Ten years on, the creating of a democratic, efficient market economy (in place of a planned economy of low efficiency and dictatorial traits) was still claiming victims among Hungary’s citizens. Not until 2001 did personal consumption recover to its 1989 level—on average, of course. Hungarian society in the early 1990s faced an explosion of unemployment, a general loss of job security and inflation rates unseen for decades. State services steadily slipped, differences of income and wealth became extreme, public security plunged, and corruption and contempt for the law became rife.

On the other hand, there were momentous positive developments, right from the start. For one, the shortage economy and its side effects were dispelled. The new-found competition for customers, domestically and from imports, had salutary effects. So did the right to own private property and conduct business without any restrictions on size, the influx of technical and cultural innovations from the outside world, the liberating of personal and economic connections abroad; last but not least, the introduction of parliamentary democracy. Since 1997 the annual rate of economic growth has exceeded 4 per cent. Employment has improved, inflation has eased and consumption has been rising appreciably. Economically, Hungary has been integrating steadily into the European Union. It became certain in the autumn of 2002 that full EU membership would follow in 2004.

If the economic recession of the 1990s and other negative effects are ascribed to the changeover from a socialist to a democratic economic order, this may justify asking whether the advantages are proportionate to the drawbacks. Except that deep down, the general crisis derived from the planned economy, not from the change of system. Back in the 1970s, the increase in Hungary’s foreign debt was still financing overall growth, but in the 1980s, it would only cover stagnation. By the early 1990s, the accumulation of debt could no longer be sustained, and a steep recession ensued. Events show how the Hungarian socio-economic system brought about by the planned economy was generally uncompetitive and that its structure suffered depreciation on the world market. Almost everyone agreed on this, but society was not confronted by the full scale of the problem until the protracted transformation supervened.

General crisis in the planned economy

Almost every country in Central and Eastern Europe underwent a grave economic crisis at the end of the 1980s and the beginning of the 1990s, with a concomitant and partly consequent political crisis as well. The process was rooted in a general crisis of the planned economy, which affected equilibrium, growth, structures and institutions, and extended to the mentality and set of values, the stratification, relative incomes, development goals, and education and motivation systems of society. This led up to a change of system, conducted at speeds and in depths that varied from country to country and region to region. (There is no attempt here to cover what prompted the Soviet state authorities to accept the change of system to various extents in the post-socialist and Soviet successor states, or what role the Western powers or efforts towards national self-determination played in the changes.)

Despite initial high hopes, the changeover in the economic system precipitated a recession. This was especially deep in most Soviet successor states and in the Balkan post-socialist countries, where shortcomings in their change of political systems—along with political chaos, tensions and even civil warfare—curbed or thwarted the implementation (indeed even the introduction) of essential economic reforms.

The recession was also severe, if less drastic in what became termed as the Visegrád countries. GDP slumped not only in Hungary and Poland, heavily indebted in the 1970s and 1980s, but also in Czechoslovakia (the Czech Republic and Slovakia). Recession came where there had not been any reform before the change of political system (Czechoslovakia) and where there had been many years of reform (Hungary and Poland). Nor did it make any difference whether the economic policy-makers adopted an express ‘shock therapy’ (Poland) or gradualism (Hungary). The recession was closely related to the collapse of Comecon and the consequent loss of export markets, coupled with the opening up of domestic markets. However, the loss of markets did not simply pose quantitative problems, it also embodied a comprehensive structural crisis. So the handling of the economic crisis—above all keeping individual countries solvent, resolving the tensions in their external and domestic balances, and curbing inflation—could not be confined simply to stabilizing measures. This handling also had to be of a modernizing
character, in the classic sociological sense of assimilating the country to the most advanced Western economic and social organization links and formats. Without such assimilation, it would not be possible to ensure the conditions for sustainable growth after the recession. But from that, it also follows that changing the system, developing a market economy and creating the set of conditions for lasting growth is a time-consuming process; as it involves major social conflicts, it only succeeds usually after setbacks and diversions, through a specific learning process.

The conditions for lasting growth and the structures to meet the new demands of a world economy can only arise through ‘creative destruction’. Nor can the destructive, conflict-inducing side of this be avoided. Although governments try to put it off in the hope of avoiding social tensions, this deferment only spreads the tensions and deteriorates the external and internal balances that are damaging to the whole economy, before leading to a renewed rise in inflation. The key, therefore, is to improve the interdependent abilities of the economy to utilize, attract and accumulate capital. In Hungary, the Németh government’s moves to prepare for the changeover of the economic system in 1989–90, the Kupa programme of stabilization and reform in 1991–2 (named after a finance minister in the Antall government), and the Horn government’s 1995 Bokros package can be seen as such measures. However, each of these programmes was followed by a slackening of effort related to, among other things, electoral politics with policy-makers becoming redistributive in outlook and seeking to avoid temporary infringements of vested interests. The Orbán government of 1998–2002 had neither the incentive nor the will to continue the process of reform. The Medgyessy government that took power in 2002 seems to be returning to a line of reforms based on the evaluation of financial criteria.

The legal and institutional system of a market economy

The introduction of the constituents and infrastructure of a market economy did not suddenly start in Hungary in 1990. (The earlier moves were alluded to in the West as ‘goulash communism’.) There had been constant efforts to reform the centrally planned economy from the decision to introduce the ‘new economic mechanism’ in 1966 and its implementation in 1968, despite some obstructions and setbacks. The last stage came in the second half of the 1980s, with the introduction of taxation reform, a two-tier banking system, and company legislation.

Hungary has introduced all the essential constituents of a European system of economic law and institutions and these are more or less functional. There are still important reforms to be made in public finance, especially in health and public administration. Still to be completed too are the processes of liberalization, privatization and EU legal harmonization. The gravest problems in legal security now lie in judicial implementation, not in legislation.

The deregulation and liberalization of the early 1990s meant that economic agents could decide freely and autonomously on almost all questions, including prices, wages, employment, investments and market cooperation. The sphere of state-controlled pricing was tightly restricted, and even in these cases, successive administrations relied mainly on negotiation, for instance, in the energy field. (However, that did not preclude the government in 2000 from beginning to intervene directly in the operation and pricing of the energy and pharmaceutical sectors. There are welcome signs that the Medgyessy government wishes to break with this practice.) For the commercial sector, the Interest-Conciliation Council formulates recommendations for pay increases, although these are not binding. Imports and exports of products and services have been liberalized. There are hardly any tariff barriers, and the movement of capital in or out of the country is unimpeded.

There has been a significant development in the system of economic-policy institutions over the last decade. The independence of the National Bank of Hungary is legally guaranteed. The state budget is broken up into more-or-less autonomous sub-systems and its deficit is financed on the market. The operation of financial institutions has been completely transformed. Competition has developed in commercial banking and in insurance, with large numbers of consultancy, intermediary and brokerage firms appearing. The Competition Office is in operation. There has been a substantive reform of the pension system. On the other hand, efforts to transform the agricultural sector, the health services and public education have achieved little.

The system of legal institutions for a market economy was built in Hungary with a speed and consistency exceptional in this region, but accompanied by widespread debate, essentially about whether ‘excessive liberalization’ was exacerbating economic problems that were clearly and objectively great. Postponing legislation to impose financial transparency in government and the banking system and financial discipline in the business
sector would probably have caused less destruction, but it would have meant less ‘creation’: much smaller inward flows of foreign capital, and less efficiency in the use of existing resources.

Meanwhile the extremely serious problems in implementing the law are slow to decrease. One reason is that the legislative process was the driving force (probably inevitably), so that new institutions were often introduced before their staff and the conditions for their operation were in place. For instance, supervision of business associations by company courts was ordained at a time when there were hardly any company courts in operation. Western-type accountancy law (i.e. giving the valuer wide scope for appraisal but heavy responsibilities as well) came into force before there were enough trained auditors and property valuers. The upshot was a constant discrepancy between the law and day-to-day practice.

Tax evasion became general across society. Contract infringement, value-added-tax swindles, fraudulent bankruptcy and other abuses of the law became socially acceptable. Legal security was further reduced by uncertainties surrounding the land registry, which only recently has been become better equipped with computers. Viktor Orbán’s centre-right government (1998-2002) especially set about evading the legal procedures for public procurement. Court proceedings are protracted and judgements often impossible to enforce. (Where rights have been infringed, the plaintiff cannot hope for commensurate compensation and the defendant is not concerned by the prospective penalties.)

Corporate structure and behaviour

Excessive concentration and centralization were characteristic of production and distribution before 1989. Most of the large enterprises had been created from artificial mergers. They practised autarky and were cushioned by a monopoly position at home. But the number of business associations and firms began to rise steeply at the beginning of the 1980s, when it became possible to found small businesses, and gained new impetus in 1989.

State ownership in the economy was still more than 90 per cent in 1990. By 2002, the ratio had almost been reversed, with private ownership accounting for 85 per cent. (Sixty per cent of this is down to foreign ownership, due to the privatization purchases, foreign greenfield investment and these investors’ greater accumulation capacity.) A similar change has occurred in contributions to GDP. The private sector produced hardly more than a quarter of GDP in 1990. This proportion had risen to above 90 per cent by 2002.

The number of companies in every category exploded after 1989, so that Hungary now exceeds the Western European average in density terms (over 8 companies per 1000 inhabitants). However, many of these in Hungary were founded simply to take advantage of tax breaks or for other reasons of necessity; these tend to behave like working individuals rather than risk-taking ventures. On the other hand, the earlier decentralization process has been paralleled in the last few years by a perceptible process of centralization. The number of large and medium-sized enterprises has been rising and sectors such as food processing, commerce, banking and insurance have seen a spate of mergers.

Privatization strategy has changed with every government and within each period of office as well. One constant feature has been the rejection of reprivatization, as technically impractical and politically unacceptable, and free distribution of state assets. Instead, the principle of sale at market value has been emphasized, complemented in some cases by preferential techniques that favour a particular class of purchaser.

There has been a demonstrable effect on Hungarian enterprises resulting from their access to international networks and from better performance through globalization. Almost all the 50 biggest multinational corporations in the world have a Hungarian subsidiary. However, the successful ventures include many medium-sized and even some small firms. The export orientation of Hungarian industry is clear from the fact that 60 per cent of Hungarian manufacturing output in 2002 was exported (with 80 per cent of this going to the EU). The international integration of Hungarian industry is reflected in the correspondence of business expectations between Hungarian and EU manufacturing firms.

Foreign-owned companies have a stimulating effect on the economy reflected in their increasing resort to Hungarian suppliers. This process is controlled basically by the multinationals, which tend especially to prefer tested suppliers with competitive experience when they procure inputs in which they are more sensitive to quality. These large
foreign suppliers, however, have an incentive to transfer some production to Hungary, which contributes to greenfield investment and later to the proportion of the client multinational’s input obtained in Hungary. Meanwhile, opportunities are also provided for existing Hungarian firms to join the supply network at the bottom of the pyramid. On the other hand, some business activities are now moving on from Hungary to countries with cheaper labour. Foreign investors are exploring prospects in South-East Europe as Hungarian wages are rising sharply and as the world economy enters a more sluggish period.

The Hungarian financial sector had a strong advantage over those of the other Visegrád countries when the transformation came in 1990. The most important aspects of this was the introduction of a two-tier banking system in 1987 (to replace the state-owned ‘monobank’ typical of a planned economy), the passage of legislation on securities, and the 1990 opening of a stock exchange. There followed, mainly in the second half of the 1990s, consolidation of the commercial banks at great expense to the budget, before they were sold mainly to foreign investors. The international assessment of the privatized Hungarian commercial banks is good. There has been strong competition among them, especially, of course, for the best classes of customers. This competition has brought a strong concentration in the banking sector. Consolidation of the insurance industry in 1990–93—mainly to remedy the acute capital shortage inherited from the planned economy—was carried out mainly by the new foreign owners, not the state, with the costs being borne ultimately by the customers. The sector has been developing especially fast since the appearance of voluntary and statutory pension funds and may start to play an important investment role on the money and capital markets.

Reform of the public finances

It became increasingly clear, especially in the latter half of the 1980s, that the incongruity between the low performance of the (planned) Hungarian economy and the country’s public spending, high even by European standards, could not be maintained. The public-finance system was weighing too heavily on the economy. Yet no consistent reform in public finance covering the revenue and expenditure sides has taken place since the 1989 change of system. Changes of a reforming nature were made in some important fields of public finance (after several attempts) and some of them have subsequently been reversed. The changes brought a structure of four sub-systems. The central budget and the earmarked state funds, which existed before, were joined by regional administrations independent of the state administration, and for a while, by social-security governing bodies as well.

Important measures of reform have included establishment of the State Audit Office (1989) and local-government authorities (1990), placing the social-security system on a self-governing basis (1991) and ‘renationalizing’ it (1998), the laws on the bank of issue and the budget (1992), establishment of the State Security Issuing Bureau (later the Centre for Handling State Debt, 1993), separation of social security from benefits of a non-insurance type and the introduction of performance financing into the health service (1994), the law on public procurement (1995), establishment of the Treasury (1996), radical reductions in the number of earmarked state funds (1996 and 1998), and raising the pensionable age (1996), followed by pension reform (1997). The ‘renationalization’ of the social-security system by the Orbán government in 1998 certainly altered a system that was operating badly, but it failed to provide better conditions of operation. Thereafter, reforms have stalled and the role of the state has begun to increase again. Measures that ran counter to the previous principles of public-finance reform included abolishing higher-education fees (introduced in the Bokros package of 1995), making several social benefits a universal entitlement again, and setting out systematically to sidestep the law on public procurement.

The performance of the economy

Not until 2000 did the GDP of the Hungarian economy exceed its level before the change of system. A long time, but that performance was still the best by any post-socialist country. A decisive factor was the economic policy aimed at attracting capital, mainly foreign capital, through privatization and other means. That made it possible for the branch, corporate and product structures of production and the sales market to undergo a fundamental alteration.

Eliminating excessive uneconomical capacity in industry was a necessary process. Suffering from a reduction in domestic and foreign demand for its products, industry also lost ground through increased competition from imports on the home market (while in other ways, the imports it employed were improving its competitiveness). At the low point in 1992, industrial sales were a third down on 1989. The decline in manufacturing (the key sector for economic development) ceased in 1992–3 and gave way in 1994 to increasingly rapid expansion. The export orientation of
industry increased dramatically, so that half of industrial production is being exported and more than three-quarters of the exports are going to the EU. Solvent domestic demand is tying down a decreasing proportion of domestic production. These developments show that the degree of autarky in industry has declined significantly, with concomitant increases in cooperation and participation in the international division of labour.

The growth rate of the Hungarian economy (and of industry) in recent years has tended to follow the acceleration and deceleration of the world economy, notably that of the EU and especially that of Germany. However, the level of integration achieved through the multinational corporations and the competitiveness that has extended to increasingly more sectors have allowed the Hungarian economy to develop faster than the EU average, during the upward and downward phases of the business cycle.

Agricultural output sank between 1989 and 1993 to an extent similar to industrial output, after which only a slow increase began. The national ratio of active wage earners in the agricultural sector shrank from 13% in 1990 to 6% today. It is clear that agriculture has been one of the big losers in the transformation in Hungary, since the sector has attracted practically no new capital, either domestic or foreign. The agricultural economy has still not emerged from its crisis and the conditions for lasting and balanced growth are still absent. Agriculture has hardly been touched at all by the huge energies that privatization has generally released in every other sector. The work of establishing and organizing the necessary market and semi-market institutions (information systems, buying, processing, selling and servicing associations, land sales and credit institutions, systems for asserting interests, etc.) has gone much more slowly than it should have. This is for want of effective governmental support and because the rapid emergence of transparent, predictable market conditions conflicts with the interests of certain decisive groups.

There has been an explosive development in telecommunications and retailing, where enormous development and modernization have taken place. The number of mobile phones in operation rose above 60 per cent in 2002, while the 20 per cent share of retail turnover done by large shopping malls and hypermarkets was much higher than in Germany. Liberalization has been slow to take effect in telecommunications, but in retail trading there is strong competition among the big chains, even by international standards.

The 1990s can be divided into two distinct stages in terms of exports. In the first four years, the collapse of the former Comecon markets and difficulties of the process of changing market directions led to a 20 per cent fall in export volume, i.e. a slightly greater fall than in GDP. The period 1994–2000, on the other hand, brought an extremely rapid increase of export volume, even by international standards. The average export increment of over 18 per cent a year far exceeded the rate of GDP growth. The growth of industry then slowed markedly in 2001–2, in line with the international downturn. The foreign-trade structure of the Hungarian economy underwent radical alteration in the 1990s, as EU relations became the decisive factor in exports and imports (although less in the latter case, due to the energy imports from Russia).

Employment in Hungary fell continually between 1990 and 1996, by almost 30 per cent (i.e. by 1.5 million, leaving some 4 million employees). Two-thirds of this fall took place in the first three years. After 1996, employment rose by about 1 per cent a year until stagnation, followed by a slight decline ensued in 2002. The workforce in the competitive sector fell sharply under market-economic conditions, while the number of those employed in the budget-financed sector hardly changed.

The fall in employment is a good indicator of the speed of transformation. In countries where the reduction is small, the earlier, less competitive enterprises and many of the jobs in them have survived, and the transformation process has hardly started. Where employment has fallen rapidly and this has been accompanied by an increase in productivity (Hungary is a good example of this) the transformation, privatization and the accompanying structural and organizational changes have taken place faster.

Investment adjusted quite flexibly to the fall in GDP after 1990, but consumption did so only after a long delay that translated into indebtedness. Hungary’s investment rate, having been 21.6 per cent in 1989, reached a trough of 18.9 per cent in 1993 before beginning to rise again and exceed 24 per cent in 2000. This is not a satisfactory rate by comparison with the modernization needs of the country. The volume of investment in 1992 was about 80 per cent of what it had been in 1989, which was not reached again until 1997. (This was about the same as the volume in 1980, due to the investment fluctuations in the 1980s.)
Dilemmas in economic policy

To simplify matters somewhat, two main opinions have been heard in recent years about the state of the Hungarian economy before EU accession, the assumed effects of entry and the strategy that Hungary should therefore be following.

One argument runs that it will benefit the underdeveloped Hungarian economy to join because of the supports obtainable above all through EU membership. On the other hand, the underdevelopment means that Hungary has to obtain as many derogations—temporary waivers of the regulations—as possible during the accession talks, because the structural backwardness of the Hungarian economy would prevent it from competing in Europe in many fields. Advocates of this would go so far as to slow down the accession to ensure that the transition was painless. They would like to see some of the supports obtained before accession, to assist in preparing for entry. This approach assigns a smaller role in transforming the Hungarian economy to internal reforms and places greater hopes on obtaining concessions and supports from the EU.

The other view regards EU accession as a matter of vital importance. It starts from the proposition that adapting to the world economy (which for a country Hungary’s size and in Hungary’s location in a globalizing world means adjusting to the multinationals and the EU) is the only realistic way to develop and modernize. Advocates of this view see structural adaptation to world-market demands and production systems as inescapable, irrespective of EU membership. While EU membership provides extra assistance for this (political stability and financial support), countries remaining outside will find the adaptation harder and more costly (for instance, due to the Schengen Agreement). Those arguing this case realize that the EU is also battling to retain its world-market positions, so that reforms involving reductions can be expected in some fields of EU and member-country activity, such as state ownership, welfare systems and budget expenditure. Modernization of the Hungarian economy depends mainly on continuing to improve its ability to attract and accumulate capital, in which the advantages of EU membership can play only an auxiliary role. Those advancing this argument therefore advocate the earliest possible membership on as equal a basis as possible.

These two opposing opinions on EU accession present some fundamental issues that have plagued Hungarian economic policy for decades. Such dilemmas concern equilibrium and growth, whether capitalism or the state should be the prime organizing force in the economy, whether growth should derive from market-economic reforms or stimulation of demand, and the scale and speed at which adaptation to the world market should occur. The debates are mainly in political and economic-philosophy forms, but behind them, of course, lie decisive economic and power-related interests.

Experience suggests that an economic policy of postponing reforms and stimulating demand without foundation produces not growth, but successive external balance-of-payments crises that lead to recurrent restrictive measures and major or minor reforms. However, the unpopularity of these measures leads to a subsequent unfounded loosening of economic policy and exacerbation of the balance-of-payments problems. Hungarian economic policy-making at the turn of the millennium has progressed beyond stabilization. It has managed to establish the main institutional constituents of a European market economy. Through these achievements, it has managed to spread international confidence in the Hungarian economy. Yet economic events in 2002 show that many see chances of expanding the room for economic manoeuvre by returning to the policy based on giving a broader role to the state, arguing that financial criteria and reforms no longer merit the same attention. These ideas gained further currency because parliamentary and local-government elections were held during the year. The facts demonstrate that there is still a strong inclination in the Hungarian economy—and its still young democracy and market economy—to apply policies that will damage the equilibrium of the economy. (Not that more developed countries are immune to this either.) However, there has been every sign since the 2002 autumn local-government elections that the Medgyessy government—like the earlier Antall and Horn governments at a similar stage in their terms—is intent on improving the financial equilibrium, furthering the reform process and meeting the EU criteria.

Bibliography


The author

Gábor Karsai, is managing director of GKI Economic Research Co., Budapest. His fields of research are market-economic transformation and analysis and forecasting of macroeconomic processes, on which he has published four books in Hungarian and one in English.