser extent in some small European countries, less developed than those in the forefront and in that respect similar to Hungary, see *Table 4*.

Not one of the country's major social problems can be solved successfully if the economy is stagnating or declining. The widespread misery in society, the poverty of certain regions, or the severe backwardness of certain neglected sectors cannot be cured by shuffling resources from one field to the other. The bargaining over redistribution, inevitable but fruitless under conditions of economic stagnation, has been going on for a decade and a half. In my view, those who preach social sensitivity while neglecting the main problem – growth – are ducking the issue.

Table 4. Growth in GDP, 1977-1992: International Comparison

Country	1992 GDP as a proportion of 1977 GDP (%)	Annual average growth rate (%)
Asian countries		
South Korea	354.3	8.8
Thailand	283.5	8.3
Malaysia	283.9	7.2
Japan	190.4	4.7
European Countries		
Turkey	178.8	4.6
Portugal	163.8	3.3
Greece	139.6	2.2

Source: World Tables, World Bank and *International Financial Statistics*, IMF.

Note: Data for Thailand and Turkey were available only up to 1990.

Clearly, the parties and leading economic politicians of government are quite aware of the importance of growth as well. Yet, I sense on various issues an essential difference between official statements and the view I expressed earlier and hold today as well.

The first difference appears *in the order of priority* given to the tasks of economic policy. Official statements convey the impression that there are two, equally important sets of tasks, one being to stabilize the economy and the other to create conditions for growth. I do not believe these two sets of tasks have equal importance: under Hungary's circumstances, there is just one main task – to establish lasting growth – to which the requirements of economic stability must be subordinated. Economists conversant with the language of mathematical models will understand if I say that a maximization of the long-term growth rate is the objective-function, while the constraints concerning the balance of payments, the budget, the price and wage levels and other economic variables must be observed. Of course, there are various stability requirements that must not be jeopardized for fear of harming growth as well. However, a distinction must be drawn in thought and the logic of decision-making between the true objective and the constraints that must be observed for the sake of attaining the objective, and more generally, in order of the normal operation of the economy. (From an ethical point of view, production growth is self-evidently not an end in itself either. The ultimate end of economic policy is to improve people's lives, to which an increase and improvement in its products and services are the main contribution the economy can make.)

The other difference concerns the *time sequence* for the tasks. The government program employs the following formula: *first* create stability and thereby the conditions for growth, *and then* the economy can start to grow. For the latter, specific dates on the calendar are even mentioned in some statements: growth will ensue in 1996 or 1997 (or put negatively, will not ensue for two, or according to some statements, three years).

In my view this formulation of the time sequence is wrong. In order to subject it to criticism, the first requirement is to clarify what growth really means.

A variety of indices are used to measure growth, of which the commonest is

Gross Domestic Product. This is an aggregate indicator of the output of millions and million of producers in the economy, some of which, at any given moment, are keeping their production steady, some raising it, and some reducing or ceasing it. The growth in GDP is the resultant of these many positive and negative changes of various sizes.

One expression that has gained currency in the debates in Hungary in recent years is the "start-up" of growth. "It is time," or in confrast, "it is not yet time to start up growth." The government program adopts the same formula: growth should only be "started up" later, not now, when the conditions are not yet ripe.

Unfortunately, the government is not in a position to start up growth. The sum of the producers does not constitute a disciplined army awaiting its marching orders. It was not like that even under classical socialism, and far less under reform socialism. As for now, after a radical decentralization in the coordination of the economy, "starting up" growth is out of the question. Economic units will decide for themselves whether to increase or reduce their production. The government can exert some influence over these decisions, either by encouraging and promoting growth, creating the macroeconomic, institutional and legal conditions that favor the growth of output, or by the opposite, talking them out of expanding and erecting barriers to impede them in doing so. Therefore, the government does not "start up" growth, it only influences whether or not growth "starts" of its own accord. Far from being a quibble, this distinction represents an essential difference of concept about the function of government.

The promotion of growth does not suddenly come onto the agenda when the conditions of economic stability become more favorable than they are now. It should come onto the agenda right now, and it should, in fact, have been put on the agenda much earlier. I would like here to recall an anecdote about Jean Monnet, the former French finance minister and one of the leading lights in European reconstruction after the Second World War. He was talking to his gardener one afternoon, and asked him how long it took for a certain type of tree, of which he was very fond of, to reach maturity. About a hundred years, was the reply, and Monnet's reaction: "Then it was a mistake not to have set about planting it this morning."

Thus, the sequence of *first* stability, *then* growth is not correct. These are two *parallel* tasks.[5] Effort must be made at every moment to ensure that whatever economic entity is willing and able to grow should do so as much as possible, and care must be taken at every moment to respect the constraints of stability. Another reason for not allowing two years for the creation of stability is that the task is not one which is ever over and done with. It can reasonably be expected that as soon as one macroeconomic tension has been overcome, the same or another tension will re-emerge. This is not a war in which there can be victory once and for all. At best only minor battles can be won before the struggle begins again perhaps on a different front. Problems with inflation, unemployment, budget and current-account deficits recur all over again. If we want to postpone growth until all these have been resolved, we shall be waiting forever.

In fact even now, the government is performing two sets of action *simultaneously*. One set is directly aimed at growth and the other at equilibrium adjustments. Let us look more specifically, in light of the earlier discussion in the study, at the aspects of the program and the measures taken so far that I think pose problems, taking these two sets of actions one by one.

5.1 *Promoting growth*. Several clever ideas can be found in the government program and the first contingency plans to be published. Here I would single out the important stimulating role the tax concessions may play on investment projects.

However, there are endeavors that work in the opposite direction and should not be allowed to become reality if growth is to be the prime objective of official economic policy as well. An illustration of this is the fact that the intended resolute cut in public spending plans to curb infrastructural investment as well. The desirable policy would be to cut other, non-investment spending, and to continue the state development projects at least at the planned rate, if not faster.

So far, the government's program has not been sufficiently rich in designing actions that can help to accelerate growth. Several things belong here: changes in export incentives, alterations in the tax regulations, further development of the banking system[6] (e.g. creating the almost totally absent institutions for long-term

[5] This idea is emphasized in V. Tanzi (1989) and G. W. Kolodko (1993).

[6] The extremely important role of reform of the banking system is underlined in M. Ellman (1994),

lending), a legal, institutional, credit and taxation system designed to promote housing construction, and so on. It would be desirable that considerations of growth be given greater attention in future plans for privatization. Much greater emphasis should be placed on what obligations the prospective owner undertakes in terms of job creation, expansion and modernization. Constructive suggestions are made at countless professional discussions. Perhaps the government or Parliament could commission a panel of experts to collect them all, elaborate and organize them and publish them in a comprehensive report.

An additional reason for gathering, in a single, effective document, a plan for the changes to encourage growth is that they are scattered about in various reports and statements. In this respect the government's policy does not constitute a "concept", nor does it offer a "vision" of a growing, modernizing, prospering Hungary that has moved out of its rut. Yet, such a vision would lend confidence and hope, engendering a new propensity to invest and bring capital into the country.

5.2 *Improving stability*. Having discussed the various imbalances individually in previous parts of this study, I would like now to make some comments summing up my views.

I fully support the efforts to reduce the budget deficit and the trade and current-account deficits, and resist the acceleration of inflation. I agree that a major shift is needed in the ratio of investment to consumption, in the former's favor. I also agree that a major shift is needed in the ratio of exports to domestic consumption, in the former's favor, but I must add quite emphatically to this endorsement that it is desirable to achieve all this at the prevailing level of macro-demand, or only with minimum contraction, and in the future with a steadily rising level of macro-demand, not at the price of a new radical fall in macro-demand. A curb on real consumption is unavoidable, but it should be compensated as much as possible by the increment in investment and exports. In other words, the total demand for production, and so total production, should not be allowed to fall during the course of the adjustment.

I do not recommend an irresponsible, amateurish "dynamization" of the economy. It is one thing to refrain from that and another to initiate a further large recession.

R. Portes (1994), and J. Corbett and C. Mayer (1991).

I do not recommend using a so-called "fiscal stimulus" in the present situation of the economy, i.e. macro-demand to be raised at the cost of increasing fiscal deficit. At the same time I would like to warn those managing the economy against making a mistake of the opposite direction: they should not risk a fall in production for the sake of a cut in the budget deficit. This was the big mistake made by financial authorities in several countries during the great depression of the 1930s, mindlessly cutting macro-demand further when the economy was already in a deep slump.

I have no illusions about how accurately the desirable proportions can be calibrated. The results of "fine tuning" are rather dubious, and might differ from the intentions of the government. It is almost certain that the changes in proportion mentioned cannot be made without friction. One cannot cut consumption exactly as much as exports and investment can be increased. My objection is to the actual intention. The government starts out by planning a fall in GDP because they want to reduce macro-demand in absolute terms. Although the contraction in production it wants is fairly small, the actual production figure could end up much lower than expected. Not only may real consumption fall but investment as well, albeit it has hardly started to increase. For eight or ten months it seemed as if the economy, mainly in terms of investment and industrial production, was starting to climb out of its trough. The risk is that a quick and radical reduction in macro-demand will push it back again, not simply into stagnation but into a further contraction of production following the output decline of 1993.

Unfortunately, it is not just a case of a single fall in GDP of 1–2%, and then it is over – production can grow again. Macroeconomics clearly shows that both increases and decreases in macro-demand have so-called multiplier effects. Decrease in production causes lay-offs. Less is spent by those who have lost their jobs and by the owners and employees of firms that are cutting production, which reduces macro-demand yet again, and that spills over time and again like a series of ripples. Just think for a moment: the spiral of restrictions and recession has started over and over again in Hungary in the last 15-18 years. There is a danger that the spiral will continue and the economy will sink deeper and deeper.[7]

[7] About the dangers of a downward spiral of aggregate demand and supply, see L. Taylor (1994).

My impression is that leading economic policy-makers and their expert advisers feel some kind of panic terror from growth. The bogey with which they are scaring themselves and each other is the ill-fated "dynamization" of the mid-1980s, which failed to lift the country out of stagnation and took it further into debt instead. It must be realized, however, that today's Hungarian economy is not identical with the one of ten years ago. The ownership relations have changed: state ownership was dominant then, whereas more than half of the production comes from the private sector now. The excessive, distorted concentration of the economy has ceased; tens of thousands of small- and medium-sized firms have appeared alongside the large ones, and so have several hundred thousand of self-employed people. The budget constraint on firms has hardened. There are realistic market prices and the market mechanism works, even if it creaks a little. There has been a major change in the structure of the economy, so that the share of the service sector, for instance, has increased substantially. The hard-currency market is now the main area in which Hungarian exports are sold. What happened after the "dynamization program" carried out in 1984 has little relevance to what effect growth would have these days.

It is most unfortunate that serious difficulties should have arisen with the balance of payments in 1993 and the first half of 1994. However, as I have tried to make clear earlier in the study, a substantial proportion of the measures planned, notably the ones aimed at repairing the balance of payments by bringing about a contraction in the economy, are based on an analysis of the imbalance that is incorrect in many respects. The policy-makers have not sufficiently, clearly seen what the real causes of the troubles are, and so the correction they are making to the course of the economy will not eliminate the real causes of them. As I have emphasized already, it would be a mistake simply to blame the deterioration in the balance of payments on growth, which has hardly begun anyway, and use it as a further argument for contraction. Although the increase in the propensity to invest has placed a burden on the balance of payments, it is a burden that I think is worth bearing. The trouble was that personal incomes ran away at the same time, and there were a number of other unfavorable circumstances and errors deteriorating the export-import ratio as well.

I would like emphatically to ask those who shrink from promoting growth what they really think the relation between growth and the current account to be. Is there a curse on our country, so that time and again in the future, when we go for growth, there will be big trouble with the balance of payments, so that we will never, ever emerge from the spiral of recession and restriction that is dragging us deeper and deeper into the mire of stagnation?

Let me point out that I oppose a contraction of the economy and a reduction in economic activity not because of the burdens it places on today's generation. As I explained in the section on wages, this burden, unfortunately, seems to be inescapable. What I would warn against is any call for sacrifices that then fail to have an effect, because the economic policy pursued fails to convert today's belt-tightening into tomorrow's growth. In other words, I am not protesting because some of the government's measures will force us to tighten our belts. I object because the "package" as a whole may deepen the recession still more, making the prospects of recovery still more remote and uncertain.

Under no circumstances can I accept a defensive, defeatist point of view. Irrational fears of damage to the balance of payment can only cripple action. Instead, there are two problems we should reconsider in an impartial, unprejudiced way.

The first consideration is how to encourage the kind of structural changes that allows GDP growth in the future without any damage – or with the least damage – to the balance of payments. Experience of other open, highly trade-oriented countries suggests that growth always places a burden on the balance of payments. The rising demand for imports usually comes sooner than export success, but this is not some kind of automatic, arithmetically determined rule. Matters can be improved by a wise government policy (on prices, exchange rates, export promotion, tariffs etc.). Such a policy can promote the country's export drive and curb its demand for imports, without drastically halting or slowing growth itself.

The second consideration is how foreign resources can be drawn to Hungary in the most practical way that places the least burden on the country. We must not shudder at the idea that we need the inflow of foreign resources. Most less developed countries used foreign resources in the period of shifting from recession or stagnation to growth. I could put this more strongly as well: I do not know if there has ever been a case of a country accomplishing this shift entirely out of its own resources.

What must be avoided is a course of events in which the fact that there was an inflow of foreign resources emevging after it has occurred, as an unpleasant surprise. It is far better to consider what to do in advance. This study does not set out to make specific recommendations on this. There are many forms of capital inflow which are not mutually exclusive, so that they can be used in various combinations. My impression is that Hungary so far has only used some of the range of possible instruments. Having consulted Hungarian and foreign experts on the subject, we should reconsider the tasks entailed in attracting and utilizing foreign resources.

6. ABOUT OPTIMISM

Success in growth and macro-stabilization have a common prerequisite, and that is a mood of optimism. The poll of economic activity taken by the research institute Kopint-Datorg in the first quarter of 1994 indicated that the majority of firms were more optimistic than for many years. Many more said at the time of polling, i.e. before getting acquainted with the new measures, that they expected both export and domestic sales' prospects to improve. I am afraid that this mood of hopefulness will now be dampened by a cold shower.

In my opinion it is incorrect to defend measures that stabilize the economy or impose wage discipline by saying that the economy is in a disastrous state. It is incorrect, first of all, because it is untrue. The Hungarian economy is robust; there are hundreds of thousands of businesses actually doing business. Luckily the Hungarian economy is already a highly decentralized system, which has a healthy self-propelling motion even if some government or minister should make a mistake. Governments and ministers come and go, but the market and production fuelled by the interests of private owners go on and keep the economy alive.

The "crisis management" should cease, in my opinion. Everyone is fed up with it. Back at the time of the 1989 negotiations for the change of political system, the tasks of "crisis management" were already being debated, and the discussion has gone on ever since. This only dilutes the meaning of the word "crisis", not that I want to remove it from the economic dictionary. If the National Bank of Hungary would become insolvent on the international financial market tomorrow, there would be a real crisis. If the currently moderate rate of inflation suddenly speeded up into multi-digit hyperinflation, we would indeed have a crisis. If life in the country were crippled by mass strikes, crisis would be the word. Real crises must certainly be avoided, but it is impossible still to be living in a state of permanent crisis management after so many years.

Roosevelt, when he wanted to raise the United States and the world economy out of the Great Depression, said, "The only thing we have to fear is fear itself." To whip up a mood of disaster is not only unjustified, but harmful, because it is self-fulfilling. The more the government talks about it, the more it will be believed in, by entrepreneurs, by investors, and Hungarian and foreign capital and business, and then there really will be a crisis.

For lasting growth, optimism is an absolutely essential requirement of economic psychology. Capital will stay here and flow in here voluntarily and contentedly so long as the perception is of a healthy, steadily growing economy with an expanding market. Just like pessimism, optimism can be a self-fulfilling phenomenon. I sincerely hope that optimism comes to prevail among the economic policy-makers and the actors in the economy.

REFERENCES

Andorka, Rudolf, Kontradas, A. and Tóth, István György, eds. (1994), "The Hungarian Welfare State in Transition: Structure, Development and First Step Towards Reforming Social Policy in Hungary," *Policy Study*, No. 3, Commissioned by the Joint Hungarian-International Blue Ribbon Commission, Hudson Institute.

Atkinson, Anthony B. and Micklewright, John (1992), *Economic Transformation in Eastern Europe and the Distribution of Income*. Cambridge and New York: Cambridge University Press.

Corbett, Jenny and Mayer, Colin (1991), "Financial Reform in Eastern Europe: Progress with the Wrong Model," *Oxford Review of Economic Policy*, 7(4), 57-75.

Ellman, Michael (1994), "Transformation, Depression, and Economics: Some Lessons," Journal of Comparative Economics, 19(1), 1-21.

Esping, Andersen G. and Micklewright, John (1991), "Welfare State Models in OECD Countries: An Analysis for the Debate in Central and Eastern Europe," in *Children and the Transition to Market Economy*. Eds.: G. A. Cornia and S. Sipos, pp.35-68.

Gomulka, Stanislaw (1994), "Economic and Political Constraints during Transition," *Europe-Asia Studies*, 46(1): 89-106.

Kessides, Christine, Davey, Kenneth, Holzman, Robert, Micklewright, John, Smith, Andrew and Hinayon, Carlos (1991), *Hungary: Reform of the Social Policy and Distribution System*. Washington, D.C.: The World Bank.

Kolodko, Grzegorz W. (1993), "From Output Collapse to Sustainable Growth in Transition Economies. The Fiscal Implications," *Working Papers*, Institute of Finance, Warsaw, No. 35.

Kopits, George, Holzman, R., Schieber, G. and Sidgwick, E. (1990), *Social Security Reform in Hungary*. Washington, D.C.: International Monetary Fund.

Kornai, János. (1992), "Postsocialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems," *American Economic Review*, Papers and Proceedings, 82(2), pp.1-21.

McKinnon, Ronald I. (1991), "Financial Control in the Transition from Classical Socialism to a Market Economy," *Journal of Economic Perspective*, 5(4): 107-122.

Oblath, Gábor and Valentinyi, Ákos (1993), "Seigniorage, inflációs adó és államadósság: néhány makroökonómiai összefüggés 余 magyarországi alkalmazása," mimeo, Budapest: Kopint-Datorg, September.

Portes, Richard (1994), "Transformation Traps," *The Economic Journal*, September, 104: 1178-1189.

Tanzi, Vito (1989), "Fiscal Policy, Growth, and the Design of Stabilization Programs," in: *Fiscal Policy, Stabilization, and Growth in Developing Countries*. Eds.: M. Blejer and K. Chu. Washington, D.C.: International Monetary Fund, pp.13-32.

Taylor, Lance (1994), "The Postsocialist Transition from a Development Economics Point of View," in: *Rebuilding Capitalism: Alternative Roads after Socialism and Dirigisme*. Eds.: A. Solimano, O. Sunkel and M. I. Blejer. Ann Arbor: The University of Michigan Press, pp.21-56.

Tóth, István György (1994), "A jóléti rendszer az átmenet idószakában," *Közgazdasági Szemle*, March, 41(3), 313-340.

摘　要

本文內容主要是探討五項匈牙利總體經濟所面臨的壓力——通貨膨脹、失業、預算赤字、國際收支逆差，以及生產下降；對於匈牙利總體經濟其他層面的問題，例如貨幣政策等則未加著墨。本文所秉持之看法是如果生產能穩定成長，則所有失衡問題將可獲紓解。(1)匈牙利之通貨膨脹本質上具有慣性，要結束工資自動指數化，並壓抑工資的上升，必須對此慣性有所瞭解。此外，消費與投資比例之轉變應該謀求穩定，以利投資。(2)高勞動成本使得失業率難以降低。(3)財政赤字之降低與消除應有一致性之措施；穩定成長是解決財政赤字問題之要件。匈牙利財政政策之核心問題在於不切實際之國家福利政策。匈牙利是一個尚未成熟的福利國家，調整國家福利不成比例的支出將造成政治困境。(4)國際收支逆差造成嚴重問題。解決之道在於採取較適當之匯率政策並伴隨生產結構之轉變，以促進出口及減少進口。(5)本文所提之策略為先補救失衡，然後專注於謀求成長，亦即，促進成長是匈牙利當務之急。