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Éva Ehrlich and Gábor Révész

Coming in from the Cold.

The Hungarian Economy in the 20th Century

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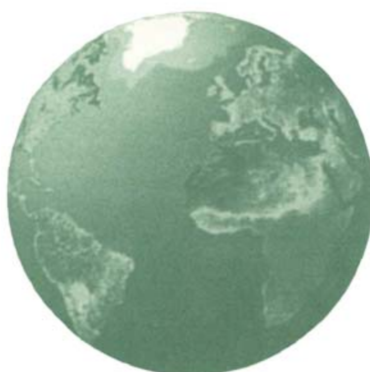

1014 Budapest, Orszagház u. 30.
Tel.: (36-1) 224-6760 • Fax:(36-1) 224-6761 • E-mail: vki@vki.hu

Summary

Hungary had to pay an enormous price for returning to the European mainstream. The output of the economy (calculated in the size of the GDP) reached the level preceding the change of the system only in 1999, although with a significantly more modern make-up. During the last two decades of the 20th century, Hungary – much like the other East and Central European countries – must have missed a potential growth of some 40 or 50 per cent which, from a historical perspective, may be regarded as a loss due to the long period of disintegration.

At the beginning and at the end of the century trends of modernization and integration were both present in Hungary. For the greater part of the 20th century, however, developments determined by political forces acted towards diverting the economy from the main trends in the Western world, and the country was breaking away rather than integrating.

The First World War put an end to the hitherto spectacular catching-up. The basis of the previous socio-economic processes and their continuity was removed by three main factors: (i) two thirds of the Hungarian Kingdom was lost, (ii) participation in the international division of labour was disrupted because of the realignment of the surrounding regions, (iii) the expansion of the world economy was halted and slowed down, and the overall pace of economic growth declined.

In 1937-1938 Hungarian industrial output exceeded the 1929 level by 25 per cent, and that of the pre-war years by some 40 to 45 per cent. With regard to the whole of the economy and 1938, the last year of peace, the growth in output in the inter-war years was about 40 per cent which, at a time when the population increased by 1.16 per cent, meant that per capita growth of GDP was 0.7 per cent per annum. This must be considered as below average, even amid the general slowdown in European economic development. In agriculture, despite some minor corrections, the wide disparity in the size of land-holdings survived (along with the rural deprivation and overpopulation they entailed), and this had a depressing effect on the domestic market. The ratio of the agrarian population was as high as 49 per cent even in 1941, when the war economy was already in full swing.

Real structural change was brought about much less by a rapid introduction of up-to-date specialities and new technologies (based mostly on electric and combustion engines) than by the expansion of outdated industries, which were already losing importance in the more developed countries. In its structure and technology, the Hungarian economy fell further behind the top level of the era than in 1913.

At the end of the Second World War Central and Eastern Europe fell under the dominance of the Soviet armed forces. Soviet economic and political control expanded continuously until the countries of the region became incorporated in the "Socialist world system" as Soviet satellites. This did not simply mean political realignment in line with the outcome of the war. The type of planned economy created in the Soviet Union appeared as a possible alternative to the capitalist, market economy for a number of reasons.

Despite some differences, it is possible to divide into major periods the largely uniform processes, policies and events within the economies of the Central and East European countries turning (or rather forced to turn) to "the building of Socialism" between the Second World War and the collapse of the Socialist regimes: reconstruction and resettlement after the war (1945-1950); the introduction of a planned economy (1949-1952); the period of forced growth (1950-1962); attempts at rationalization (1960-1980); the period of decline (1979-1989).

The Hungarian model of Socialism, made acceptable to the people by the "domesticated" and softened one-party regime, reached its limits by the end of the 1970s. The accumulated debt of the country proved insurmountable. Huge industrial capacities built for second-rate, poor-quality mass production, which grew increasingly outdated at the time of the rapid spread of high-tech industries world-wide, shortage of capital and external trade relations oriented for decades toward the Soviet Union and the other COMECON countries, made it

inevitable that this should turn into a debt trap in which servicing (and the avoidance of financial collapse) required more and more heavy borrowing.

At the moment of the changeover, the country had a huge debt obligation, with the majority of the debt being loans from private banks and of government bonds sold on foreign stock exchanges rather than credits extended by other governments. Consequently, there was little chance of rescheduling or easing the burdens. Thus there was no other way for diminishing the paralysing debt burden than to sell the business assets of the state and to use the money from these transactions (or some of it) to reduce the debt.

Meanwhile, in the last decade of the century, the recession of the Hungarian economy of the 1980s turned into large-scale decline and crisis. The main cause of this was the loss of liquidity of the Soviet market, followed by the disintegration of the Soviet Union. A considerable part of the industrial capacities geared to that market, could simply not be converted or redirected. Some products proved sellable in other markets but only at huge discounts and under conditions favourable to the buyer. Import competition caused further difficulties, yet the liberalization of imports, being one of the fundamental conditions for the effective functioning of market forces (especially in small countries), was absolutely inevitable. The agricultural sector owed its own crisis, in addition to suffering heavily from the collapse of the Soviet market, to privatization involving compensation. Many co-operatives went out of business, and the majority of their land – fulfilling compensation claims – went into the hands of former co-operative members or urban heirs in the form of small properties covering a couple of hectares. The disintegration of a considerable number of co-operatives that had functioned as co-ordinators, the division of their lands into small holdings, the shortage of equipment and capital, together resulted in a serious decline in agricultural production and in insolvency.

The above explains the enormous decline both in industry and agriculture: between 1989 and 1992, their output declined by an average 10 per cent annually, and in 3 years, by approximately 30 per cent. Services (including education and health as well as the bureaucracy) naturally acted as stabilizers. Nevertheless, the decline in GDP was extremely large: 18 per cent in 3 years (an average of 6.3 per cent per year), a decline comparable only to the worst of the Great Depression of the 1930s.

Within the conditions described above, the government of the changeover had no choice but to continue an economic policy oriented towards maintaining macroeconomic equilibrium. A strict fiscal and monetary policy limiting consumption continued and, following the decline between 1990 and 1993, it was actually intensified. The country had to face tough restrictive measures once again in 1995, following a period when, as a consequence of politically motivated and too hasty measures taken to invigorate the economy, the balance of payments deficit became dangerously large. New currency devaluations followed, and a special, temporary customs surcharge was levied on imports. After that, the volume of imports was reduced to a certain extent, and, as a consequence of the steep price rises (some 60 per cent in 2 years), the real value of incomes dropped drastically again, and so did consumption (by nearly 20 and 10 per cent, respectively).

These harsh economic measures restored the relative balance of the economy. At the same time, privatization and the expansion of foreign capital, renewing the economic microstructure and abruptly improving the potential of the economy, began to make themselves felt. The economy, as we have shown, was able to enter on a path of lasting, export-driven growth. Since 1996, the annual growth rate of technology-intensive exports, directed mainly to EU countries, has been a two-digit figure; since 1997 the annual growth of the GDP is 4-5 per cent, real income and consumption have slowly begun to grow, too, and since 1998, the number of jobs has also been increasing. On the basis of its economic achievements (and following its admission to NATO) Hungary is a top candidate in East and Central Europe for EU membership.

INTRODUCTION

At the start of the 20th century, the Hungarian economy, on the fringe of the highly developed areas in Europe, showed a powerful and sustained upward trend. The first hesitant moves toward modernization had been made in the early 1840s. The Compromise *(Ausgleich)* with Austria in 1867 ended the difficulties following the 1848-1849 revolution, and Hungary was integrated into the legislative, government and taxation systems of the Empire, which displayed more developed social conditions than those prevailing in Hungary. All this created a relatively favourable framework for the Hungarian economy. The pulling force was provided by the new wave of industrialization on the continent, the driving engine of which was Germany. The general industrial upswing carried Hungary along, and also produced an agricultural boom, strengthened by protective tariffs, which created a basis for the expansion of Hungarian industry. It also ensured access to the capital imports indispensable for the early stages of development, especially for the infrastructure.

In the period between 1867, with the *Ausgleich,* and the First World War, the output of the Hungarian economy grew at a rate which was among the highest in Europe, indeed in the world. GDP rose threefold in 40 years, and per capita growth averaged 2 per cent per annum. Even this was surpassed by the 2.2 per cent annual average per capita growth of the economy of the territory of today's Hungary (the post-Trianon-peace-agreement territory). Land under cultivation grew by a third despite the disparities in land holdings, worsened by the feudal heritage (and the resulting rural overpopulation and poverty); crop rotation was spreading, equipment improved, animal husbandry expanded and was modernized. In employment, the growth in industry and mining from 10 to 18 per cent indicates mainly that this was the period when the food processing industry, based on the agricultural boom, took wing,[1] so also did metallurgy and engineering, fuelled by the expansion of the railways. Since the country is a water-collecting basin, river control and inland waterways were developed on an unprecedented scale. A railway network connecting almost every town and village was constructed, and Budapest emerged as a European metropolis.

The structure of the economy reflected the effects of the country's extensive foreign trade. The huge agricultural potential, far exceeding demand, was counterbalanced by weaknesses in the production of consumer goods. In textiles, the most important among consumer goods, the market was dominated by the more modern and competitive Austrian and Bohemian textile industry. The ratio of exports against gross national income was extremely high, around 30 per cent (the European average at the time was 11 per cent). The overwhelming majority of goods exported were agricultural and food processing products, the most important export markets being Austria and Germany. The capital needs of the rapidly growing Hungarian economy were financed largely by German and Austrian banks, including the Vienna Rothschilds, the Credit-Anstalt, the Deutsche Bank or the Disconto Gesellschaft. Between the *Ausgleich* and 1914, some 40 per cent of all investments were covered (although to a diminishing degree) by foreign capital. A considerable portion of incoming capital turned into government debt. The significance of the latter was indicated by the fact that in the early 1910s, debt service (interest payment and capital repayments combined) made up 6 to 7 per cent of GDP.

At the beginning of the 20th century Hungary saw a successful integration, continued on an agricultural basis. It suited co-operation with the more highly developed economies in the neighbouring countries,

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[1] Between 1900 and 1910, Budapest became the world's second biggest flour milling centre after Minneapolis. Hungary supplied 24 per cent of the world's entire exports of flour.

which in turn aided Hungary's modernization.

What lends historical importance to processes at the end, as at the beginning, of the century is that they unambiguously embody economic integration with more developed neighbours, Europe and the world. In the second half of the nineteen-nineties the weight of foreign trade in the Hungarian economy is beginning to approach that characteristic of small countries with a developed economy. The value of both exports and imports amounts to and even exceeds half of the GDP. Three quarters of Hungarian foreign trade is with developed countries, within that two thirds with the fifteen member countries of the EU (around 40 per cent with Germany). The product structure is characteristic: two thirds of the goods are high-tech. Modern engineering (including vehicles) account for over 50 per cent of exports. The most important export items are high-tech mechanical installations and vehicles and computer and electronic instruments.

The expansion of foreign trade and the renewal and forceful modernization of the Hungarian economy was primarily due to the local operation of large multinationals. Financially powerful giant corporations[2] participated in privatization, in the renewal of green-field units, naturalizing new competitive technologies, modern management practices and marketing methods. A disproportional ratio (around a quarter) of the capital flow to the successor states of the former Soviet empire found its way to Hungary in the past ten years, $1550 per inhabitant till the end of 1997. The same index is $840 for the Czech Republic, $220 for Poland, $190 for Slovakia and $100 for Russia. About half the stock of venture capital is in the hands of firms in which foreign interests are involved,[3] more than a third of the total venture capital stock is of foreign origin. The deepest segment of the organic integration with the world economy is provided precisely by this extraordinarily extensive presence of foreign capital in the Hungarian economy.

At the beginning and at the end of the century trends of modernization and integration were both present. For the greater part of the 20th century, however, developments determined by political forces acted towards diverting the economy from the main trends in the Western world, and the country was breaking away rather than integrating.

A SHRUNKEN ECONOMY

The First World War put an end to the hitherto spectacular catching-up. The basis of the previous socio-economic processes and their continuity was removed by three main factors: (i) a sizeable chunk of the Hungarian Kingdom was lost, (ii) participation in the international division of labour was disrupted because of the realignment of the surrounding regions, (iii) the expansion of the world economy was halted and slowed down, and the overall pace of economic growth declined.

The economy suffered immense damage when Hungary lost some two thirds of its former territory, including several areas rich in natural resources. The territorial settlement cut off or destroyed connections which had developed in the course of history. The *Trianon treaty* put a major part of rail links outside the new borders, thus splitting a large number of minor regions into two and causing difficulties in domestic traffic. With the disintegration of the Empire, the supply capacities and demands of several larger regions, earlier interconnected, became separated, resulting in losses of balance which were difficult to handle and which, in some cases, had a destructive effect. Last but not least, totally in contradiction with the Wilsonian principle of self-determination, some 2 to 2.5 million ethnic Hungarians living in clusters (and not in a Diaspora) found themselves beyond the new borders.

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[2] Such as General Electric, Deutsche Telecom, IBM, TDK, Philips, Samsung, Nokia, Suzuki, Opel, Volkswagen-Audi, General Motors, Siemens, Unilever, Nestlé, ABM-Amro, Raiffeisen Unicbank.

[3] This figure includes those firms whose registered capital is at least 10 per cent foreign owned.

Thus, in the aftermath of the First World War, developments in both the immediate neighbourhood and in the world economy became unfavourable.

At the end of 1919, Hungary, truncated, having gone through revolutions, experienced the first period of peace in a state of exhaustion. Everyday life was full of bitterness and misery, with the obligation of providing subsistence to hundreds of thousands of refugees pouring in from the areas cut off from Hungary and to soldiers and POWs returning in rags. This was accompanied by a huge inflation which, although depressing, helped to kick-start the economy. Printing banknotes assisted in financing part of government obligations, helped make available the minimal credit necessary for starting the economy, and contributed to the decline in wages and thus to a supply of cheap labour. Between the summer of 1914 and the beginning of 1924, prices rose 8,000 fold, while wages rose only 3,500 fold, a drop in real wages of over a half. This latter naturally served as an incentive for business and towards employment. In addition, inflation proved beneficial in reinvigorating business, since savings (including insurance and old-age pension savings) lost their value. In this way the losses of some individuals – or families – can become the engines driving the economy. Within a few years, the Hungarian economy moved away from the bottom level, and slowly adapted to the changed conditions. The country's import-restriction policy also contributed to this. In 1924, agricultural yields had already reached 70 to 80 per cent of the pre-war levels, and the consumer goods industries, protected on the domestic market, also showed greater activity. Again, the textile industry's output in 1924 exceeded the 1913 figure by 70 per cent. With this surge in production and a League of Nations loan, it became possible, in the summer of 1924, to fix the exchange rate of the *korona,* and in 1927 a new currency, the *pengő* was introduced. By the end of the decade the economy could be said to be in a more or less consolidated state, with output somewhat exceeding the pre-war level.

Developments in the world economy were, however, unfavourable to the integration processes once again under way in Hungary. The Great Depression in October 1929 soon hit Budapest. In the spring and summer of 1931, Hungary could only be saved from complete financial collapse by tough government measures. Hungary, with a powerful agricultural sector and a high ratio of agricultural exports, suffered especially heavy losses due to the depression. In 1934, the prices of agricultural products, including export prices, dropped to less than 40 per cent of their level before the depression, and the Hungarian economy suffered a price loss of nearly one third of its full export value. Industrial activity declined heavily because of a chronic lack of orders. The level of registered industrial unemployment reached 35 per cent in 1932.

Attempts to avert the consequences of the depression made restrictive fiscal and foreign exchange measures a permanent feature. In many countries, government-financed communal developments and public works were started to counter unemployment.

The attempts aimed to lift Hungary out of the slough of depression soon ran parallel with the political and economic trends developing in Germany (this also conformed to the economic possibilities). In 1932, the programme of Hitler's National Socialist Party asked that Germany should direct its external economic strategy towards South-east Europe, that it should cover its raw material and food needs largely by imports from the countries of this region. Since agriculture was its largest sector, for Hungary's economy to climb back out of the pit it was imperative that agricultural surpluses should have a secure market abroad at acceptable prices. At the beginning of 1934 a German-Hungarian, then an Italian--Austrian-Hungarian agreement were concluded on large-scale exports of Hungarian agricultural products.

With the new momentum of agricultural exports, complemented by various additional measures (like the settlement of farm-

ers' debts, price-balancing subsidies, *etc.*) incomes in the agricultural sector slowly began to climb. With the imposition of tough import restrictions, this had a stimulating effect mainly on the development of light industry. In 1929, only 60-70 per cent of domestic demand was covered by the Hungarian textile industry. By the mid-1930s this ratio had risen to 97-98 per cent. Heavy industry output was also growing. It was given a boost through fully or partly government-funded orders directed at a partial modernization of the railways, the modernization of electricity supplies and telephone systems, and the slow spread of motor vehicles; some orders were for the replacement or completion of military material.

Industrial output in 1937-1938 exceeded the 1929 level by 25 per cent, and that of the pre-war years by some 40 to 45 per cent. With regard to the whole of the economy and 1938, the last year of peace, the growth in output in the inter-war years was about 40 per cent which, at a time when the population increased by 1.16 per cent, meant that per capita growth of GDP was 0.7 per cent per annum.[4] This must be considered as below average, even amid the general slowdown in European economic development.

Yet even in the inter-war period, the Hungarian economy recorded some remarkable achievements. Despite all this, however, the economy as a whole did not come close to the highest performance of the time either quantitatively or – even less – qualitatively. If anything, it fell somewhat farther behind.

In agriculture, despite some minor corrections, the wide disparity in the size of landholdings survived (along with the rural deprivation and overpopulation they entailed), and this had a depressing effect on the domestic market. The ratio of the agrarian population was as high as 49 per cent even in 1941, when the war economy was already in full swing.

Real structural change was brought about much less by a rapid introduction of up-to-date specialities and new technologies (based mostly on electric and combustion engines) than by the expansion of outdated industries, which were already losing importance in the more developed countries. In its structure and technology, the Hungarian economy fell further behind the top level of the era than in 1913.

Nevertheless, the Hungarian economy was able to keep a position among the countries of the world which had been achieved in more fortunate circumstances, at the turn of the century. This, in more concrete terms, meant that the per-unit output of the economy was about half or two fifths of that of the highly developed Western countries, and 30 to 40 cent less than that of Austria or Czechoslovakia. At the same time, Hungary was definitely ahead of Poland, its eastern and southern neighbours, as well as Portugal, Spain and Greece.

Germany set out on the road of conquest in March 1938. Hungary, having profited from previous German expansion, joined Germany in the war against the Soviet Union in 1941, and fully surrendered herself to the German political will. That was how Hungary became an active participant and, in 1945, one of the vanquished in the Second World War.

THE *CUL-DE-SAC* OF STATE SOCIALISM

Hungary was driven out of the war as one of Germany's last allies by the Red Army. The region fell under the dominance of the Soviet armed forces. Soviet economic and political control in Central and Eastern Europe expanded continuously until the countries of the region became incorporated in the "Socialist world system" as Soviet satellites.

This did not simply mean political realignment in line with the outcome of the war.

[4] A realistic view of the results achieved by the Hungarian economy between the two World Wars, should be based on the years 1937 and 1938. The forced development of the war economy of the following years does not reflect the genuine performance and capabilities of the Hungarian economy in normal conditions.

The type of planned economy created in the Soviet Union appeared as a possible alternative to the capitalist, market economy. It was seen as a "Socialist" economic model, in which social ownership of the means of production and the centralized economic and political power corresponding to it would be a basis for a rational concentration of resources, rapid and planned economic development and the elimination of economic backwardness. This approach was lent credence as, in the 1930s, the Soviet economy had developed rapidly and without recessions. Another cause for confidence, mainly in its industry, was that the Soviet Army (though with some outside help), was even capable of gaining superiority over the German war machine and its technology, which had defeated France in a few weeks, and also put Britain in jeopardy.

Despite some differences, it is possible to divide into major periods the largely uniform processes, policies and events within the economies of the Central and East European countries turning (or rather forced to turn) to "the building of Socialism" between the Second World War and the collapse of the Socialist regimes:

- Reconstruction and resettlement after the war, Communist take-over, the clearing of ruins, rebuilding, stabilization, ending inflation, distribution of land, nationalization, the expansion of economic control by the state and the development of the necessary institutions (1945-1950).
- The introduction of a planned economy rejecting market mechanisms, economic isolation and placing foreign trade on intergovernmental-bureaucratic bases; rejection of the Marshall Plan, establishment of COMECON for the implementation of Soviet dominance and the co-ordination of foreign trade in the Soviet bloc (1949-1952).
- The period of forced growth based lopsidedly on heavy (military) industry; nationalization of agriculture, overdriven investment, declining and then stagnating living standards (1950-1962).
- Attempts at rationalization: efforts and experiments aimed at developing a more consumption-oriented economic policy, a search for ways of international co-operation (1960-1980).
- The period of decline (1979-1989).

Estimates based on the current territory of the country put the number of Hungarians who died in the war at eight or nine hundred thousand. (Nearly 10 per cent of the population), of whom some 400,000 Jews and 50,000 Gypsies were murdered in concentration camps. Material losses (including the number of homes destroyed) were as high as 40 per cent of the national assets of the year 1938. In addition, Hungary was obliged by the peace agreement to pay reparations, completed by 1952, to the Soviet Union, Czechoslovakia and Yugoslavia, the value of which made up 8-10 per cent of the national income of the post-war years.

Despite these enormous losses and heavy burdens, the re-starting and transformation of the economy was accomplished within some five years. In 1949, total output somewhat exceeded the level of the last year of peace. State ownership was close to 100 per cent in industry, transport, banking and wholesaling (and already some 30 per cent in retailing). Following the nationalization of large enterprises and banks, at the end of 1949, smaller businesses with 10 or more employees were also nationalized. Land reform, favouring poor peasants, was completed as a part of the democratic transformation in 1945-1946. In 1949, against the will of most of the new owners, landowners were forced to join collective farms (often by the use of brutal measures). Inflation, starting during the last years of the war, then gaining momentum by the financing of production to fulfil the reparation quotas, was curbed in the summer of 1946, when a new currency, the *forint,* stable in value, was introduced. In 1949, a national government agency controlling the organization of production and the distribution of resources along the Soviet model,

the National Planning Office, was already in operation.

Hungary's first Five Year Plan was a prime example of “Socialist” heavy-industry-oriented, forced industrialization. It is practically certain that the possibility of a third world war was taken into account when drawing up the plan; although this was never declared openly, it can be taken for granted.[5] The revised (February 1951) version of the plan included targets which appear completely absurd today, like an annual 18 per cent growth in national income and 26 per cent in industrial production. This implied that 35 per cent of the national income was to be accumulated every year. Half of the accumulated funds were to go to industry, especially mining and metallurgy. That was the way in which Hungary, a country with precious few natural resources was meant to become “a country of iron and steel”. The plan was similarly lavish with promises regarding living standards: they were to rise by 50 per cent. In reality, production declined in agriculture due to forced collectivization and the accompanying squeeze put on rural incomes.[6] The rise in national income remained moderate. The rate of accumulation (investment), on the other hand, stayed on target. It was mainly consumption that suffered most from the unrealistic objectives of the plan. In 1952 and 1953 the real wages of workers and employees were some 15 per cent lower than in 1950, and the real value of rural consumption 10 per cent lower. At the same time, shortages became a permanent feature of the food and consumer goods markets.

The new leadership after the revolution of 1956, headed by János Kádár, consolidated its power through a severe and bloody retaliation,[7] and clever concessions made in answer to economic demands. Following the crushing of the revolution by Soviet troops, some 200,000 people left the country, whose borders stayed open for months.

The turbulent months after the revolution and the politically motivated strikes were followed by an amazingly rapid consolidation, Kádár and the new party leaders were capable of learning from 1956. Their moves were motivated by a cautious pragmatism; it was etched into their minds, and almost became an instinct with them, that people must feel year after year that life is improving. The regime did not demand continuous demonstrations of sympathy, and it kept to its own slogan, “He who is not against us is with us”.

One of the major successes of this new policy, aimed at avoiding confrontation and seeking consensus and new solutions, was that the organization of collectives was completed, often with the use of force but without serious trouble and without a decline in yields in 1961.[8] Spectacular achievements were produced in agriculture by some innovations unheard of in other countries of the bloc. The scope for household farming and for small-scale units in general was broadened, and more market-oriented methods, based on prices and procurement, replaced plan quotas and the system of compulsory deliveries which had been done away with in 1956. This led to a growth in output and an improvement in quality and choice. The success of innovations in agriculture encouraged politicians to experiment more freely with other non-socialist methods.

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[5] In the early summer of 1950 the Korean war (a trial war?) broke out.

[6] Tens of thousands moved from villages to towns, fleeing from the violence and because of their dissatisfaction with the conditions in collective farming. Between 1949 and 1954 the total number of those moving from overpopulated rural areas to towns, most to seek better jobs and higher pay, was about 300,000.

[7] Thousands were imprisoned and some 400 are known to have been executed. The latter included Prime Minister Imre Nagy and his closest associates.

[8] The success was due mainly to the fact that the government concentrated its efforts on persuading the most highly respected farmers of villages to enter the collectives, rewarding them with leading positions. Another factor was that it was made clear by the recurring waves of organization at home, as well as by the examples of the neighbouring countries, that resistance was hopeless.

An awareness grew among economists that the problems were inevitably being created by a system and institutions of economic management that disregarded market rules and its own internal interests. It was the “operational mechanism”, as it was then called, of the economy, that was to be blamed for the production of goods with no consideration for demand, for waste, for huge quantities of superfluous stocks, and for the almost permanent shortage in economic resources and in goods needed by the market.[9]

A series of measures aimed at improving national economic planning, at “perfecting” the breaking down of central plans into local units failed. In the mid-1960s this led the Czechoslovak, the Hungarian and, to some extent, the Polish leadership into putting a radical reform of the economic mechanism on the agenda, reinstating the market. The fundamental idea underlying the reform was that the system of a planned command economy had to be abolished, enterprises made autonomous agents on the market, operating in the conditions of a regulated market where only priorities, not specifics, were predetermined. As the brochure published by the Hungarian Socialist Workers' Party put it: “the reform is based on the organic unity of planning and market.”

The reform was introduced fully in Hungary only. The ruling elite in Poland chose to initiate centrally directed modernization programmes instead, mobilizing foreign loans. After the failure of these, Poland ended up in a state of open crisis at the beginning of 1980, which was only “resolved” by Jaruzelski through the introduction of a state of emergency and martial law. In Czechoslovakia, the launching of reforms in 1967, similar to those in Hungary, led to a process which reached a stage where it broke taboos: it called into question the advantages of the Warsaw Pact and COMECON. Consequently, in August 1968, Soviet troops supported by military units from other „fraternal” countries, invaded Czechoslovakia.

The reform succeeded in Hungary because – drawing conclusions from, among other things, the 1956 Revolution – it attempted to change the practice of state Socialism not from a political stance but exclusively from the aspect of the economy. No attempt was made to question the international political position and internal power structure of the country, and not a word was said about any eventual modification of ownership relations.

The reform introduced in Hungary in 1968 freed the country's economy from many of the burdens of over-centralized and bureaucratic control, although when it began to work, it involved many cautious half-solutions and the postponement of some major moves. Growth sped up for a couple of years: it reached 6-7 per cent annually in contrast to the 4-4.5 per cent of the previous years. Efficiency also improved; supply became better adjusted to demand; stocks declined. Exports to capitalist markets, marginal in significance in the earlier period, grew in importance, and, along with the growing number of export-import transactions, the market-oriented attitude and the number of personal contacts in the West of the managers of independently trading Hungarian firms also increased. In agriculture, the reform brought to full maturity a production structure based on a voluntary co-operation (involving self-interest) between large co-operative farms and small-scale private (household) farming. The supply of farm products on the domestic market became plentiful despite sizeable agricultural exports; farmers and some other rural dwellers, with a second income, became relatively affluent. Market supplies, meeting everyday demand, furnished the basis for an annual 4 to 4.5 per cent increase in the consumption of urban inhabitants.

Despite the successes, the Hungarian reform soon came to face major handicaps. It came

[9] These recognitions were voiced mainly in “inside” working documents and a few openly published papers by Hungarian, Polish and Czechoslovak economists. Quite a few high-quality analyses, available also in the socialist countries as “inside” material to selected persons, were published in the West, too.

under heavy, ideologically motivated attacks in the party press of the other socialist countries as well as from home-grown conservatives. The countries of the Soviet Bloc made the achievement of self-isolation, economic autarchy their objective with the COMECON Complex Programme, accepted in 1971, extending the bureaucratic bonds. These decade-long ties made it impossible for Hungary to escape the programme, and its implementation further increased the number of intergovernmental economic agreements, mainly with the Soviet Union, based on division of production profiles. Under the Complex Programme, for instance, Hungary's large bus manufacturing industry and the supply of automobile parts for the Soviet automobile industry were established.

A huge challenge to the continuation of the reform (which was to prove impossible to cope with) was posed by the "oil price explosion" and the large-scale realignment it brought in international terms of trade. The momentum of the reform broke; the next steps planned were never implemented (some re-surfaced in the second halt of the 1980s), and the old bureaucratic methods were restored at several junctions.

By developments fitting into the framework of COMECON programmes and seemingly favourable to the economy, Hungary managed to maintain an annual 4-5 per cent growth rate and a 3-4 per cent growth rate in consumption, measured in the volume of output. The unfavourable external messages indicating a new economic era were judged by the political leadership, conditioned to evade controversy and conflict, as signs of a temporary and transitory trend. The losses caused by shifting terms of trade, highly disadvantageous to Hungary, were compensated with foreign loans available in abundance and on favourable conditions.[10] Hungary's loss in terms of trade was some 20 per cent between 1972 and 1978. By the end of 1978, net national debt reached nearly double the annual value of hard currency exports. It ran into $6.1 billion, which was roughly equivalent to the losses suffered due to differences between the price increases of imports and exports.

Between 1950 and 1980, calculations using different methods indicate that the country's per capita GDP was tripled or even quadrupled under a state Socialist economy. That historically unprecedented growth of 3.7 to 4.7 per cent per year was, in the given period and in Europe, just a little above average. Correspondingly, Hungary's position in Europe, measured by economic performance, did not change. Its relative level of development moved to a somewhat higher point. Full employment and relative security of employment were achieved by the mid-1960s, to be followed by a chronic labour shortage. The ratio of those employed, especially female employees, rose well above the European average (51 per cent compared to the total population, as opposed to 42 per cent). During those three decades, the per capita real income of the total population rose by 3.5-4 per cent annually. Within the inner composition of the total income of the population, the various financial and other benefits provided socially to individuals and family members gained in importance.[11] The level and choice of daily consumption and health and education services approached the standards of the economically developed regions of Europe at the time.[12] In thirty years, the number of persons per inhabited room declined from 2.7 to 1.3. New apartment houses, mainly prefabricated, were constructed at a rate much like the European average (6-7 apartments per year/1000 population), increasingly subsidized by the government. Private and col-

[10] In this period cheap credits, abundantly available from oil dollars, were offered at interest rates below inflation levels.

[11] *E.g.* at the end of the 1970s, in keeping with the extremely high employment rate of women, nearly 90 per cent of children between 3 and 5 years of age attended government-funded nurseries whose standards were recognized as high.

[12] There were huge shortages in, and waiting lists for, non-perishable consumer goods, especially cars; the choice was narrow and the quality poor. Hundreds of thousands waited for a telephone for years, even decades. In the mid-1980s, the number of unfulfilled applications for telephones was 700,000.

lective home construction, often involving the owners' labour, was also subsidized in the form of special, long-term, low-interest loans. Millions of small weekend and holiday homes, often no more than makeshift shacks or discarded buses, were erected on tiny plots of land all over the country. In more popular holiday regions, privately--owned holiday houses offering rooms for rent began to appear in growing numbers besides those owned or ran by trade unions, firms or offices. From the end of the 1960s on, the isolation of the country's citizens was also gradually loosened. Hard currency traffic remained virtually closed, but Hungarian citizens were entitled every three years to buy hard currency supposedly enough to finance a two to three week trip to the West, even if in very modest circumstances. Those who could produce proper invitations were permitted to stay a month in the West every other year, and travel to the Socialist countries was unlimited, at least as far as the Hungarian side was concerned. (An invitation and a Soviet visa was necessary to travel to that country.)[13] With its relatively abundant supplies in consumer goods, Hungary became the centre of shopping tourism in Central and Eastern Europe. In Prague, East Berlin or Moscow, people queued up to buy Hungarian forints from their limited foreign currency allowances. These were some of the minor facts characterizing living conditions under "goulash Communism", which could be described as a kind of modest petty-bourgeois lifestyle.

Hungary's model, made acceptable to the people by the "domesticated" and softened one-party regime, reached its limits by the end of the 1970s. The accumulated debt of the country proved insurmountable. Huge industrial capacities built for second-rate, poor-quality mass production, which grew increasingly outdated at the time of the rapid spread of high-tech industries worldwide, shortage of capital and external trade relations oriented for decades toward the Soviet Union and the other COMECON countries, made it inevitable that this should turn into a debt trap in which servicing (and the avoidance of financial collapse) required more and more heavy borrowing.

This debt-trap stayed with the Hungarian economy in the period following the change of system and only started to vanish when the new stage of integration was kick-started with the help of imported capital.

The long final decade of state Socialism in Hungary (1979-1990) was characterized by three major tendencies.

1) Throughout these years the primary priority of economic policy was to avoid financial collapse. Tough restrictions (siphoning off of incomes, limitations on salary outflow, inflation) were employed in order to reduce investments and real wages (and through these, limit domestic consumption). The drastic consumer price rises (nearly 20 per cent in 1979; 150 per cent for the whole period, meaning almost 10 per cent per year) not only held back real wages but also reduced the subsidization and non-realistic character of consumer prices.[14] Growth declined, then stopped, and the last four years were characterized by stagnation. Even though dollar-related exports doubled while imports grew only by 20 per cent, the debt pressure intensified: Hungary, with raised interest rates, closed the year 1989 with a total net debt of $14.9 billion (three times the total of annual exports). The country could only be kept solvent by further international bridging loans.[15]
2) Legal opportunities for private enterprise on a small scale were increasing, and so were the possibilities of getting work and earning money in ways unfettered

[13] With the exception of Yugoslavia, none of the other socialist countries allowed its citizens a similar freedom of travel.

[14] *E.g.* in the summer of 1979, meat prices rose by 40 per cent.

[15] These loans became accessible when the country won membership of the International Monetary Fund. The application for IMF membership was the first international move by any Hungarian government since 1950 for which no previous approval by the Soviet Union had been sought.

by the rules applying to the Socialist economy; consequently, the so-called second economy was growing fast. In the mid-1980s, already more than 3 million people were active in this second economy, most engaged in a second, market-oriented occupation.[16] This sector provided some 20-25 per cent of the output of the national economy, and a third or even a half of families had a direct interest in it.

3) This long decade, especially following Gorbachev's appearance on the scene, after 1985, was the period of the second wave of reform. The changes were unequivocally inspired by the need to adapt to a market economy and the value system of the world market. This was indicated by the most important moves: switching to a price system approaching the price rates of Hungarian exports and imports (1980), foreign currency valuations adjusted to actual conditions of supply and demand, and later, relying on these, the beginning of export liberalization; the extension of the autonomy of state-owned firms by the introduction of (self-governing-type) ownership rights exerted by company councils (1985); decentralization of the banking system and the beginning of the institutional separation of commercial and central bank functions (1987); the introduction of a tax system modelled on that developed in Western European countries. It must be noted, though, that these changes were taking place in a contradictory environment, and that their scope of movement was limited.

It led to contradictions that these reforms were instituted in the conditions of full employment, and in a predominantly state-owned economy. The measures meant to differentiate between firms according to their performance could potentially result in bankruptcy for the "poor" ones, threatening a loss of value of state property and a decline in jobs. Bankruptcy on a massive scale was something that the authorities could not tolerate, and even though they had turned into reform Communists in the meantime, they felt compelled to intervene and take rescue measures in many individual cases. COMECON obligations also had to be met. Naturally, when it came to bargaining between the authorities and the firms in need of such individual deals, *i.e.* measures tailor-made for the farm concerned, it was the latter – the firms – which were in a better position, having more specific information. Thus there were heavy brakes limiting the full development of market forces.

The genuine driving forces of a market economy are associated with private property owned by private individuals. That the predominantly state-owned means of the economy had to go into private ownership (and ultimately into the hands of individuals) was, however, beyond the limits of tolerance. Consequently, in the course of the reform, artificially created institutions ("company councils") were chosen among the possible alternatives, with which to associate the ownership role. This new ownership form, however, turned out to be dysfunctional in practice because the "owners' decisions" followed mostly the direct (short-term) interests of a narrower or wider circle of the staff or managers.

Nearing the final change of political system, the reforms passed these limits with regard to ownership. A Corporation Act conforming to the conditions of a market economy was passed, making the foundation of private firms (employing fewer than 500 people) possible. Investments by foreigners were made legal, and provided with the necessary security under civil law. Finally, in 1990, the year of the changeover but still before the first free elections, a State Property Agency was established in order to control privatization, which had begun spontaneously as a consequence of the Cor-

[16] This category included, beside independent shopkeepers, artisans and small-scale farmers, all those who were producing something for the market rather than just for their own consumption. Furthermore, it included members of subcontracting groups belonging to larger organizations, individuals who by working extra hours, contracted for well-paid extra work at their own regular workplaces under special agreements.

poration Act, and measures were taken to regulate the procedures to be employed in the course of the selling of state-owned firms and their assets. These moves were in keeping with the analysis of empirical facts, and especially with the changes of external and internal political conditions.[17]

THE YEARS OF TRANSITION

Post-socialist change means, above all, the withdrawal of the state from the business sector, and the victory of private ownership. After 1989, the replacement of state-owned property by private property began in every East and Central European country. Privatization was probably completed fastest in Hungary. In 1989, state-owned and co-operative assets still made up some 75 or 80 per cent of the capital working in the Hungarian economy. Statistics compiled at the end of 1997 show state-owned business assets making up only 21 per cent of all recorded business capital. That ratio is roughly the same as the Western European average.

The process was threefold. One side of the rapid conquest of private ownership was the sudden increase in the number of smaller, mainly Hungarian-owned businesses (between 1989 and 1996, the number of limited companies increased ten times over, that of jointly owned businesses without legal personality seven times, and the number of each exceeded 100,000).

The bankruptcy of a smaller part of the formerly state-owned large organizations was accompanied by the privatization of their greater part. The third factor was the emergence of newly founded larger manufacturing and service businesses.

In the past decade the participation of foreign direct investment in the privatization of the economy was probably highest in Hungary in the whole of Central and East Europe. This is explained by the historical antecedents, by the fact that the "soft" Kádár dictatorship, which executed many reforms, created a receptivity for a change of system in society as a whole and particularly in the economy. During the years of transformation, the value of imported capital was 5 per cent of the GDP. This capital, mainly multinational, played a major part – roughly half and half – both in the privatization of large organizations and in the foundation of green-field investments.

The reorganization of the state-owned assets of the large-scale enterprises into private property has been crucial for policy-making. It was one of the major tasks of the governments and parliaments of the transition period to work out a rational solution for the privatization of large firms, through which the inherited factors of production are properly exploited, and ensure that both the employment situation and the influencing of who will become owners is kept under control.

In Hungary the successive establishments have stuck quite consistently to the view regarding large firms (even if with a few exceptions) that "anything that can be sold must be sold". Firms which would need more than one-time aid for a specific purpose, and could only be kept functioning with continuous support, have not been allowed to avoid bankruptcy and liquidation. This happened in the hope that the selling of large firms (or their units) via tenders, the stock exchange methods or in other cases to professional investors invited (or volunteering) to bid, may result in the emergence of capable owners. Thus a large part of the formerly state-owned assets has turned into genuine operating capital, and the buyers have been owners of this capital. All in all, the privatization of large companies went on as a uniform process, largely independently of the changes in government.

Combining privatization with company self-management (*i.e.* privatization based on ownership by employees) was regarded as applicable only in marginal cases. It had

[17] After the withdrawal of the Soviet Union (or Gorbachev) as a great power, the situation became a good deal more unambiguous. It was now dear that the countries of East and Central Europe historically and culturally affiliated to the West, could look forward to a bourgeois-type change.

been amply proved by the self-government-type management forms in the 1980s that its effects were irrational, and that they would result in the direct boosting of personal incomes as the dominant interest. Similarly a type of privatization common in other countries, that is the distribution of coupons backed by the property of large enterprises, or their sale at a nominal price, was of merely marginal importance.

At the moment of the changeover, the country had a huge debt obligation, with the majority of the debt being loans from private banks and of government bonds sold on foreign stock exchanges rather than credits extended by other governments. Consequently, there was little chance of rescheduling or easing the burdens. Thus there was no other way for diminishing the paralysing debt burden than to sell the business assets of the state and to use the money from these transactions (or some of it) to reduce the debt.

The effort to reduce the debt burden also explains (at least in part) the Hungarian „speciality" that large units of the electric energy industry, gas and telecommunications (or their majority ownership) were also privatized, and, after consolidation, so were the state-owned commercial banks. All in all, nearly two thirds of the privatization income was received as foreign investment in convertible currency, making it possible to repay debts to the value of more than $3 billion ahead of schedule. By this move the debt burden left the danger zone and was reduced to a level conforming to international norms.

In recent years, Hungary was the scene of privatization on an unprecedented scale, mobilizing mainly imported professional investment. Privatization extended to the viable units of the entire manufacturing industry, nearly all hotels, half of the country's electricity plant capacity, nearly the entire utilities distribution network and the major part of banking and insurance.

The national assets formerly owned by the state were not sold to Hungarian capital simply because such capital did not exist on the scale necessary to buy them, and because without the participation of imported capital, anything like technological modernization and market development would have been out of the question.

With some exaggeration it may be said that for forty years Hungarian industry (and trading) was based on the COMECON and mainly the Soviet markets. The disintegration of COMECON and the Soviet contacts alone were the cause of an enormous loss in Hungary's business assets. Economic opinion, based on 1989 data, puts the loss at more than 50 per cent.

It is often asked if it was permissible or acceptable to let electric energy production and distribution, gas distribution, telecommunication and banking services go into foreign majority ownership. In today's globalizing world economy, the idea of "national self-sufficiency" is becoming rapidly outdated. In all areas, the European Union is moving towards the elimination of the isolation of national economies and markets. By moving in that direction, Hungary is adapting to the mainstream.

Purely on a national basis, relying on its own capital, Hungary would never have been able to raise, say, telecommunications (one of the major systems of a market economy) to international standards. And it would be similarly incapable in the future of modernizing and maintaining the standards of energy supply and banking services.

In the last decade of the century, the recession of the Hungarian economy of the 1980s turned into large-scale decline and crisis. The main cause of this was the loss of liquidity of the Soviet market, followed by the disintegration of the Soviet Union. A considerable part of the industrial capacities geared to that market, could simply not be converted or redirected. Some products proved sellable in other markets but only at huge discounts and under conditions favourable to the buyer. Import competition caused further difficulties, yet the liberalization of imports, being one of the fundamental conditions for the effective func-

tioning of market forces (especially in small countries), was absolutely inevitable.

The agricultural sector owed its own crisis, in addition to suffering heavily from the collapse of the Soviet market, to privatization involving compensation. Many co-operatives went out of business, and the majority of their land – fulfilling compensation claims – went into the hands of former co-operative members or urban heirs in the form of small properties covering a couple of hectares. The disintegration of a considerable number of co-operatives that had functioned as co-ordinators, the division of their lands into small holdings, the shortage of equipment and capital, together resulted in a serious decline in agricultural production and in insolvency.

The above explains the enormous decline both in industry and agriculture: between 1989 and 1992, their output declined by an average 10 per cent annually, and in 3 years, by approximately 30 per cent. Services (including education and health as well as the bureaucracy) naturally acted as stabilizers. Nevertheless, the decline in GDP was extremely large: 18 per cent in 3 years (an average of 6.3 per cent per year), a decline comparable only to the worst of the Great Depression of the 1930s.

Within the conditions described above, the government of the changeover had no choice but to continue an economic policy oriented towards maintaining macroeconomic equilibrium. A strict fiscal and monetary policy limiting consumption continued and, following the decline between 1990 and 1993, it was actually intensified. The devaluation of the forint, improving the foreign trade balance and the balance of payments but also generating inflation, continued. Devaluation amounted to 30 per cent in 3 years. The rise in consumer prices was similar, eroding buying power. The drop in domestic consumption followed the decline in output.

The stops, halts and losses in the economy brought about chains of non-payment; the liquidity problems of one company engulfed other companies as well (suppliers, then the suppliers of the suppliers). Nor were credits granted to firms (sometimes under the previous system) repaid to banks. Many of their outstanding debts turned into “bad debts”. Their capacity for extending new credits declined, causing further problems for producers. In the end a situation arose when no one really knew who would fail to pay for what, and where the centres of trouble actually lay.

A proper legal framework had to be created for responsible business management (including banking management),[18] a system of business and bank accounting and, within that, the qualification of debts, making the composition of debt and capital stock transparent, so that the losses could be localized.

Bankruptcy procedures had to be carried out, and the companies (units) and banks capable of survival were stabilized or consolidated, having some of their bad debts settled by the state and by the replacement of their capital losses.

By the end of 1995 the economy had completed that operation. Around a third of the inherited industrial capacities had to be written off, and the number of jobs in industry dropped at about the same rate. Credit and bank consolidation was accomplished via the issuing of government bonds to a nominal value of several hundred billion forints. The interest due on these to be funded by the exchequer (in other words, by society) makes up some 2 per cent of the GDP in any given year. The mass of bankruptcies and the credit and bank consolidation served basically to get rid of the financial consequences of the shrinking of the economy due mainly to the loss of the COMECON and Soviet markets.

Hungary had to face tough restrictive measures once again in 1995, following a period

[18] The laws on financial institutions, banking and accounting were codified in 1991. These furnished the basis for the separation and mutual independence of the basic institutions of a modern financial system, the central bank and commercial banks, and the money and capital markets.

when, as a consequence of politically motivated and too hasty measures taken to invigorate the economy,[19] the balance of payments deficit became dangerously large. New currency devaluations followed, and a special, temporary customs surcharge was levied on imports. After that, the volume of imports was reduced to a certain extent, and, as a consequence of the steep price rises (some 60 per cent in 2 years), the real value of incomes dropped drastically again, and so did consumption (by nearly 20 and 10 per cent, respectively).

These harsh economic measures[20] restored the relative balance of the economy. At the same time, privatization and the expansion of foreign capital, renewing the economic microstructure and abruptly improving the potential of the economy, began to make themselves felt. The economy, as we have shown, was able to enter on a path of lasting, export-driven growth. Since 1996, the annual growth rate of technology-intensive exports, directed mainly to EU countries, has been a two-digit figure; since 1997 the annual growth of the GDP is 4-5 per cent, real income and consumption have slowly begun to grow, too, and since 1998, the number of jobs has also been increasing. On the basis of its economic achievements (and following its admission to NATO) Hungary is a top candidate in East and Central Europe for EU membership.

Hungary had to pay an enormous price for returning to the European mainstream. The output of the economy (calculated in the size of the GDP) reached the level preceding the change of the system only in 1999, although with a significantly more modern make-up. During the last two decades of the 20th century, Hungary – much like the other East and Central European countries – must have missed a potential growth of some 40 or 50 per cent which, from a historical perspective, may be regarded as a loss due to the long period of disintegration. Measured by the degree of economic development, the gap between Hungary and the highly developed countries widened, and the country has now been overtaken and left behind by the rapidly developing economies of Spain, Portugal, and Greece, which were considerably supported after gaining EU membership. Hungarian incomes are somewhere between one third and two fifths of the European average. According to business calculations, the cost of Hungarian labour – because of the undervalued Hungarian currency – is even lower: 15-20 per cent compared to the European average. In the period of transition, employment dropped by a third, meaning that the earlier, extremely high rate fell back to the lowest European level (from 50 per cent to 36 per cent). Some backward regions and unskilled segments of the population, especially the Gypsies, where discrimination also increases the problem, suffer from severe, almost paralysing unemployment, reaching 50 or in some places even 80 per cent.

The country's rise can only be based on the development of the economy. The path of growth entered by Hungary in the last years of the century and the fact that EU membership now seems within reach indicates that once again, Hungary has set its course towards a rapid catching up.

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[19] These measures were taken when the 1994 parliamentary elections were imminent.

[20] It was one of the ironies of history that these extreme measures had to be taken and implemented by a government and parliament with a Socialist majority.