CHAPTER III
ISSUES AND OUTCOMES IN TRANSITION ECONOMIES
WITH REFERENCE TO HUNGARY AND POLAND

In this chapter we provide a context by examining the historical changes sweeping across the Eastern Europe in the late 1980s. Three strands have been woven together in this chapter: i) the principal strategies and reforms adopted by Hungary and Poland to reorient themselves to market economy in 1990, ii) the signing of the ‘Europe Agreements’ which set the framework for mutual economic relations between the transition economies and the EU, and iii) the surge in Foreign Direct Investment (FDI). The objective of this chapter is to examine the distortions present in the pre-transition period and the reform programs implemented, to be able to appreciate the herculean task that these economies were undertaking to move towards a market economy and integrate rapidly with the world and the European Union.

We begin by examining briefly in Section 3.1 the distortions present in the centrally planned economies, its eventual collapse and the beginning of a long journey to market economy, with no clear road map to follow. In Section 3.2 we present the framework for the transition to a market economy, which includes the main elements of the reform package, and issues regarding the speed and sequencing of reforms. It provides a theoretical background and economic logic for the reforms implemented in Hungary and Poland. In Sections 3.3 and 3.4 we examine the deteriorating economic conditions in Hungary and Poland and their halfhearted experiments with market socialism in the late 1960s, 1970s and 1980s. A subsection presents the reforms undertaken in both these countries in 1990s and their effects. Sections 3.5 and
3.6 present the main elements of the ‘Europe Agreements’ and the trends in FDI inflows in Hungary and Poland respectively. The Europe Agreements have been largely responsible for increased access for the Central European industrial exports to EU and have also been decisive in attracting FDI and shaping the foreign trade relations of Hungary and Poland. Section 3.7 presents some conclusion.

3.1 DISTORTIONS IN THE CENTRALLY PLANNED ECONOMIES

The system of central planning, in the former USSR and Eastern Europe was a coordinated mechanism, based on directions from governmental ministries regarding the allocation of resources in physical terms. Allocation of the resources was biased in favour of heavy industries and military. Resources, choice of technology and inputs were allocated by plan and not by market-determined prices, because of the virtual absence of the latter in these economies. These economies inherited many problems due to widespread distortions caused by central planning that are briefly summarized below:

i) The plans emphasized heavy industry, large firms and specialized production. In most product lines, fewer firms were responsible for total output and the motivation for this concentration was to simplify the task of planners in allocating resources. Thus industry was overbuilt; especially machine and heavy industries, while services, trade and distribution were underdeveloped.

ii) Prices had little relation to world prices and energy, food and rent were subsidized for households. State-owed enterprises (SOEs) that were able to earn profit under the price system provided the government
with tax revenues. Enterprises that could not cover their costs were either subsided or supplied with inexpensive credit i.e. they functioned under the regime of ‘soft-budget constraint’ i.e. they were not required to alter or close down operations when they were unprofitable. Managers spent substantial time bargaining for additional subsidies and inputs.

iii) The policy of maintaining full employment had a negative impact on economic efficiency and incentives. Strong incentives to motivate managers and workers were absent.

iv) The excess spending by enterprises combined with deficits in government budget tended to generate inflation that was held down repressed by price controls. The households therefore accumulated large amounts of liquid assets – a condition known as a monetary overhang that they would have spent if goods had been available.

v) In most countries foreign trade was conducted by state trading organizations and differences between foreign and domestic prices were compensated for by taxes and subsidies.

Despite these shortcomings, the system of central planning produced reasonably rapid rates of growth in the first two or three decades. But in the 1980s, growth slowed down in these economies. The slowdown was caused by:

- Rise in energy prices, though less than in the world
- The Eastern European countries had began to borrow in western financial markets in the 1970s and some of them became heavily indebted. High
interest rates in the west in the early 1980s made things worse for these highly indebted countries.

- These economies could not keep up with a rapidly changing technological frontier. Even when growth rates were more satisfactory, the quality of output was inferior.

The system was becoming increasingly inefficient. It was imperative to shift to a system that would efficiently allocate economic resources and free prices that would provide correct signals to producers and consumers. The formidable challenges facing the reforming European socialist economies are frequently said to be unique. The challenge is unique in its system-wide scope, in its political and historical context, and in the desired speed of reforms (Fischer and Gelb, 1990). Capitalism in the Central Eastern European Countries (CEECs) was destroyed and not merely suspended (as in Germany before 1948) or distorted (as in Latin America or India before their liberalization reforms). The CEECs would therefore need exceptionally high amount of liberalization, stabilization and institutional reforms as they began their journey to market economy from scratch. Economic reforms under state socialism had been implemented to some extent for four decades. What distinguished the current transition from the former economic reforms is that the latter took for granted the persistence of a number of crucial elements of the traditional model: State ownership, political dictatorship and membership of the socialist world market. What were implemented in 1990 were not reforms of the traditional model but its replacement by a totally different model of economic organization, characterized not only by large-scale market

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relations but also by private ownership, liberal democracy and full membership of the international economic community (Ellman et al, 1993).

Making the transition to a market economy was a difficult process for which there was no precedent and no blue print. From a long term perspective the transition process can be broadly divided into two phases – a phase of initiation of reforms and a phase of their consolidation. In the initiation phase the focus was to restore macroeconomic balance and letting the economic agents work freely. In the second phase of consolidation, the focus was to move on to institutional building and securing social consensus for reforms further.

The main elements of reforms, their speed and sequencing forms the subject matter of the following section.

3.2 FRAMEWORK FOR THE TRANSITION

A framework for the transition to a market economy must cover the comprehensiveness of the reforms (how much to change), the speed with which the various reforms can be implemented (how quickly can it be changed) and the sequencing of the various reforms (what to change first).50

Both comprehensiveness and speed are vitally important. The chosen sequencing should take into account, interdependence and complementarities in reforms, which is widely recognized and accepted. For example, as long as prices are controlled production will stagnate. But price liberalization alone,

without macroeconomic stabilization does not help. In the end, everything is linked to everything else, a market economy is an indivisible mechanism that grinds to a halt if any one of the essential elements of reforms is missing (Gros and Steinherr, 1995). Section 3.2.1 discusses the main elements of reforms, Section 3.2.2 examines the speed of the reforms since the initial policy dilemma seem to be between the radical strategy of fast comprehensive reforms on one hand and on the other hand the evolutionary way of changes. Subsections discuss and debate upon ‘The Shock Therapy’ versus ‘The Gradualist Approach’ to reforms. Section 3.2.3 examines the fundamental reasons for sequencing of the reforms and the issues involved therein.

3.2.1 MAIN ELEMENTS OF REFORMS

The main elements of economic reforms are: A) Macroeconomic stabilization B) Price liberalization C) External liberalization D) Enterprise reforms E) Financial markets and Institutional reforms. Each of these is discussed below.

A) Macroeconomics stabilization

The macroeconomic stabilization of an economy in transition to a market economy was somewhat different because the factors that constitute dangers were different. It involved the elimination of monetary overhang and reducing fiscal deficits. Monetary overhang may be defined as excess savings deposits or stock of cash to income, because the population was forced to save. In the 1960s the households were content to accumulate savings, as growth was satisfactory. But as growth slowed and turned into stagnation, households were forced to save as queues became longer and longer. Other indicators of
monetary overhang were black marketing and rationing. The policy makers had a range of options from explicit to implicit confiscation to sterilize the excess money. It included the sale of state-owned property, the freezing of bank deposits, the creation of new financial assets bearing creditable interest rates and confiscation through inflation. The inflationary route was in fact taken in Poland at the end of 1989 (Fischer and Gelb, 1990). Fiscal stabilization involved the introduction of income, expenditure and corporate taxation and sharp reduction of subsidies to firms and households.

The size of macroeconomic stabilization required varied from country to country. Monetary overhang and inflationary expectations were present in all the transition economies. Only Hungary had a smaller monetary overhang and inflationary expectation due to macroeconomic discipline. The above characteristics determined the agenda of macroeconomic policy in 1st phase of transition in these countries (Dabrowski, 1996).

B) Price liberalization

One of the main problems of planned economies was distorted prices. Price liberalization was fundamental for transition to market economy and there is broad consensus on this point.

Price liberalization was necessary to allow the market allocation mechanism to work. Liberalization was important for elimination of price distortions inherited from the command economy. A gradual liberalization of prices was not a rational solution, as it would lead to selective shortages and more distortions. Without free price setting, real demonopolization and privatization with the development of new private sector cannot be expected. Price
deregulation was crucial for the elimination of market shortages.\textsuperscript{51} It was also fundamental for the creditable long term hardening of budget constraints. Until prices are rational, profits and loss are not necessarily good indicators of efficiency, and therefore not a good guide to decisions on which firms should be closed and which should obtain additional finance.\textsuperscript{52}

The key difficulty of price reforms was its timing. The debate was on whether large-scale privatization should precede price liberalization. The line of argument was, under the planned economy large SOEs were monopolies. Freeing their prices would reduce consumer welfare and only increase their profits. On the other hand it was argued, that unless property rights were not settled, the managers did not have the incentive to control cost and redirect use of resources. This problem offered no easy solution because privatization takes a long time. But to retard price liberalization until the successful completion of privatization process was also not an option. Speeding up privatization and opening up foreign trade was the solution. Price liberalization was a part of the solution.

Price reforms yielded economic gains to consumers as they reoriented their consumption pattern increasing demand for goods whose prices fell and decreasing demand for goods whose prices increased (for e.g. oil).\textsuperscript{53}

Price liberalization led to general rise in price level because of the monetary overhang and the elimination of subsidies. It led to fall in real wages. In Poland for e.g. there was an initial jump in price level by about 70 percent in

\textsuperscript{51} Dabrowski (1996), p. 21
\textsuperscript{52} Fischer and Gelb (1990), pp. 20-22
1990, and in Russia by over 250 percent in 1992 and the price level continued to increase after the initial jump.

C) External liberalization

The link between price and trade liberalization is evident and one without the other does not make sense. Liberalization of foreign trade includes abolition of state monopoly on foreign trade, unifying exchange rates, eliminating all quantitative restrictions and moving to unrestricted foreign exchange convertibility for current account transactions.

The state monopoly of foreign trade and payment was an integral part of the centrally planned economies. It implied an unusually strict assignment of trade domains (commodity, trading partners) to clearly defined economic agents, usually foreign trade enterprises. Every producer of export goods and buyer of import items knew exactly which agent was responsible for realizing the export goods or for distributing the import goods.54

It encouraged the specialization of mass products, which were traded in bulk, but did not pay adequate attention to specialized products produced in small quantities. Therefore, a number of market opportunities remained unexploited. Similarly, on the import side scarcity in the domestic market was partially due to a lack of interest to import small quantities. This contributed to a long spell of isolation of domestic producers from the world that weakened the market impulse. Abolishing the state monopoly of foreign trade and payment was a step in the right direction. It provided the much-needed flexibility to the

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54 Mizsei (1991), p. 15
system, and at the same time strengthens the market impulses. The state monopoly of foreign trade in Hungary ceased to exist in 1989.\textsuperscript{55}

The rationale for exchange rate unification was that it eliminated the many different implicit export taxes and import subsidies. The unified exchange rate transmits world market prices to the economy only if exporter and importer have access to foreign exchange. This is why current account convertibility for residents was an additional required step.\textsuperscript{56} To set a realistic exchange rate that would close the gap between official and unofficial exchange rate required devaluation of the currency. Poland undertook a sharp devaluation of the polish Zloty and introduced current account convertibility in 1990. Hungary’s currency Forint was not convertible to foreign currencies.

Consensus was unanimous in elimination of quantitative restrictions while retaining tariffs. Therefore, in case of trade liberalization there is good case for gradualism. Tariffs were retained because they yielded substantial revenue for the government. Moreover, viable state-owned industries needed temporary protection to prevent them from failing all at same time. It allowed the firms to adjust to input mix and scale of production in the long term.\textsuperscript{57} The trade liberalization measures had far reaching effects on the foreign trade of the transition economies.

\textsuperscript{55} Mizsei (1991), p. 76
\textsuperscript{56} Gros and Steinherr (1995), p. 131
\textsuperscript{57} Gros and Steinherr (1995), p.132
D) Enterprise reforms

Enterprise reforms are the heart of the transformation process. The process requires interrelated changes: The imposition of bottom line discipline, definition and change of ownership, and reform of management arrangements (Fischer and Gelb, 1990). The two components of enterprise reforms are privatization and restructuring. Opinion on which should come first differ.

(i) Slow privatizers argued that firms should be sold off gradually after restructuring in a more rational price system, after the new rules of economic behaviour emerged. The prices of firms will be more realistic, and the sales process more equitable, both because the new owners will pay the right prices, and because the government will obtain more revenue (Fischer and Gelb, 1990). Hungary opted for slow process of case-by-case sale. Moreover, foreigners have not been discouraged as one of the objectives of privatization was to encourage transfer of technology and best business practice from abroad.

(ii) Fast privatizers argued that more comprehensive and rapid ownership reform was necessary to increase efficiency. It is widely accepted that more rapid privatization reduces the expected total sales revenue to the state, but the benefits of a rapid and irreversible shift to private production outweigh the costs of reduced state revenue, and that higher tax revenues from a more efficient economy offset the loss of revenue from rapid privatization. Thus, the ownership issues were a political minefield. The workers, managers and bureaucrats believed that they had substantial claims on the firms. For the government it was an
important policy question. Political reaction against initial bursts of spontaneous privatization in Poland resulted in their suspension, and a lull in privatization activity.  

The purpose of restructuring is to change both the sectoral and branch structure of the national economy, and to change the internal structure and the behaviour of an individual firm. The restructuring of state-owned enterprises is not a one step process. As in the case of privatization, it can be done with varying speed. Faster restructuring can give a positive output response sooner than a slower one. But, it threatens a larger output decline, larger number of bankruptcies, and higher unemployment that may have unpleasant political and fiscal implications. On the other hand, if governments want to slow down this process, open or hidden subsidization often becomes unavoidable. It involves the risk of fiscal crises and negative pressure on monetary policy.  

E) Financial markets and Institutional reforms  

The development of financial markets and private sector financial institutions, including banks, was an essential step in the transition to a market economy, and in moving investment decisions away from government control. Financial markets depend on underlying legal and informational systems and skills that barely existed in these economies. Institutional reforms were introduced in the tax system and tax administration, banking sector reform and restructuring insurance law, civil and commercial law, bankruptcy law, justice administration and budgetary law (Dabrowski, 1996).  

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58 Fischer and Gelb (1990), pp. 21 - 25  
59 Dabrowski (1996), p. 26
A competitive banking system can emerge only after enterprises restructuring and price reforms are substantially under way. Price liberalization and external liberalization must be linked, again in case of external liberalization, some elements like tariffs may call for a gradualist policy, others may require rapid reforms. This raises the issue of speed and sequencing of reforms, which are discussed in the following sections. The key question that has to be asked at the outset of any major reform process is whether to adopt the big bang approach or gradualism.

3.2.2 SPEED OF REFORMS

The initial policy dilemma seemed to be the radical strategy of fast and comprehensive changes (very often called shock therapy) on the one hand and the evolutionary way (gradual approach) of changes on the other.\textsuperscript{60} The shock therapy strategy implies simultaneous and rapid implementation of stabilization (S), liberalization (L) and institutional measures (I). By contrast gradualism involves differentiation in the speed of S, L and I policy.

One of the commonly used metaphors describing the dichotomy between the two strategies was, that the command economies were separated by a kind of abyss, and it was stupid to leap across the abyss with small hops. Others saw the process more like the task of climbing a precipice with the command economy at the bottom and capitalism at the top. To try to jump to the top instead of systematically climbing the hill would be fruitless. Transformation included elements of jumping the abyss and sometimes climbing a hill or

\textsuperscript{60}Dabrowski (1996), p. 17
This line of argument has been backed by empirical evidence from Hungary, a country known for ‘gradualism’, but had to undertake comprehensive austerity programmes in 1995.

The distinction between shock therapy and gradualism gave rise to extensive discussions among economists and policy makers on the advantages and shortcomings of the two approaches, which are discussed, in the following section. In part A we discuss the ‘shock therapy’ approach, and in part B we examine the Gradualist Approach and the debate between the ‘shock therapy’ and the Gradualist Approach

(A) THE ‘SHOCK THERAPY’ APPROACH

The most untiring advocates of the shock therapy are Lipton and Sachs (1990 a, 1990 b). The shock therapy is nothing less than a revolutionary strategy for the complete reconstruction of the economic arrangements of a country. It tends to be adopted when there is sharp deterioration in the economy and a strong crisis perception. At the very heart of the shock therapy lies quick conversion of state sector into a decentralized market sector, through swift and comprehensive policy changes that gives shock therapy its name. This is necessarily followed as soon as possible by forced privatization. The slowing of this top-down privatization process is to be regarded as evidence of the stalling of reforms, or perhaps even their failure.62

61 Hausner (1995), p. 45
According to the shock therapists, reforms in pre–1989 Eastern Europe were unable to succeed in changing the essential characteristics of their economies because of piece-meal reforms. Such reforms were thwarted because they allowed existing economic forces time to organize to block changes detrimental to their interests. Moreover, the old central planning system was an interconnected whole so that attack on all fronts was necessary to ensure its demise. Speed and scope must be maximized in a strategy that aims at achieving a set of self-sustaining reforms. The mark of progress in reforms lies therefore in the implementation of measures that break the existing fusion of structures of economic and political power. There is a ‘window of opportunity’ during which forces of resistance to change can be side stepped.  

Once the political window of opportunity is lost for radical economic transformation, it may not return. The Latin American experience shows that once vicious circle of macroeconomic populism and dictatorship was started, it was not easy to stop. Sometimes 20 or 30 years was lost for countries like Argentina, Peru and Brazil before they found a way to economic and political stability. The ‘shock therapy’ approach is not without its limitation and they are briefly outlined below.

First, under the ‘big bang’ approach policy reversals may be possible but at a very high cost.

Second, a ‘big bang’ policy announcement may fail to deliver the desired policy outcomes because of failure in coordination. This may be in the case of

63 Murrell (1997), p. 229
64 Dabrowski (1996), p. 29
65 Ronald (1997), pp. 267 - 277
privatization, where despite government's preference for fast and complete privatization it may not be achieved. This is because decisions by private investors on the acquisition of firms are made independently, the investors response may not be strong enough to avoid large-scale unemployment, leading to partial re-nationalization that may further deter private investors.

Third, the 'big bang' approach to reforms may also be dangerous for public finances. Certain type of expenditure may be difficult to avoid. If the government chooses a policy of massive restructuring, then the level of unemployment benefit will be very high. Moreover, a fast approach to reform does not allow the screening of those who lose much from those who lose less. A faster approach to reform may put a big burden on public finances. The inability of government to finance these expenditures may jeopardize the macroeconomic stability achieved in the early period of reform.

Fourth, if the government, during its 'window of opportunity' hurt large sections of the population in the short term through its 'big bang' package, it will lead to a political backlash.

Finally, the 'big bang' approach assumes that all major decisions can be taken at the beginning of the transition period by the reformist government. This may be technically impossible to do so. Some programmes (e.g. privatization) may require a long time to be implemented and may need careful monitoring to be successful.
Despite the limitations of the ‘big bang’ approach it is generally acknowledged that stabilization is best achieved through shock therapy. Poland, Czech Republic, Estonia and Latvia are countries that embarked on a radical path of transformation.

(B) THE GRADUALIST APPROACH

Slow and gradual macroeconomic stabilization, slow price and trade liberalization applies only in countries which had more open and deregulated economies before the post communist transition started and inherited less price and structural distortion – for example Hungary and the former Yugoslavia. Gradual changes make accommodation to the new rules of game and institutions easier. It concerns producers, consumers, and the public administration, which must also pass the complicated period of transition, and have time to learn the new system. Moreover, slower restructuring of SOEs can dilute, to some extend, political resistance against change. Too large a number of bankruptcies in a relatively short period of time and too high a level of open unemployment are probably not acceptable politically, even for the most popular government.66

This strategy also gives an option for early policy reversals at low cost if the outcomes are unfavourable. The gradualist approach also has its limitation. Table 3.1 gives a list of traps connected with slow transition.

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66 Dabrowski (1996), pp. 28 - 30
TABLE 3.1 TRAPS OF SLOW TRANSITION

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<tr>
<th></th>
<th>Microeconomic traps—mainly the danger of systemic vacuum</th>
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<td>1</td>
<td>In regulatory sense—central planning does not work already,</td>
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<td></td>
<td>market competition does not start yet</td>
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<td>The lack of effective property rights</td>
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<td>2</td>
<td>Macroeconomic traps (especially countries which started with big</td>
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<td></td>
<td>macroeconomic imbalances)</td>
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<td></td>
<td>The danger of a big budget deficit, monetary expansion and</td>
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<td></td>
<td>hyperinflation</td>
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<td></td>
<td>The danger of balance of payment crisis</td>
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<td>3</td>
<td>Credibility issue – domestic and external</td>
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<td>4</td>
<td>Information and administrative barriers of monitoring slow</td>
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<td></td>
<td>transition + problem of transitory solutions (e.g. subsidization,</td>
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<td>price control foreign trade control)</td>
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<td>5</td>
<td>Economic costs</td>
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<td></td>
<td>Greater cumulative decline of GDP</td>
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<td></td>
<td>Higher inflation, less domestic and external savings more</td>
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<td></td>
<td>balance of payments problems</td>
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<td>6</td>
<td>Social costs</td>
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<td></td>
<td>Unemployment issues</td>
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<td></td>
<td>More unequal distribution of income and wealth</td>
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<td></td>
<td>More corruption and criminal behaviour</td>
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<td>7</td>
<td>Lost political opportunities</td>
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<td>Rebuild pressure groups</td>
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Source: Dabrowski (1996)
Having examined the initial policy dilemma regarding the choice of transition strategy i.e. the 'shock therapy' versus 'the gradual approach' we proceed to show that the transformation strategy debate suffers from certain weaknesses:

- Neither shock therapy nor gradualism was defined precisely in terms of speed of the transition process and the types of policy instruments relevant to each alternative strategy. It leads to misunderstanding resulting in much unnecessary confusion (Dabrowski, 1996).

- The debate had a very strong emotional component coming from the field shock therapy. The term belongs to the field of psychiatry where electrical shocks are given to treat patients suffering from certain types of severe depression. Here electrical shock is the therapy. In other words, the shock is the intended means to achieve an end - relieve the symptoms, if not cure the patient. By contrast, for a post command economy, the shock that flowed from a simultaneous and speedy implementation of a transitional strategy was an unintended, though avoidable consequence.  

- The length of the observations period also played a significant role. In 1990, Hungary and Poland were seen as representing completely different approaches to the transformation strategy. Poland was viewed as a leading case of shock therapy, and Hungary was treated as an example of the gradual approach. This difference was determined, to a significant extent, by the different starting points of each country, especially in respect to macroeconomics conditions and the level of domestic and external liberalization. Looking at these countries after a

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67 Islam (1993), pp. 182 - 205
period of five years show that, the real differences between these countries are not very important (Dabrowski, 1996).

We can say that the general debate on shock therapy versus gradualism is oversimplified and of small practical usefulness with the specific transition agenda and timetable. The issue of sequencing is important which is briefly discussed in the following section.

3.2.3 THE SEQUENCING OF REFORMS

The fundamental reason for sequencing reforms is that some changes are preconditions for others: for instance, macroeconomics stabilization is needed if price reform is to be successful. Financial market liberalization is extremely risky unless a sound system of accounting, auditing, prudential regulation and supervision is in place (Fischer and Gelb, 1990). The sequencing of reforms also serves the purpose of providing a broad outline of a transition strategy.

The question often raised under sequencing was whether widespread privatization ought to precede stabilization and liberalization. This sequencing assumed that privatization was possible before macroeconomic stabilization was achieved and that sale of SOEs would generate revenues for the government budget. It was argued that price liberalization without prior privatization would only benefit SOEs in form of rent earnings, as most of these SOEs were monopolies. Therefore, proponents argued that well-defined property rights were a must, so that firms react appropriately to price signals. On the other hand, privatization without macroeconomic stabilization would
create an unhealthy private sector prone to bargaining with the government. Moreover, under condition of higher inflation and severe shortages, macroeconomic stabilization was a first priority and the only option available.

Another issue was whether to first privatize and then restructure or vice-versa. Restructuring may be defined as measures taken to enhance productive and allocative efficiency. It includes the breaking up of large enterprises, employment shedding and closure of unviable activities. The ‘big bang’ approach favoured fast privatization, leaving the task of restructuring to the private owners.

Banking system reforms involved several stages: banks were first restructured and then privatized. This included establishing accounting and asset valuation standards, enterprise and bankruptcy laws and staff training.\(^{68}\)

Wage determination presented a major challenge. In the early phase wage determination was left to the managers where the governments gave them target for wage bill reduction. At the same time, wages must respond to inflation and changing relative prices. Wage guidelines or formulae were used initially. Later, wage determination was increasingly left to the market as firms restructured and privatized.\(^{69}\)

Having examined the various aspects of the transition strategy and the issue of speed and sequencing, in the following sections we present a summary of the pre-transition conditions present in Hungary and Poland and the reforms

\(^{68}\) Fischer and Gelb (1990), p. 32
\(^{69}\)Fischer and Gelb (1990), p.31
implemented. Examining the initial conditions present in these economies will enable us to understand as to why a particular transition strategy was adopted.

3.3 HUNGARY ON THE PATH OF REFORMS

In Hungary in the late 1950s, traditional central planning was heavily centralized. Various partial reform measures designed to improve incentives were instituted after the October 1956 revolution was put down. By the mid-1960s it was recognized that these reforms had failed to restore rapid economic growth or to improve living standards. Section 3.3.1 examines the New Economic Mechanism (NEM) implemented by Hungary in 1968, Section 3.3.2 discusses the market-oriented reforms in the 1980s that created some of the institutional preconditions of a market system and aided the transformation in Hungary. Section 3.3.3 discusses the favorable macroeconomic balance inherited by Hungary as a result of earlier reforms and also presents a brief summary of the reforms implemented by Hungary in 1990, Section 3.3.4 discusses the Adjustment programme of 1995 that was radical in contrast to the earlier gradual approach. These sub-sections together give an overall picture of the massive changes that took place in the Hungarian economy.

3.3.1 NEW ECONOMIC MECHANISM IN HUNGARY

Central planning was retained under the NEM, but mandatory plan directives to enterprises and central resource allocation were replaced by financial and administrative regulation by indirect planning. SOEs were given partial autonomy in making contracts, distributing profits and making investment decisions. Coordination with central authority was necessary only
in case of major investment projects. The enterprises were required to finance all other projects from their own resources and bank credit. A few enterprises were given licenses to directly enter into trade relations with foreign countries. This weakened the state monopoly of foreign trade. Emphasis was also laid on improving the quantity and quality of consumer goods, as a sign that consumer preferences were really being taken seriously. For the next two decades, the NEM represented the most comprehensive reform program actually implemented in Eastern Europe.

Although most administrative controls were eliminated under the NEM, some informal direct controls remained. Hungary also managed to build up huge external debt, but the excesses of Poland were avoided in the 1970s. The 1968 reforms were the first of several reform ‘waves’ in Hungary over the following two decades, each meant in principle to move the economy closer to a vaguely defined target system, yet none of them fundamentally changing the system nor, after the late 1970s, enabling the economy to break out of a period of relative stagnation. 70

3.3.2 MARKET ORIENTED REFORMS IN THE 1980s

In the 1970s the reforms stalled and there was even partial recentralization especially in case of large SOEs. Foreign policy considerations, the oil price shocks were also responsible for stalling the reform process. New sets of reform measures were introduced in 1978-1989, to improve economic efficiency and the balance of payments. These created

70 Wolf (1991), pp. 45 – 48
some of the institutional preconditions of a market system. They were as follows:71

- Some of the large monopolistic producers and distributors were broken up.
- Foreign trade decisions became more and more decentralized, and in some areas competition between traders replaced the monopoly of foreign trade.
- Enterprises were given the right to issue bonds, which could be traded on a seedling financial market, newly established.
- A bankruptcy law was enacted.
- New laws enacted eased restrictions on foreign investment, guaranteed profit repatriation, and treated joint ventures and foreign subsidies the same as local business.
- A value-added tax, a personal income tax, and profit tax on enterprise were instituted, creating a tax system similar to those found in market economies.

The market-oriented reforms implemented in Hungary during the 1980s were the most far reaching in the socialist world. Hungary was the first country to allow new private or cooperative business to be established, to lease out shops, restaurants and other establishments to their managers and to accept that such activity should be legal and taxed. Thousands of new businesses were formed during the 1980s in the services, small-scale industry, and agriculture and construction. By 1990 a business survey estimated that small firms were

71 Marer (1993), pp. 53 - 85
producing about 10 percent of industrial output. The small sector was allowed to flourish providing goods and services, which were in short supply, and also provided services to some large firms. It gave the people an opportunity to work in market environment. This was a huge advantage for Hungary as such activities in the rest of the region were discouraged or considered illegal until the end of the 1980s.\textsuperscript{72} Hungary was the only country in the region to introduce value-added tax, profit taxes, personal income tax before the collapse of communism.

The reforms in the foreign trade sector also had for reaching effects. In harmony with the Hungarian commitments to GATT, (Hungary joined GATT in 1973) the average rate of tariffs was lowered to 16 percent. The mechanism for allocation of foreign exchange had been simplified. Hungarian firms could automatically acquire convertible currencies if they wish to import products on the liberalized list. By the end of 1985, 270 enterprises had been authorized to conduct foreign trade. Companies were given the freedom to export goods to hard currency areas and import goods that they required for their own production. Foreign capital played a moderate but increasingly important role in the Hungarian economy. Since 1972, foreign firms were legally allowed to establish joint ventures. At the beginning of 1990, 1000 joint ventures operated in Hungary, the total value of foreign investment amounted to $650 million.

Thus, the reforms although partial had a positive impact on the country’s performance and aided the transformation process in the subsequent years. By

\textsuperscript{72} Hare and Révész (19982), pp. 233-235
1990, almost about 30 percent of the GDP originated in the private sector. The state enterprises in Hungary were more market oriented and were more familiar with ways of doing business with the west as compared to the other CEECs. These reforms in a way contributed towards creating institutional foundation of a market economy.

3.3.3 MACROECONOMIC BALANCE AND THE TRANSITION STRATEGY

As a result of earlier reforms, Hungary was able to move away from the classical shortage economy. The supply and quality of consumer and industrial goods was better than other CEECs. Queuing, a regular feature of most CEECs, was eliminated. At the beginning of 1990, 75 percent prices were liberalized. Open inflation was about 30 percent in Hungary, as compared to 600 percent in Poland in 1990.

Thus in the critical years before transformation Hungary did not face the calamity of hyperinflation and therefore did not have to place emphasis on macroeconomic stabilization via shock treatment as in Poland.

In Hungary there was no day zero of the reform with maxi devaluation, massive price and trade liberalization, structural reforms in the enterprise and financial sectors have also proceeded gradually (Dervis and Condon, 1994).
A summary of reforms in trade and exchange rate policy implemented in 1990 are discussed.73

i) Foreign exchange system:

The forint was not convertible to foreign currencies, but foreign exchange was made available to importers automatically if the product was not subject to licensing. Other transactions were subject to foreign exchange license. The exchange rate was set on the basis of a basket of currencies, with the value of the Forint adjusted against the basket at irregular intervals.

ii) Tariffs

Tariffs averaged around 13 percent in 1991. Other charges such as customs clearance fee, statistical fee and licensing fee were applied if the imported item was subject to licensing.

iii) Licensing and Import quotas

Until January 1989, all imports and exports were subject to licensing. Continued liberalization since then has reduced the scope of licensing to imports covering less than 10 percent of total imports values.

iv) Export measures

Voluntary export restraints applied to exports of sensitive products like exports of steel to EU and USA, sheep meat to the EU and textile and clothing to EU, U.S, Canada and Norway. Export subsidies on a number of agricultural products were maintained.

---

Table 3.2 summarizes some key events that characterize Hungary’s systemic transformation. It captures some quantitative aspects of gradualism. The historical path described in Table 3.2 was not the implementation of a theoretical construct but the result of uneasy compromises between guardians of the old regime constantly loosing ground, ‘reform communists’ trying to improve the system and maintain control, more radical reforms trying to accelerate change, the Bretton Woods institution trying to encourage moves towards freer markets, and finally since mid-1990 rather pragmatic center-right politicians seeking to accelerate the process of systemic transformation and integration with Europe while minimizing social hardship (Dervis and Condon, 1994).
TABLE 3.2  HUNGARY: INDICATORS OF LIBERALIZATION AND SYSTEM TRANSFORMATION

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Private sector share of GDP (%)</td>
<td>&lt;10</td>
<td>&lt;10</td>
<td>&lt;10</td>
<td>10 – 20</td>
<td>20 – 30</td>
</tr>
<tr>
<td>Share of imports liberalized (%)</td>
<td>0</td>
<td>0</td>
<td>16</td>
<td>37</td>
<td>72</td>
</tr>
<tr>
<td>Maximum tariff in manufacturing (%)</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Average tariff (simple average) (%)</td>
<td>18</td>
<td>16</td>
<td>16</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>CPI inflation (annual average) (%)</td>
<td>7</td>
<td>9</td>
<td>17</td>
<td>29</td>
<td>35</td>
</tr>
<tr>
<td>Real effective exchange rate index (1985=100)</td>
<td>100</td>
<td>97</td>
<td>88</td>
<td>94</td>
<td>106</td>
</tr>
<tr>
<td>Share of consumer prices freed (%)</td>
<td>35</td>
<td>41</td>
<td>62</td>
<td>77</td>
<td>90</td>
</tr>
<tr>
<td>Share of subsidies in GDP (%)</td>
<td>15</td>
<td>16</td>
<td>13</td>
<td>9</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: from Dervis and Condon (1994)

Thus, with a history of partial reforms prior to 1990 and the reform package of 1990, put Hungary on to the road of growth. But the government had ignored the huge external debt and growing budget deficit. As a result the macroeconomic situation had deteriorated rapidly by 1994.

The budget deficit was about 9 percent of GDP and the current account deficit was of similar size and growing. The debt ratios (ratios of gross and net foreign debt to GDP) were increasing. Such a macroeconomic situation was clearly not sustainable. In March 1995 the government adopted the first
comprehensive stabilization package of Hungary’s transition. In the following section we briefly discuss the Adjustment and Stabilization Programme of 1995 (ASP’95).

3.3.4 ADJUSTMENT AND STABILIZATION PROGRAMME OF 1995

The 1995 ASP was a preventive therapy to avoid the crises looming large over the economy. If Hungary had not taken the preventative action in 1995, it would have led to flight of capital and a massive recession leaving the economy crippled. Measures taken are briefly outlined below:74

- To reestablish the budget public primary spending was cut by more than 15 percent in real terms.
- The currency was devalued by 9 percent and its regime was changed from fixed rate to a crawling peg, with a preannounce monthly rate of depreciation. A temporary import surcharge of 8 percent amounted to a further devaluation.
- The government committed itself to containing nominal wage increases.

The March 1995 measures had a rapid and lasting positive impact on the economy. The reduction in public expenditure led to significant improvements in internal and external imbalances. The ratio of government deficit to GDP was reduced from peak 9.6 percent in 1994 to 4.8 percent in 1996, while the current account deficit declined by more than 5 percent points from 9.4 in 1994 to 3.8 percent in 1996. The macro economy was finally stabilized, but Hungary had to a pay a price for it in terms of high inflation.

74 Halpern and Wyplosz (1998), p. 5
3.4 POLAND ON THE PATH OF REFORMS

A brief summary of piecemeal reforms undertaken in the early 1970s, with the objectives of accelerating growth and improving efficiency are presented. In Section 3.4.1 a brief historical background about Poland's economy is presented providing a context for the partial reforms of 1980s that are discussed in Section 3.4.2. We examine the huge macroeconomic imbalances present in Poland as the reforms of the 1980s failed to create efficient enterprises and eliminate shortages. Section 3.4.3 discusses the economic conditions of 1989 and the events that triggered hyperinflation dictating the choice of 'The Shock Therapy' as a transition strategy and Section 3.4.4 briefly outlines the reforms implemented by Poland in 1990. Section 3.4.5 briefly examines the effects of reforms in Hungary and Poland.

3.4.1 A BRIEF HISTORICAL BACKGROUND

As in other European countries, the growth of Poland’s economy in the 1950s and 1960s created the impression that central planning could generate sustained economic growth. The growth of production in industrial and agriculture sector was based upon large-scale investment and absorption of labour from the rural sector.75

By the early 1970s, it became apparent that these sources of growth were being exhausted. In response, the government embarked on a program of modernization, based on imports of capital and technology from the west. Fed by these imports, investment increased and industrial production also

75 Lipton and Sachs (1990), pp. 103
increased between 1970-1978. But the modernization strategy led to deep balance of payment crisis. This was because the imports from the west in the 1970s were financed by western credit. There was a sharp increase in the current account deficit. External debt, which had been negligible in 1970s, was almost 40 percent of GDP, by the end of the decade. Finally, as the supply of foreign capital dried up, imports from the west were reduced.  

During the crisis years 1978-1982, industrial production fell by one-third. Investment projects slowed down. Standard of living deteriorated. Poland was also unable to increase its exports to the west to service its debts. Poland’s exports to the west increased by only 19 percent from 1978 to 1989.

3.4.2 PARTIAL REFORMS OF 1980s

After the onset of the balance of payment crisis, the government of Poland undertook two stages of partial reforms in 1981-1982 and 1987-1988, intended to decentralize economic decision-making. The objectives were to create efficient enterprises as to improve production and export performance and eliminate shortages. The process of decentralization touched the following areas:

i) Enterprises were given greater autonomy over productive decisions. Central allocation of inputs was reduced. But on the other hand, two special practices introduced in 1982, ‘operational program’ and ‘government contracts’ provided new form of central coordination of productive activity and the allocation of inputs. These mechanisms

76 Lipton and Sachs (1990), p. 103
77 Lipton and Sachs (1990), pp. 106 - 110
meant that the government was still involved in 80 percent of the sales of producer goods.

ii) Centrally planned investment was gradually reduced, enterprises had to find means to finance and execute the projects.

iii) Some producer prices were freed from administrative control. For a wide range of goods, prices were regulated on the basis of costs and subjected to government monitoring.

iv) Attempts were made to decentralize the wage setting process and thereby increase efficiency in the use of labour by permitting enterprises to determine wages more frequently. But it resulted in accelerating wage increases, as managers intend on industrial peace, were content to agree to wage demands.

v) Enterprises were given some freedom to conduct trade themselves. In 1985, the government began to depreciate the official exchange rate, but even this policy measure failed to trigger fundamental improvement in export performance. Shortage of foreign exchange ensured a thriving parallel market when the exchange rate remained a multiple of official exchange rate.

Thus, we see that decentralization failed to serve its objective of creating efficient enterprises and eliminating shortages. It actually increased bureaucratic bargaining, as direct central control was replaced with a plethora of indirect policy instruments. Enterprises bargained for credits, subsidies, tax relief and access to foreign exchange. The attempt at decentralization did not bring about the desired changes because the reforms were not sufficiently
comprehensive and radical as the basic features of central intervention remained in one form or other.

The inherited economic conditions in 1989 are summarized in the following section as these macroeconomic imbalances largely dictated the choice of strategy i.e. radical reforms adopted by Poland in January 1990.

3.4.3 INITIAL CONDITIONS AND THE TRANSITION STRATEGY

Poland's initial conditions in middle of 1989 can be identified by the state of affairs in its economic system and structure, macroeconomic situation and the level of human capital. This system was dominated by the state sector, characterized by heavy industrial concentration, accompanied by distorted prices due to massive price subsidies and controls, geared to import substitution and deprived both of internal and external competition. There was heavy dependence on the Soviet markets for exports in machinery, textiles, electronics and pharmaceutical and for imports of oil and gas below world market prices. In the last pre-reform year (1989), 44 percent of polish exports went to the CMEA compared with 45 percent from Hungary, 51 percent from Czechoslovakia. Poland also under a heavy burden of foreign debt, increased mostly in the 1970s. Net foreign debt in the last-reform year stood at 44 percent of GDP as compared to 16 percent in Czechoslovakia and, 61 percent in Hungary. In early 1988, the government attempted a new austerity programme involving cuts in subsidies, which led to sharp increase in consumer prices followed by demand for wage increase. The result of price increase was to unleash a wage-price-exchange rate spiral.
Three events in 1989 appeared to have played key roles in pushing the spiral into hyperinflation:

i) In March 1989 households were given legal access to foreign exchange in parallel market, turning the black market white. This supported a flight from the currency.

ii) Most retail food prices and some agricultural input prices were freed and there was a sharp reduction in the level of food subsidies.

iii) These measures led to an explosion of food prices and an intensification of the wage-price-exchange rate spiral.78

Table 3.3 presents a picture of macroeconomic imbalances present in Poland and Hungary during the last two pre-reform years.

We can see that the imbalances were more severe in Poland compared to Hungary. Poland’s macroeconomic imbalances were reflected not only in near hyperinflation but also in massive shortages.

The choice of available strategy was more dramatic in Poland as compared to Hungary, because of the very difficult initial situation. None of the policy options were free of risk. The radical option involved swift stabilization, fast liberalization and deep institutional transformation of the economy.

78 Lipton and Sachs (1990), p. 111
TABLE 3.3 A COMPARISON IN MACROECONOMIC IMBALANCE BETWEEN POLAND AND HUNGARY

<table>
<thead>
<tr>
<th></th>
<th>Poland</th>
<th>Hungary</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Annual Percentage change</td>
<td>Annual Percentage change</td>
</tr>
<tr>
<td>Net material product</td>
<td>4.9   -0.2  -13.0</td>
<td>-0.5  -1.1  -5.5</td>
</tr>
<tr>
<td>Consumer prices</td>
<td>59.0  259.8  584.7</td>
<td>15.5  18.8  28.9</td>
</tr>
<tr>
<td>Gross Industrial</td>
<td>5.3   0.5   -23.3</td>
<td>-0.3  -2.5  -4.5</td>
</tr>
<tr>
<td>Production</td>
<td>Export Volumes</td>
<td>9.1   0.2   14.0</td>
</tr>
<tr>
<td>Import Volumes</td>
<td>9.4   1.15  -15.6</td>
<td>-2.0  -1.0  -3.4</td>
</tr>
</tbody>
</table>

Source: The Economic Survey of Europe, Various Years

However, this risk had to be measured against the dangers inherent in the alternative option of gradual reforms. Postponing the fight against high inflation until a time when the economy has basically been privatized would be like abandoning a fire to try and rebuild a house while it was still burning inside. Similarly, attempting to eliminate galloping inflation gradually would be like trying to put the fire out slowly. Gradually liberalizing prices and trade would fail to produce a definite improvement in the price structure. It would simply mean repeating the same old partial reforms, all of which had ended in failure (Balcerowicz et al, 1997). Gradual reforms would also mean wasting a political ‘window of opportunity’. Thus, the ‘shock therapy’ program implemented by Poland and discussed in the following section was more a matter of compulsion rather than choice.
3.4.4 IMPLEMENTATION OF REFORMS IN 1990

The stabilization and liberalization program introduced on January 1, 1990 was prepared with the advice from IMF. The major components of the program are outlined below:

i) Fiscal Policy: The program provided for a tightening of fiscal policy to restore a balance in the general government account for 1990 (in 1989 the deficit was 7.5 percent of GDP). The goal was to cut subsidies to reduce expenditure by 8 percent of GDP.

ii) Credit and Monetary Policy: A restrictive monetary policy accompanied by drastic reduction in money supply and increase in rates of interest was implemented. The rate of interest was increased from 7 percent to 36 percent by the National bank of Poland (Calvo and Coricelli, 1992).

iii) Price liberalization: Since January 1990, the markets determined 90 percent of the prices. Official prices remained for only 13 groups of goods, accounting for 3 to 5 percent of sales of consumer goods and services. Coal prices were raised by 600 percent, gas and electricity by 400 percent. There was also a sharp increase in petrol prices and public transport fares.

iv) Wage Policy: General wage indexation was eliminated in the state enterprise sector. In addition, severe tax penalties on wage increases in the state sector were introduced.

v) Exchange rate system: Poland’s ‘big bang’ devaluation on January 1, 1990 eliminated the parallel market premium overnight. The exchange rate was stabilized at 9,500 Zlotys per 1 U.S. dollar and
was kept at this level till May 1991, after which the Zloty was pegged to a basket. A pre-announced crawling peg formula was adopted, which worked until May 1995. The polish Zloty was made convertible for current account transactions.

vi) Tariffs: The average tariff rates were 8.9 percent in 1989. During 1990 and the first half of 1991, tariffs were suspended on a wide range of goods (mainly raw materials, intermediate goods, and engineering products), pulling the average rate down. On 1 August 1991, a new tariff schedule was introduced, with eight basic rates from 0 to 40 percent, and suspensions were considerably limited. They raised the average tariff rate to 13.6 percent.

vii) Licensing system and quota: import quotas were eliminated (except for alcoholic beverages), only trading in radioactive and nuclear materials and military equipment required a license.

viii) Export measures: There were no export subsidies. Exports restrictions were applied on some ‘essential goods’ for the domestic market and on goods subject to voluntary export restraint as they fell in the sensitive category. They were textiles and clothing, steel, sheep meat exports to the EU, U.S., Canada and Sweden.

We thus see that the ‘Gradual approach’ adopted by Hungary and the ‘Shock Therapy’ followed by Poland was more of a compulsion dictated by the initial pre-reform economic condition rather than a matter of choice. One of the characteristic features of the post-socialist countries was severe recession that they faced. In the following section we briefly explain the general causes
responsible for this recession in part (A) and in part (B) we briefly examine the economic conditions in Hungary and Poland in the immediate post reform.

3.4.5 EFFECTS OF REFORMS IN HUNGARY AND POLAND

(A) All the post-socialist countries without exception suffered from grave economic recession. Since the phenomenon differed substantially from the cases in the theories of economic fluctuations, Kornai (1995) called it 'Transformational recession'. In the recession of a mature capitalist economy the production of each and every firm and product does not decline. Even near the trough, successful, expanding enterprises are found at least sporadically. In a transformational recession, this was not exceptional at all; contraction and expansion, failure and success, mass exit and mass entry were observed side by side. It was referred to as a recession in the macro sense because the balance of the two processes was negative; the pace of contraction processes was greater than the pace of parallel processes of expansion.

According to Kornai (1995) the recession can be explained as a result of many factors interwoven together that are briefly presented below:

i) A change from sellers to a buyers market as stabilization and price liberalization policies eliminated the monetary over hang and firms were left with unsold stock

ii) The transformation in the structure of the economy resulted in changes in product composition and the processes of privatization led to emergence of small and medium firms that were eliminated under socialism.
iii) Disruption in coordination as new institution and information center were not in place.

iv) Financial discipline and enforcement of efficiency led to unemployment and reduced demand and caused a recession in the short run period.

v) The banking system had to function on commercial basis.

vi) While Hungary did not make use of nominal anchors Poland used exchange rates and wage policy as nominal anchors. In Poland, the huge devaluation had a strong inflationary impact through sharp increase in input prices.

vii) Unfavourable external conditions such as dismantling of CMEA and disintegration of Soviet Union reduced the demand for their traditional exports.

Thus to sum up, post socialist transformation gave rise to the processes that worked towards a reduction in aggregate production in the initial phase.

(B) In the following section ‘transformational recession’ in terms of decline in GDP, rise in unemployment and inflation and effect on foreign trade in Hungary and Poland are examined.

i) Decline in GDP

The table presents indices of GDP in Hungary and Poland clearly showing that the decline in GDP in Poland was more severe as compared to that of Hungary. Losses were higher under the ‘big bang’ reform package. But at the same time fall in output in Poland, slowed down in 1991 and took a ‘U’ turn in 1992. In 1996 Poland became the
first of the transition countries to surpass the pre-transition level of GDP of 1989. Hungary a gradual reformer had not joined the group of the fast-growing countries till 1996.

The general trend of output recovery has been accompanied by a dramatic shift in the sectoral composition of the GDP, with services taking over from industry as the dominant sector in the economy. This correction was long overdue as; the previous socialist regimes were biased in favour of heavy industries. Furthermore, the change in the sectoral competition of GDP is accompanied by a structural change in the industries. Some industries like precision instruments, clothing and food processing industries have emerged as winners in Poland, whereas coal and mining and metallurgical industries have been hardest hit.
TABLE 3.4  INDICES OF GDP (1989=100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Poland</th>
<th>Hungary</th>
<th>E. Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>95.9</td>
<td>99.4</td>
<td>99.3</td>
</tr>
<tr>
<td>1988</td>
<td>99.8</td>
<td>99.3</td>
<td>100.7</td>
</tr>
<tr>
<td>1989</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1990</td>
<td>88.4</td>
<td>96.5</td>
<td>92.5</td>
</tr>
<tr>
<td>1991</td>
<td>82.2</td>
<td>85.0</td>
<td>82.0</td>
</tr>
<tr>
<td>1992</td>
<td>84.4</td>
<td>82.0</td>
<td>77.7</td>
</tr>
<tr>
<td>1993</td>
<td>87.5</td>
<td>81.9</td>
<td>77.2</td>
</tr>
<tr>
<td>1994</td>
<td>92.1</td>
<td>84.3</td>
<td>80.3</td>
</tr>
<tr>
<td>1995</td>
<td>98.5</td>
<td>85.5</td>
<td>84.7</td>
</tr>
<tr>
<td>1996</td>
<td>104.5</td>
<td>86.0</td>
<td>88.1</td>
</tr>
</tbody>
</table>

Source: Economic Survey of Europe, Various Years

ii) Employment by broad sectors

During the period 1990-1993, all the transition economies experienced not only large declines in total employment and significant changes in the ownership pattern, but also considerable changes in the sectoral distribution of employment, reflecting changes in the pattern of production. Table 3.5 presents the structure of employment by broad sectors. The percentage share of employment in agriculture declined in Hungary and Poland. The share of services in total employment registered a dramatic rise.
iii) Inflation

Most transition economies implemented rapid price liberalization in the early stages of their stabilization programme. This resulted in massive increase in prices, although the degree of rise in the price varied from country to country and the initial macroeconomic imbalance prevailing in the economy. Price liberalization typically leads to one time jump in prices, contracting the stock equilibrium. Then if the government pursues restrictive monetary and fiscal policies, inflationary pressures will subside. On the supply side, drastic increase in prices of energy alone with reduction in subsidies led to substantial increase in costs. The devaluation of currency also led to increase in import prices.

### TABLE 3.5 THE STRUCTURE OF EMPLOYMENT BY BROAD SECTOR: PERCENTAGE SHARE IN TOTAL EMPLOYMENT

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>15.5</td>
<td>9.1</td>
<td>37.8</td>
<td>33.8</td>
</tr>
<tr>
<td>Poland</td>
<td>26.8</td>
<td>25.8</td>
<td>36.8</td>
<td>31.6</td>
</tr>
</tbody>
</table>

Source: *Economic Survey of Europe*, Various Years
<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>17.0</td>
<td>28.9</td>
<td>35.0</td>
<td>23.0</td>
<td>22.1</td>
<td>19.12</td>
<td>28.5</td>
<td>23.6</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>264.3</td>
<td>585.3</td>
<td>70.3</td>
<td>45.3</td>
<td>36.9</td>
<td>33.2</td>
<td>28.1</td>
<td>19.8</td>
<td></td>
</tr>
</tbody>
</table>

Source: *Economic Survey of Europe*, Various Years

Table 3.6 shows that inflation was much more severe in Poland than Hungary in the first two years of reform. In the transition economies the origins of inflation can be traced to indexation scheme for wages, pensions, exchange rate adjustment and inflationary expectations. Increasing inter-enterprise indebtedness was another factor. Inter-enterprise loans were the most ‘cost effective’ mechanism of borrowing. This method of borrowing reduced the effectiveness of monetary policy in controlling inflation. The massive increase in prices not only wiped out the monetary overhang, but also the savings of the people. The worst affected were the pensioners and elderly people who were left with no financial cushions to protect from onslaught of rising prices. The large increase in prices led to a steep fall in real wages. Poland experienced a large reduction in purchasing power, while in Hungary the fall in real wages was relatively small.
iv) Foreign trade

The liberalization of foreign trade in Hungary and Poland opened new avenues for exploiting their comparative advantage. Exports to the west increased. The surge in exports to the west can be attributed to a surprising market for these goods in west, a substantial fall in domestic demand immediately after stabilization measures were introduced, devaluation and the ‘Europe Agreements’ which paved way for increased access to European markets. The changes in the direction and composition of trade will be taken up in Chapter IV. Since the ‘Europe Agreements’ have been to a large extent responsible for increased access in EU markets, we discuss them in detail in the following section.

3.5 THE EUROPE AGREEMENTS

This section is largely based on the Kaminski (1994) study. The single most important trade initiative for the transition economies were the so-called ‘Europe Agreements’ between the EU on the one side and the former Czechoslovakia, Hungary and Poland on the other, signed in December 1991. Bulgaria and Romania followed a year later.

The ‘Europe Agreements’ aimed to further the integration of CEE-5\(^7\) with the EU by providing steps towards the free movement of goods, services and factors, establishing framework for political dialogue cooperating on science and technology and providing for financial assistance and technical

\(^7\) CEE-5 include the former Czechoslovakia, Hungary, Poland, Bulgaria and Romania

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cooperation from the EU in a number of areas. These agreements explicitly recognized from the start the ultimate goal of joining the EU (Gross and Steinherr, 2004).

The ‘Europe Agreements’ established a free trade area for trade in goods between the EU and the respective partners within a period of up to ten years. The provisions of the Agreements were asymmetric: the period for phasing out import restriction were usually much shorter for the EU than for the CEE-5 partner. The ‘Europe Agreements’ thus assured the very fast movement of the CEE-5 economies to the top of the pyramid of EU preferential trading arrangements.

The ‘Europe Agreements’ distinguished six various groups of industrial products with different schedules of transition to free trade and different mixes of trade liberalization measures. The groups of industrial products subject to different time schedules were as follows: i) The ‘one-year delayed’ free trade group–duty free access envisaged in the second year ii) The ‘four-year delayed free trade group – i.e. at the beginning of the fifth year tariffs are eliminated iii) The quota five year delayed free trade group iv) The ECSC group (coal and steel group) v) The Multi Fibre Agreement (MFA group), and vi) The ‘Residual’ free trade group. They are briefly discussed below (Kaminski, 1994):

i) The ‘One-Year Delayed’ free trade group:

It included products for which customs duties were reduced by 50 percent upon entry into force of the Agreement and eliminated at the
beginning of the second year. It included mainly industrial raw material. This group accounted for a small share of total CEE-5 industrial exports to the EU – it was about 2% in 1991. The elimination of trade barriers significantly improved their competitive position. For example Poland’s share of these exports to EC markets increased from 0.1 to 0.6 percent between 1988 and 1991.

ii) The ‘Four-Year-Delayed’ free trade group

This group contained products for which tariffs were reduced by 20 percent on the day of entry into force of the agreement, and then lowered by 20 percent annually so that they were fully eliminated at the end of the 4th year. All intermediate goods i.e. lightly processed, resource intensive products, were included. The group accounted for a minuscule share of CEE-5 exports of the EC. This group had limited potential for growth.

iii) The ‘Quota / Five Year-Delayed’ free trade group

The trade liberalization measures for this group of industrial products were a mixture of cuts in customs duties and increase in tariff quotas and ceilings. The group subject to these provisions was the largest in terms of CEE-5 imports into the EU, accounting for between one fourth and one third of their industrial imports. It included products of most industrial sectors. The margin of preferences provided to the CEE-5 was quite substantial. For instance, MFN tariffs on polyethylene and cars were relatively high, but the CEE-5 suppliers of these products had free access to EU markets for a significant proportion of their exports. (Duty-free component for Hungary was
100% and 70% for Poland). This undoubtedly gave Hungary and Poland a substantial competitive edge over MFN suppliers.

iv) The Multifibre Agreement (MFA) Group

Textiles and clothing products rank second in terms of shares in industrial product exports. Market access for these products was governed by quantitative restrictions rather than tariffs (quantitative restrictions were abolished under the Uruguay round). The increase in CEE-5 exports to the EC was a result of obtaining increased quotas and filling previously underutilized quotas. The CEE-5 economies took advantage of the improved market access, as their exports increased dramatically in this period.

v) The European Coal and Steel Community (ECSC) Group

The ECSC product group, accounted for a significant but declining share of CEE-5 exports. The product group was not treated uniformly in terms of concessions granted by the EU. In case of steel, customs duties were to be eliminated after five years, but non-tariff barriers remained. The EU and CEE-5 had significant surplus capacity. Between 1988 and 2000 Poland’s exports to EU market doubled that triggered calls for protectionist measures. Coal includes coal products, iron ore and concentrates, manganese ores and concentrates. Poland is a major exporter of these products. Again, concessions granted by EU were not uniform and varied between countries. Exports of coal products were not likely to increase in future from the CEE-5 countries. It shows that the Agreements have not deprived EU from using trade management instruments.
vi) The ‘Residual’ free trade Group

The residual group is subjected to free trade upon entry into force of the agreements. The residual groups accounts for 32 to 50 percent share of CEE-5 industrial exports to the EU.

Thus the CEE-5 export baskets undoubtedly changed in response to opportunities offered by the ‘Europe Agreements’. Changes in export basket called for modification in technologies and distribution networks. This in turn allowed for capital outlays. Foreign Direct Investment played an important role here.

The ‘Europe Agreements’ substantially improved access to EU markets for CEE-5 exporters by eliminating tariffs. These reductions translate into a competitive edge over other suppliers. It also gave Hungary and Poland an advantage over exporters from Mediterranean countries that benefit from preferential agreements with the EU. Thus the ‘Europe Agreements’ have virtually established free trade. In the following section we briefly examine the foreign direct investment flows in Hungary and Poland.

3.6 FOREIGN DIRECT INVESTMENT IN HUNGARY AND POLAND

The section is largely based on Kaminski’s (2001) study. Integrationist accords, even those limited to trade, enhance the credibility of the government in a transition economy. When a country becomes party to an agreement with a highly developed partner, the credibility of a country is enhanced, even when no special clauses on treatment of foreign investment are included. Integration process affects inflows of foreign capital in two ways i) FDI may be diverted
from other regions due to improved business climate in the country. Combined with additional incentives associated with the improved access to market of developed countries, the increased inflows may be quite considerable. ii) The increased participation in investment outlays contributes to a faster industrial restructuring based on better technology and know how. FDI also allows for easier access to international markets through distribution channels of a parent company. Section 3.6.1 examines the FDI inflows into Hungary and Poland partially triggered by the ‘Europe Agreements’ and the advantages offered to the foreign investors, Section 3.6.2 briefly summarizes the contribution of FDI inflows in Hungary and Poland. Thus, in spite the fact that the Europe Agreements did not provide any explicit measures for treatment of foreign investment, it offered a number of advantages to foreign investors.

3.6.1 EUROPE AGREEMENTS AND FDI FLOWS INTO HUNGARY AND POLAND

The ‘Europe Agreements’ triggered integration process offered a number of advantages for attracting foreign investors. The elimination of tariffs and quotas through a scheduled timetable attracted investors seeking access to EU markets, to locate production facilities in Hungary and Poland. The ‘Europe Agreements’ required aligning economic regimes with those in the EU, thus promised orderly transition to an economy based on competitive markets. The duty drawback scheme provided by the EU to CEEC exporters provided the CEEC exporters an edge over the other suppliers in the EU markets. Third countries targeting EU would save on import duties, if they would locate production in CEECs. It also provided on incentive among EU
producers, especially those heavily relying on imports of third countries to move production to CEECs.

Table 3.7 shows that Hungary attracted huge inflows in the beginning, but subsequently the inflows of FDI to Hungary were falling, whereas for Poland they were increasing.

TABLE 3.7 FDI FLOWS TO HUNGARY AND POLAND BETWEEN 1991-2000 (IN MILLION U.S. $)

<table>
<thead>
<tr>
<th>Year</th>
<th>Hungary</th>
<th>Poland</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>1462</td>
<td>291</td>
</tr>
<tr>
<td>1992</td>
<td>1479</td>
<td>678</td>
</tr>
<tr>
<td>1993</td>
<td>2350</td>
<td>1715</td>
</tr>
<tr>
<td>1994</td>
<td>1144</td>
<td>1875</td>
</tr>
<tr>
<td>1995</td>
<td>4519</td>
<td>3659</td>
</tr>
<tr>
<td>1996</td>
<td>2274</td>
<td>4498</td>
</tr>
<tr>
<td>1997</td>
<td>2167</td>
<td>4908</td>
</tr>
<tr>
<td>1998</td>
<td>2037</td>
<td>6365</td>
</tr>
<tr>
<td>1999</td>
<td>1977</td>
<td>7270</td>
</tr>
<tr>
<td>2000</td>
<td>1692</td>
<td>9342</td>
</tr>
</tbody>
</table>


Apart from the ‘Europe Agreements’ geography also mattered. Hungary and Poland share a common border with Austria and Germany respectively giving these countries a superb geographical location. Geography suggests that the western regions of these two countries were potentially the location for EU multinational corporations.
The choice of the mode and scope of privatization as well as debt-servicing record favoured Hungary during the initial stages of transition. The decision not to default on its foreign debt put to rest the debate about ‘dangers’ of foreign capital in Hungary. Hungary opted for privatization to an outsider investor, and opened the telecommunication, utilities and financial services to foreign investor. Privatization related FDI flows to Hungary accounted for around 40 percent of total inflows. But after 1996, FDI inflows into Poland were much larger as compared to that of Hungary (Kaminski, 2001).

3.6.2 FDI AND TRADE WITH THE EU

FDI are a powerful vehicle for transfer of technology and best practices in management. They also contribute to integration of domestic production capacities into global markets. Foreign firms in Hungary and Poland are more foreign trade oriented than domestic firms, thus making a relatively large contribution to reintegration of these countries into the world economy especially the EU. Foreign firms have emerged as the largest exporters in countries like Hungary, Poland, Czech Republic and Estonia. In 1998 they accounted for around 80 percent of Hungarian EU-oriented exports of manufactures and 40 percent of polish exports (Kaminski, 2001).

3.7 CONCLUSIONS

The main components of the reforms package, their speed and sequencing give us an idea of the mammoth task that confronted the transition economies. We have seen that the strategies adopted by Hungary and Poland were dictated more by the prevailing economic conditions in the economy
rather than by choice. The stabilization and liberalization programmes caused a steep decline in output and employment and led to inflation. This 'transformational recession' was anticipated, but the degree of decline was more severe in Poland as compared to Hungary. This was because macroeconomic imbalances in Poland were on a higher scale as compared to 'gradualist' Hungary. But in spite of these differences, both the economies were able to orient their exports to the west accompanied by change in composition of their export basket.

The EU factor' was not present in the choice of subsequent development. The preferential access granted by the EU, eased considerably the pain of transition. It provided creditability for economic reforms and institutional guidance that has been decisive in attracting FDI flows into these countries. Even if 'Europe Agreements' had not been signed these countries would have succeeded in attracting FDI because, before the collapse of CMEA, the CEECs were closed to FDI inflows and trade reforms forced them to liberalize their foreign trade regimes. But nevertheless, the EU factor may also have been decisive in shaping foreign trade of Hungary and Poland. The process of European Eastern enlargement initiated by 'Europe Agreements' led to significant integration of Hungary and Poland into the EU. This chapter thus provides a background for this study and to a large extent explains the developments in foreign trade of Hungary and Poland that will be the focus of Chapter IV.