

## Transformational Recession: The Main Causes<sup>1</sup>

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### **Kornai, János—Transformational Recession: The Main Causes**

All the post-socialist 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-economic consequences of the hardening of financial discipline, and (5) the backwardness of the financial system. Two components of macro-demand, investment and exports, are then examined. The most important factor here is the dwindling propensity to invest. Finally, a summary of the conclusions to be drawn from the analysis is given. There are good reasons for placing the tasks of emerging from the recession at the top of the list of economic-policy priorities, but it is important to do so without permitting an acceleration of inflation or a resumed increase in indebtedness. *J. Comp. Econom.*, August 1994, **19**(1), pp. 000–000. Harvard University, Cambridge, Massachusetts 02138; and Collegium Budapest, Institute for Advanced Study, P.O. Box 16, H-1250 Budapest, Hungary. © 1994 Academic Press, Inc.

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All the post-socialist countries have undergone a deep recession in the 1990s, and by the autumn of 1993 no recovery had begun in any of them except Poland. Although each country's development has specific features, there seems to be emerging a common pattern that differs essentially from

<sup>1</sup> The article has been written as part of a broad research program on the subject of the transformation of the Hungarian economy in the period 1986–1992. Certain sections of this text coincide with an earlier, longer study (Kornai, 1993b). I explored the same field in the 1993 Francois Perroux Lecture at the Collège de France in Paris and in a subsequent lecture at the Economic Revolution in Eastern Europe conference in Amsterdam. I thank the participants in the debates after those lectures for their thought-provoking contributions. I am most grateful to Mária Kovács for her wide-ranging assistance with the research, to Michael Ellman for valuable

TABLE 1

INDICES OF GDP, INDUSTRIAL PRODUCTION, AND PRODUCTIVITY IN HUNGARY, 1980-1992

Year	GDP <sup>a</sup>	Gross industrial production <sup>a</sup>	Gross production per employee <sup>a</sup>
1980	86.3	89.4	76.6
1981	88.0	91.2	80.2
1982	91.3	93.2	83.8
1983	91.9	93.9	86.0
1984	94.4	96.3	88.7
1985	94.1	97.2	90.2
1986	95.5	98.9	92.4
1987	99.4	102.7	98.4
1988	99.3	102.1	100.5
1989	100.0	100.0	100.0
1990	96.5	89.8	95.0
1991	85.0	74.9	89.1
1992	81.2	67.5	92.5

Source: Központi Statisztikai Hivatal (1993b, p. 71 and 95).

<sup>a</sup> 1989 = 100.

the usual cases discussed in theories of economic cycles. To distinguish this pattern I will use the expression transformational recession.

The main purpose of this study is to analyze the causes of this special kind of recession. The problems will be illustrated throughout with the example of a single country, Hungary. The depth of the recession is shown in Tables 1 and 2. Through the Hungarian example I attempt to outline a general conceptual and analytical framework appropriate for examining other post-socialist countries.

Some authors dealing with the question single out one main cause, such as the collapse of intra-CMEA trade. For my part I agree with those who consider the recession a multi-causal phenomenon.<sup>2</sup> The first section of the study looks at the general causes of the recession, the second deals with the constituents of macro-demand, and the third examines the economic-policy implications.

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editorial suggestions, to Brian McLean and Julianna Parti for the excellent translation, and to the European Bank for Reconstruction and Development and Hungary's National Scientific Research Foundation for their financial support to the program.

<sup>2</sup> There is a widespread literature on the recession in post-socialist countries. I mention only those that have influenced my thinking the most: Commander and Coricelli (1992), Erdős (1992), Gomulka (1991a,b), Laski et al. (1993), and Kolodko (1992).

TABLE 2

## VACANCIES AND UNEMPLOYMENT

	Number of registered vacancies	Number of registered unemployed	Unemployment rate (%)
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
1993/03	35,760	697,585	13.4
06	30,771	657,331	12.6
09	35,784	669,761	12.9
12	28,089	632,050	12.1

*Source.* Reports of the National Labor Center, Budapest, 1991–1994.

*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.

## I. THE GENERAL FACTORS INDUCING THE RECESSION

### 1. *From a Sellers' Market Toward a Buyers' Market*

Not even at the peak of the business 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 that intensifies competition even more.

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' to a buyers' market, from a supply-constrained economy to a demand-constrained economy. This is a process that

is to some extent consciously controlled by monetary and fiscal policy, as well as by pricing policy, out of a desire to bring the shortage economy to an end. Its course is influenced by several uncontrolled, spontaneous circumstances as well. There is a complex mutual interaction between recession and the switch from a sellers' to a buyers' market, so that neither process can be plainly said to have caused the other.<sup>3</sup>

In the countries that were moving away from the classical form of socialism before the political turning point, especially Hungary, the transition to a buyers' market began earlier. Table 3 is instructive in this respect, because it shows how the supply constraints, such as shortages of labor, materials, semi-finished products, and components, eased steadily over a period of seven years. Already it is rare for physical resource constraints to constitute a direct obstacle to production growth. The low frequency with which production in Hungary runs up against input constraints can be found in any mature market economy. 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 to this very substantial change, the role of the demand constraint increases. The table shows clearly that this is now the most often encountered obstacle to raising production, although a very important role is also played by financial constraints, which are discussed later.

To simplify somewhat, this long period of transition in Hungary can be divided into two stages. In the first, repressed inflation, which constituted one feature of the shortage economy, turned into a moderate rate of open inflation. The gradual, increasingly widespread freeing of prices moved toward this change; a price level developed at which macro-supply and demand could reach equilibrium. This was also helped by supply factors such as 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 sped up, reaching a peak in June 1991, when prices were 38.6% higher than those of a year before. These processes presumably soaked up the unspent purchasing power or monetary overhang. In other words, there was an end to the macro-economic situation that some economists characterize as a general excess demand.

The disinflationary efforts of the financial administration commenced in 1991 and became more perceptible in 1992. The rate of inflation reached its lowest level in July 1992, when the price level was 20.1% higher than that of 12 months before. In 1993 it fluctuated within the range of 20–26% on a yearly level. To some extent, demand actually had been held in check even

<sup>3</sup> For the link between the switch from a supply-constrained to a demand-constrained regime and the fall in output, see Ellman (1993).

TABLE 3  
 IMPEDIMENTS TO PRODUCTION, HUNGARIAN SURVEY DATA (%)

Quarter	Insufficient demand	Shortage of labor	Insufficient supply of raw materials and spare parts			Financing problems
			Domestic origin	Imported from ruble area	Imported from dollar area	
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
2	68.8	3.0	8.0		3.2	47.3
3	67.9	3.7	7.5		3.1	46.6

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 as a 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 that are not included in this table. Ruble area refers to the former member countries of CMEA. 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.

earlier by monetary policy. Although no orthodox monetarist economist would call the financial policy of the late 1980s and early 1990s restrictive, as scope constantly remained for a very sizable inflationary growth in the money supply, demand clearly did not run away.<sup>4</sup> In fact, it fell appreciably in volume terms, and the gap between demand and the earlier maximum supply, i.e., potential GDP, steadily widened. Ultimately, the economy on the macro-level tipped from a state of excess demand to insufficient demand.

The recession cannot be explained solely in terms of insufficient demand. Even now, only two-thirds of firms consider the lack of demand an obstacle to production.<sup>5</sup> We currently face a half-Keynesian situation for whose treatment a doctrinaire Keynesian therapy is not suitable in itself. But precisely because the situation is already half-Keynesian, demand plays a very marked role in determining output. So the second part of this study analyzes this issue in detail. In a post-socialist 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 by the demand side, the demand side has assumed the primary role.

In fact I am troubled by the use of the expressions general excess demand and excess supply, because they simplify the description of the situation. For a long time I have been against the rash use of aggregate macro-categories in this subject area. Unsold goods also existed in the shortage economy. Occurrences of excess demand and excess supply can coexist at the micro-level. Some producers run up against supply constraints, while others meet with demand constraints. This caution is now more apposite than ever, but it leads 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 the 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

<sup>4</sup> A part in curbing demand was played 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 was accompanied by a lessening of investment hunger. Firms, and even the state budget, became less prodigal in their spending.

<sup>5</sup> 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 Laffont (1985, p. 354).

this is accompanied by liberalization of foreign trade, which, in Hungary, took place simultaneously to a substantial extent, the more strongly and immediately the effects of foreign relative prices are felt. It suddenly emerges that there is not 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 suffer 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, and 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. 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 post-socialist transition. Some of these reasons will be discussed 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 past few years. At the 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 4). Within this process, thousands of alterations, great and small, take place on the micro level in the specific product composition of output.

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 change. There is a fall in the proportion of the purely state-owned sector and a rise in that of the purely privately owned and the mixed-ownership sectors that cover various combinations of state and private ownership. This occurs in such a way that the production of the purely

TABLE 4  
COMPOSITION OF GDP IN HUNGARY

Branches	Sources of GDP by economic branches (%)			
	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
Total 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	—
Total nonmaterial activities	15.1	21.0	23.1	25.6

*Sources.* 1986, Központi Statisztikai Hivatal (1989, p. 57); 1988 and 1990, Központi Statisztikai Hivatal (1992a, p. 95); 1991, Központi Statisztikai Hivatal (1992b, p. 61).

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 political system change. 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 too wrong to say that the two most characteristic actors in a post-socialist 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, but because 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 business cycle; the idea features large in the cycle theories of Spiethoff and Schumpeter.<sup>6</sup> In the transformational recession, this process is far more intense and comprehensive. At the end of a capitalist business 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.<sup>7</sup>

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 learned the new behavior to suit the new situation.

Certain former institutions of bureaucratic coordination (organizations and legal regulations) have ceased operation, but the erection of the new market institutions either has 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 is woven.

The information structure of bureaucratic coordination has disappeared, 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.

Bureaucratic coordination, especially in its more consolidated periods be-

<sup>6</sup> See Spiethoff (1902) and Schumpeter (1934, 1939). An excellent account of these two cycle theories can be found in Hansen's well-known summarizing work (1964).

<sup>7</sup> Calvo and Coricelli refer in their study (1992) to a trade implosion. Trade relations are destroyed by the absence of market institutions. Similar phenomena are mentioned by Ábel and Bonin (1993), who refer to "desertion by the state." 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.

fore the final disintegration, supplied a kind of order and predictability. The market, by its nature, involves its participants in great uncertainty and risk. This is exacerbated 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 that jumped almost directly from classical socialism to post-socialism. 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 Bauer as one that was "neither plan nor market."<sup>8</sup>

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 fallen sharply. Cooperative production based on collective ownership complemented by private farming on household plots 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, 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 ceased to function under these conditions, but the requisite new system of coordinating institutions, an up-to-date new wholesale and retail network to link the smallholders to the consumers, a new credit system for smallholders, and a stability-enhancing price and subsidy system in line with European practice, still have not developed. All these factors gravely impede production. They have been compounded by a succession of government mistakes, above all regarding the compensation of formerly expropriated landowners and the reorganization of the cooperatives.

The other example is the construction industry, and in connection with it, housing construction and urban planning. Although this sphere was neglected under the socialist system, it still had an established organization and

<sup>8</sup> See Bauer (1983).

system of institutions. There were periods when its performance was relatively good, at least in terms of housing completions, even though the quality of the housing completed was poor. Now this sphere is in a state of collapse as well, even though there is a great demand for housing. 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 a clear 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 conflicts between them. As a result of all this, housing construction has fallen seriously, whereas it might have been one of the leading sectors in the post-socialist 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 regulation 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, organizing supervisory agencies in conformity with the market economy, and supplying a system of state guarantees in certain areas requiring them.

#### *4. Financial Discipline and Enforcement of Efficiency*

A hardening of firms' budget constraints can be observed in the Hungarian economy.<sup>9</sup> The most tangible manifestation of this is the forceful implementation of bankruptcy legislation, even if some mitigation of this originally very strict piece of law has come about. A large number of insolvent firms are undergoing reorganization through bankruptcy proceedings, and many of them are being liquidated.

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.

Whether these changes have an effect on the recession, the phenomenon discussed in this study is a critical question. Some of the firms go bankrupt and exit, which means layoffs and an end to the firm's demand for inputs. The survivors, who from now on use market instruments to fight for their survival, economize on their expenditure better than they previously did, which means that their demand for inputs is decreasing. They try to use up

<sup>9</sup> This process is analyzed in greater detail in Kornai (1993a).

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 1 shows 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. In many cases experience confirms what would be expected from theory: the first thing the new owners do is dismissal of 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 and thereby growth 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. 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 post-socialist 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 a wholly monetized capitalist economy and a semi-monetized socialist economy be appreciated.

Let me now return to the last column in Table 3 which shows 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.

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. In the successor states of the Soviet Union, thousands of money-losing firms are being kept alive by bank credits. This phenomenon does not occur on a mass scale in Hungary, but not even here 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.<sup>10</sup>

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. So a paradoxical situation has developed. On one hand, commercial banks are shy of lending on a broad scale, but on the other, entrepreneurs are shy of drawing credit because they think it is too risky.

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 somewhat less alarming because of the steep rate of inflation, but still high enough to deter many entrepreneurs from borrowing. Nevertheless I tend to agree with those who say that the main cause of the reluctance to borrow is uncertainty.<sup>11</sup> 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 the least, the forecasts about 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 above, 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 a few examples. There has not yet emerged a system of collateral and guarantees that is not just a copy of the rules and conventions of mature market economies and that allows for the immaturity of the Hungarian economy and the initial problems of entrepreneurs. The network of various kinds of development banks, investment funds, venture-capital companies, decentralized pension funds, and other financial intermediaries has still not consolidated. The development of the capital market is at an early stage.<sup>12</sup>

<sup>10</sup> 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 they find it hard to bring themselves to take harsh measures to force repayment.

<sup>11</sup> See, for instance, the article by Valentinyi (1992).

<sup>12</sup> It is particularly worth noting that the country is facing problems of immaturity not only in the banking sector in a narrow sense, but also in the broader financial sector. It would be a mistake for credit to play an excessive role in financing 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 and the underdevelopment of the organizations managing investments deters many money holders from bringing their savings to the capital market.

Mention must again be made of the two branches referred to earlier, agriculture and housing construction. Throughout the world, both of these have special credit and investment schemes. In Hungary, the development of these proceeds very sluggishly, which has 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. Hesitation and a lack of imagination have occurred in a field where there is a real need for constructive governmental initiative.

Calvo and Coricelli (1992) 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. In my view the problem lies in the excessive friction and low efficiency with which the financial system operates as an intermediary between the depositor-saver and the borrower.

To sum up the first section, the post-socialist transformation necessarily gives rise to processes that tend toward a reduction in aggregate production. This painful consequence of the transformation has been examined in five dimensions. These, intertwined with and reinforcing each other, hinder growth and retard production. Their negative effects are compounded by mistakes on the government's part.

## II. INVESTMENT AND FOREIGN TRADE

Attention was drawn in part I of the previous section to the conspicuous and constantly expanding role played by the demand side in determining output during the period of the post-socialist transition. The change in the components of macro-demand is surveyed in Table 5. Here attention will center primarily on the reduction in investment and export demand. Although the fall in consumption and government spending also plays a major part, closer examination of this will be omitted for reasons of space. I would like to stress in advance that I do not confine myself to the demand side; mention will also be made of some aspects of supply. Although I take a macro approach as the point of departure for examining the phenomenon, I also refer to the micro-economic 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 6) to 27% below its peak.

TABLE 5  
CHANGES IN GROSS DOMESTIC PRODUCT OR EXPENDITURE

Components	Volume indices (%)				
	1989/1988	1990/1989	1991/1990	1992/1991	1992/1989
Private consumption	102.3	96.4	94.2	97.8	88.8
Collective consumption	93.7	102.6	97.3	98.9	98.7
Final consumption	100.8	97.3	94.7	98.0	90.3
Gross fixed capital formation	107.0	92.9	88.4	93.6	76.9
Gross capital formation	101.2	95.8	77.7	78.6	58.5
Total domestic use	100.9	96.9	90.4	93.8	82.2
Exports	101.2	94.7	84.7	—	—
Imports	101.8	95.7	91.2	—	—
Total GDP	100.7	96.5	88.1	95.5	81.2

*Source.* Period 1988–1991, Központi Statisztikai Hivatal (1993a, p. 105); 1992, National Bank of Hungary (1992, p. 129).

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

TABLE 6  
FIXED CAPITAL FORMATION IN HUNGARY, 1980–1992

Year	Fixed capital formation <sup>a</sup>
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	72.8

*Source.* The data were given by the Central Statistical Office of Hungary.

<sup>a</sup> 1980 = 100 (on the basis of comparable prices).

works manager to the prime minister were driven by the expansion drive. The fact that the bill for investment was paid, in the end, out of public funds, so that the financial failure of the investment was hidden, 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 it. Investment hunger came to an end, to be replaced by caution, and even fear in many people.<sup>13</sup> Let us take the various spheres of investment decisions in turn.

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 major investments, as the decision could be made 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 infrastructure investment.

The state-owned firms that are likely to remain in long-term or permanent state ownership need investment to secure their survival and to modernize. The trouble is that many of these firms are also up against serious financial difficulties and are 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. Managers, of course, have a responsibility for these investment decisions, which they cover out of public money after all, but this should not stop all such decisions from being made. Public opinion within the business community should also encourage the state sector to invest.

The situation is even worse in firms that are still in state ownership but are 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.

<sup>13</sup> 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.



An acceleration of privatization 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 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 greater incentives to carry out the tasks just described, so that the assets privatized are as valuable as possible, not in a run-down condition.

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 in the financial sector discussion: 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 insufficiently favorable toward investment. Many would also include among the factors curbing the propensity to invest the high level of interest rates. Overcoming these unfavorable circumstances is the key factor in recovering from the recession.

Household investment in the construction of owner-occupied apartments or houses financed from savings and credit could also play a major role. 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, through more easily accessible credits and tax concessions, could play an important part in overcoming the recession.

## 2. *Foreign Trade*

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 CMEA countries, including the breakdown of the former Soviet market, has caused the greatest upheaval.<sup>14</sup>

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 in a geographical

<sup>14</sup> An attempt to quantify this effect numerically was made in a study by Rodrik (1992).

sense, but all the characteristics of CMEA trade can be traced back to the fundamental features of the socialist economic order, and its effect is deeply embedded in the regularities of the system. The sellers' market was able to work because there was a CMEA 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 CMEA trade, however, has lasting effects. The structure of these economies must be altered once and for all before they can prosper without it.

Table 5 shows plainly that, of the main components of macro-demand, exports fell dramatically up to 1991 even more than gross fixed capital formation.<sup>15</sup> 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. This ensured that the Hungarian economy stayed on its feet, that the fall in production did not assume catastrophic proportions, and that the country's international payments position consolidated. Unfortunately, this westward expansion of exports could not be sustained. We are unlucky, because a recession appeared in the West just when we had the greatest need to expand into their markets.

Another problem is that the first great advance was made according to the old formula, export at any cost. Many firms, particularly in the state sector, shouldered great losses in forint terms to be able to export and not have to shut down production. This cannot continue in the future as the budget constraint hardens. Instead, the struggle now must be for all possible additional exports that are profitable without a state subsidy. On the other hand, the restriction of domestic demand has eased somewhat, so that firms feel 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 unfavorable weather, the growing tendency of protectionism shown by importing countries, and the crisis in agricultural production discussed earlier in the study.

I agree that exports constitute one of the growth-inducing branches for small open countries in the long term, but it is hard to decide to what extent exports can contribute to the urgent short-term task of overcoming the recession as soon as possible. Some of the means mentioned earlier in connection

<sup>15</sup> Export and import data for 1992 according to the breakdown of Table 5 are not yet available. Hungary's export performance improved somewhat in 1992. The value of exports settled in convertible currencies and measured in U.S. dollars was 1.1% higher than that in 1991. However, exports decreased dramatically in 1993. In the first half of the year Hungary's exports amounted to only 72.4% of exports in the same period of 1992 (National Bank of Hungary, 1993, p. 73).

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 exports.

Detailed analyses do not support the proposition that imports always squeeze the domestic producers out of the domestic market even if there are examples of this. Many firms without an import rival have sunk into deep crisis, while many firms continue to produce and sell successfully despite competition from imports. This is not an argument against giving temporary protection to some domestic products or groups of products on a considered basis of economic rationality, although not under pressure from lobbies. This can contribute to curbing the recession, but the protection must be temporary, until the necessary adjustment has been made, and in line with the prescriptions of GATT, so that it does not lead to protectionist retaliation by foreign trading partners.

Concerns about both imports and exports make it necessary once again to rethink 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 deepen the recession. The campaign against recession must include a revision of exchange-rate policy.<sup>16</sup>

Devaluation is known to give a boost to inflation.<sup>17</sup> Whichever way Hungary goes, either recession or the inflation will get worse. This dilemma arises in connection with most of the measures to be considered, and so it must be faced in its more general form, which the final section will do.

To sum up the second section, the contraction observed in all four components of macro-demand is largely the result of the transformation process itself, but a role in the development of macro-demand is also played by the economic policy of the state, and the severity of the recession is partly attributable to errors and mistakes on the part of the government.

### III. CONCLUSIONS

#### *I. Priorities*

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

<sup>16</sup> This idea is argued in detail in a study by Oblath (1993). I agree with its conclusions.

<sup>17</sup> 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 exchange-rate policy is that it should be based on a social consensus.

1. The increase in indebtedness had to be halted, and 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 managed from the point of view of welfare policy.

Neither the political statements and government programs nor the writings of economists included as 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 range of moderate inflation.<sup>18</sup> 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 increase in foreign-exchange reserves.<sup>19</sup> A slight deficit in the current account is temporarily tolerable, although any marked deterioration in the balance of payments 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. From past experience, I know there is the possibility of my proposals being misinterpreted.<sup>20</sup>

There is no justification for relaxing attention on inflation and the balance of payments. In fact the danger of inflation and accumulation of debt will be greater than ever, precisely because measures are being taken against recession. Countries that only have to cope with one of these three painful problems, inflation, for example, or only with recession and the accompanying

<sup>18</sup> Experience in many countries shows that an economy can remain within this band for several years without reaching single-figure inflation but still avoid the danger of a renewed acceleration of inflation. See Dornbusch and Fisher (1993).

<sup>19</sup> This last proposal should be understood as follows. The yardstick is not the absolute size of exchange reserves, but rather the ratio between them and the volume of imports. Point 3 embraces the suggestion that it is not worth increasing this ratio further.

<sup>20</sup> 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, and 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.

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 to which disease to devote the most attention in the immediate future, that is, the disease we consider most acute.

My proposal is a half-turn toward 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. Success will require a convincing, detailed, practical program whose implementation must begin at once.

What justification is there for rearranging 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 sought at all times. They are intermediate goals and instrumental values that must be appropriate for a specific situation and rearranged if the situation changes. No universally valid order of priority can be established between growth of production, reduction of unemployment, curbing of inflation, and improvement of the international payments position. So the question could be more specifically phrased: what alterations in the situation justify reappraising the priorities? Let me pick out a few circumstances.

First, as I pointed out in the introduction, a protraction of the recession cannot be ruled out. The recession 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 health services, education, and infrastructure, and so on. None of these problems can be solved satisfactorily by redistribution, by transferring resources from elsewhere to carry out tasks that have been put off or neglected. Only a growing economy can slowly but surely resolve these and other problems.

Second, while the private sector is the force on which we can most rely for overcoming the recession, insufficient demand is already holding back private-sector development. It is increasingly hard for many private firms coping with the difficulties of start up to keep their heads above water.<sup>21</sup> If the total volume of the private sector's production should start to decline, the prospects for recovery would become almost hopeless.

<sup>21</sup> 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 of the large firms that had expanded rapidly. See Hámor (1993).

The third, and possibly weightiest, factor is that the reduction in the real income of a sizable 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 post-socialist region, including Hungary.<sup>22</sup> It should be remembered that mass unemployment and waves of inflation in Weimar Germany 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 the half-turn proposed in this study sets out to do.

## 2. *The Role of the State*<sup>23</sup>

In theory there are two ways out of the recession, forward or backward. Backward means restoration of the old structure of the economy with subsidies, support for inefficient exports, subsidies for state-owned firms in financial crisis and many jobs along with them, protection for all domestic producers from import competition by protectionist means, and maintaining 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 an economic sense can be realized by a combination of hyper-Keynesian demand-inflating monetary and fiscal policies and bureaucratic interventionism. Ideas of this kind appear in several places, tinged with the various colors of the Hungarian political spectrum.

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

<sup>22</sup> In my reading, I first encountered this expression in an article by Tamás (1990).

<sup>23</sup> Here and elsewhere in the study, I mean by the state the ensemble of all the branches of state power, legislative, executive, and judiciary. I note 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 they share responsibility for the development of the country with the government.

Among those who agree with this progressive policy of consistent transformation, two views on the strategy to be followed exist. 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 it 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 favored 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.

I am now, however, obliged to adjust this perhaps too-doctrinaire position somewhat. I am inclined to do so by awareness of the political danger of Weimarization mentioned above. Another argument for this change is a recognition that simply to await a spontaneous, self-engendered movement in the present political and economic situation in Hungary could yield what is known in economics as a low-level equilibrium trap. In Hungary's case this situation would bear the following characteristics:

There would be a prolonged slackness to invest. 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 remain at its present level for lack of entrepreneurial spirit. Foreign capital would lose interest 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. The decline in economic activity would halt, but the economy would be unable to climb out of the trough.

This is no mere hypothetical 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 do not advocate superabundant state intervention and bureaucratic micro regulation. This would lead to the very situation of backward movement with which I strongly disagree, combatting the recession by partially restoring the old system.

It is worth referring, in my view, to these 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, which is to 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 natural monopolies. It must do all these things in such a way that they serve the priorities of the present day. In the

second grade the state must take a more active role 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.

Thus I do not support those who propose that the state should do nothing. That would relieve the legislative and executive branches of the responsibility 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.

One of the grave problems with exports, investment, and economic development as a whole is that the uncertainty surrounding the consequences of decisions increases during the post-socialist transition. The state can help to reduce this uncertainty in a number of ways. It should narrow down as far as possible the sphere in which it makes economic decisions, for example, in state investments. A far better solution is for the state to give partial government guarantees to private investors or to the financial institutions extending credit to them. In other cases it may take over some of the burden, e.g., by a tax concession or other subsidy, but only provided that the private investor assumes the greater part of the risk. So a kind of risk-sharing partnership emerges between the state and the private entrepreneur. The confidence of foreign lenders or investors will also be increased if the risk is seen as shared with both the state and private Hungarian capital.

The role of the state is among the most debated theoretical and practical economic-policy aspects of the transition. In my view there is no chance of determining theoretically, once and for all, the optimum degree of state activity. The protraction of the transformational recession will force people to make practical compromises and to show a pragmatism that rules out extreme, doctrinaire solutions.

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