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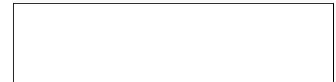

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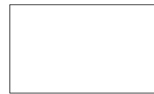
Hungary: Reform Tested by the Credit Crunch



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An Intelligence Assessment

State Dept. review completed

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EUR 82-10088
September 1982

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Hungary: Reform Tested by the Credit Crunch

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An Intelligence Assessment

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Hungary: Reform Tested by the Credit Crunch

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Key Judgments

Information available as of 3 September 1982 was used in this report.

Despite its reputation as having the best managed East European economy, Hungary is dangerously close to insolvency. After suffering cutbacks in Western credits for over a year, Hungary is beginning to receive from Western governments, banks, and the IMF the loans needed to forestall rescheduling in 1982. Nonetheless, Hungary is still well short of covering its 1982 borrowing requirement and, without more funds, could fail to meet obligations late this year. Even if Hungary raises all the loans it projects, we believe it will face a financial crisis again next year unless its trade performance or borrowing conditions improve.

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Much of Hungary's plight stems from events beyond its control—Western recession, high interest rates, and the collapse of bank lending to Eastern Europe. The Hungarians have tried to reduce their hard currency deficits in recent years through deliberate economic slowdown and revitalization of their market-oriented reforms. The reform program, however, has not produced the expected gains in efficiency and competitiveness; as a result, Hungary's trade performance has not improved sufficiently to offset rising debt service. The prospect of continuing tight financial markets—coupled with increasingly difficult trade relations with the USSR—forces Hungary to reduce investment and economic growth even further and to demand sacrifices from the consumer. Although external pressures may lead to a strengthening of some central controls, we believe that Hungarian leaders are committed to economic reform.

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Hungary: Chronology of Significant Economic Events

November 1966	*Central Committee approves New Economic Mechanism.*
1 January 1968	*New Economic Mechanism implemented.*
1969-71	*Trade deficits increase and investment rises sharply.*
1971-73	*New Economic Mechanism under fire from hardliners who want to recentralize. Growth remains high; some recentralization begins.*
1975-78	*Trade deficits soar—reach $782 million in 1978. Hard currency debt rises sharply.*
1978	*Government announces slowdown in growth to achieve twin goals of external equilibrium and maintaining living standards. Reform increases markedly.*
1979	*Investment slashed. Consumer prices raised, cost of living climbs 9 percent. Growth slows precipitously. Current account deficit shrinks.*
1 January 1981	*Three branch industrial ministries merged into single, leaner Ministry of Industry. Bureaucrats laid off. Enterprises given greater autonomy.*
1 October 1981	*Budapest unifies commercial and noncommercial forint exchange rates and promises ultimate convertibility of forint.*
4 November 1981	*Hungary applies for membership in IMF.*
1 January 1982	*Small business reform implemented. Greater scope for individual initiative granted.*
6 May 1982	*IMF membership attained.*
May 1982	*Hungary draws down $210 million in credits from Bank for International Settlements.*
August 1982	*Hungary receives $260 million commercial loan. Budapest raises some food prices and announces limits on imports.*

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Hungary: Reform Tested by the Credit Crunch

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Background

Since the late 1960s, two major developments have shaped Hungary's economy (see box):

- The New Economic Mechanism (NEM), by which the regime sought to shift from a largely autarkic, centrally planned system to a more open, decentralized structure relying more on market mechanisms.
- Serious financial constraints, stemming from the country's failure to ensure equilibrium in the hard currency balance of payments and from unfavorable developments in the world economy and within CEMA.

The regime launched the NEM because it attributed Hungary's economic stagnation of the mid-1960s to growing inefficiencies of central planning. Hungarian economists argued that the highly centralized economic structure was proving increasingly inappropriate for a country with a poor resource base and small domestic market.[1] Like most other East European countries at that time, Hungary turned to increasing imports of modern technology and industrial materials from the West to improve economic performance. But, in contrast to other Soviet Bloc regimes, the Hungarian reformers also believed that decentralizing decisionmaking and introducing more market forces would accelerate growth by improving the economy's efficiency and competitiveness in world markets. The leaders shifted the government's role from direct control toward regulation of the economy by:

- Expanding the authority of enterprise managers over investment, production, and pricing decisions.
- Reducing subsidies and taxes—particularly on producer goods—so that prices could more closely reflect true economic costs.
- Setting more realistic foreign exchange rates so that managers could make more economically rational decisions in buying and selling.

Hungary enjoyed good economic growth during the first years of the NEM, but a flood of imports to support surging investment led to balance-of-payments problems by 1971. Critics of the NEM took this opportunity to challenge the reform: the inequality of widening wage differentials, the danger of unemployment if inefficient producers shut down, and the inappropriateness of profits as a performance indicator in a socialist economy. In 1972-73, the government tightened central control over prices and investment, increased subsidies to unprofitable enterprises, and gave across-the-board wage increases. In effect, the leaders held economic reform in abeyance as they resorted to more traditional mechanisms to deal with excess demand and balance-of-payments deficits.

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The regime further tightened central controls as it sought to shield the domestic economy from the explosion of world prices for raw materials and energy in 1973-74. Hungary's hard currency terms of trade deteriorated by over 20 percent, and rising import costs helped push the trade account even deeper into deficit. Although the regime raised some prices, the government largely offset the impact of world inflation through increased consumer and producer subsidies.

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The regime's actions helped accelerate the growth of foreign debt in 1975-78. The softness of Western markets hurt Hungary, but the main problem was the government's failure to restrain domestic demand and provide incentives for exports. Price controls and growing consumer subsidies sustained a rising tide of imported consumer goods and limited the availability of exports, particularly of food products. Continued producer subsidies enabled enterprise managers to invest without concern for efficiency. Controls on imports of goods competitive with Hungarian products—instituted for balance-of-payments reasons—

[1] Foreign trade turnover (exports plus imports) is the equivalent of nearly one-half of the Hungarian GNP

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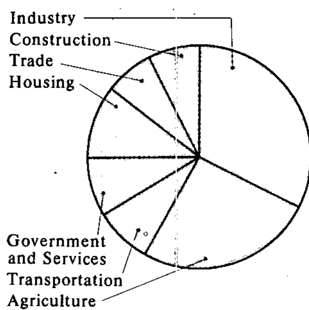
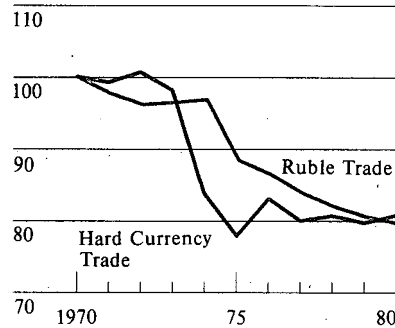
Hungary: Selected Economic Indicators

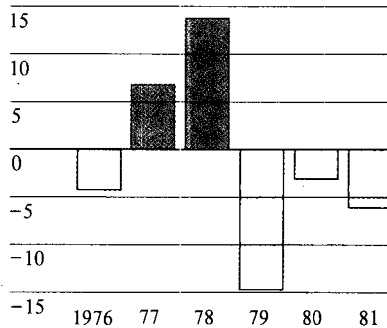
GNP by Sector of Origin



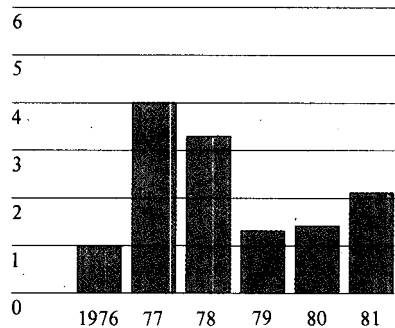
Terms of Trade
Index: 1970=100



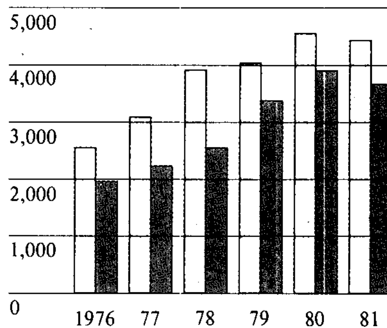
Growth in Investment
Percent Growth



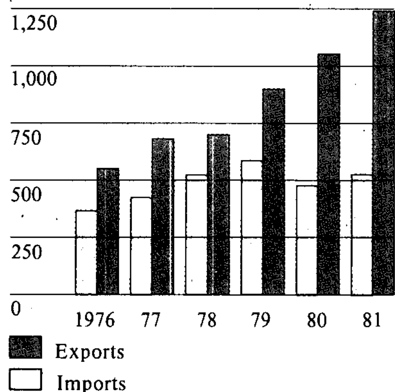
Growth in Personal Consumption
Percent



Hard Currency Trade With Non-Socialist Countries
Million US $



Hard Currency Trade With Socialist Countries
Million US $



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ensured secure, protected markets for domestic enterprises. Hungarian managers thus lacked strong incentives to produce quality goods or to enter competitive Western markets.

By 1977-78, Hungarian policymakers and Western creditors realized that failure to control the hard currency balance of payments was leading toward a financial disaster. The regime responded by shifting the focus of policy from economic growth toward external equilibrium. While recognizing the need for an economic slowdown, the government was still unwilling to lower living standards. Thus the regime sought to place the burden of adjustment on investment by implementing more restrictive domestic credit policies in 1979. To improve trade performance, Budapest channeled the reduced pool of investment funds primarily toward export and import-substituting industries.

The regime also revived the reform program in an effort to improve export competitiveness and to offset reductions in imports and investment through greater efficiency. Since 1978 Budapest has moved economic management back toward the principles of the 1968 reform by:

- Adjusting domestic prices closer to world prices and cutting producer subsidies.
- Liquidating or merging some unprofitable firms with profitable enterprises.
- Breaking monopolies to increase competition and allow greater flexibility.
- Permitting more small privately owned businesses.

Impact of Stabilization Measures

Hungary's stabilization program cut the growth of GNP from an average annual rate of 2.7 percent in 1976-78 to less than 1 percent since 1978 (see table 1). Investment, which had increased as a share of GNP between 1968 and 1978, has fallen more than 20 percent over the past three years. Increases in consumption have been the key source of growth. Real private consumption increased by an average of 1.6 percent per annum in 1979-81, faster than in any other East European country except East Germany.

The decline in economic growth helped Hungary improve its hard currency balance of payments in 1979-80. The current account deficit fell from $1.2 billion in 1978 to $365 million in 1980 thanks to a $700 million decrease in Hungary's trade deficit with the West and a $400 million increase in the hard currency trade surplus with socialist countries The cutbacks in investment and the slowdown in industrial production reduced imports of capital goods and industrial materials and spurred sales of semimanufactured goods (such as steel and chemicals) to the West. Imports of consumer goods continued to rise because of the high priority assigned to maintaining living standards. At the same time, strong agricultural performance helped Hungary increase food exports to the West and meet rising Soviet demand for hard currency purchases of meat and grain. 25X1

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Hungary's efforts to eliminate its current account deficit have faltered over the past year and a half. In 1981, the current account deficit widened to $700 million as skyrocketing interest charges on debt overwhelmed a small additional increase in the hard currency trade surplus. Although Hungary improved its trade balance slightly during the first half of 1982, continuing high interest costs leave Hungary's balance of payments in deficit. 25X1

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Western recession and, to a lesser extent, a poor harvest last year have hurt Hungary's exports in 1981-82. Sales to developed countries declined sharply in 1981 and were only partly offset by increased hard currency exports to the USSR, Libya, Iraq, and Algeria. Some Hungarian economists and economic policymakers have argued publicly that the falloff in

[2] Although most of Hungary's trade with socialist countries is conducted on a clearing account basis, approximately 20 percent of imports and exports involve hard currency transactions or exchanges of goods otherwise salable in Western markets (so-called hard goods). Most of this trade is with the USSR and, according to Hungarian officials, mainly involves the exchange of Hungarian grain, meat, and other agricultural products for Soviet oil outside planned soft currency deliveries. Hungarian sources have never directly indicated whether Budapest has actually received hard currency from the USSR in settlement of its growing surpluses in this trade. Nonetheless, Budapest and the IMF include these surpluses in Hungary's overall hard currency balance of payments.

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Table 1
Hungary: Annual Rates of Growth of GNP by Sector of Origin

Percent

	1965-70	1971-75	1976-80	1978	1979	1980	1981
GNP total	**3.1**	**3.4**	**2.1**	**2.4**	**0.2**	**0.3**	**0.6**
Industry	3.4	2.6	2.4	3.5	0.5	−0.1	1.5
Agriculture and forestry	0.7	3.8	0.8	−0.9	−2.9	1.1	−0.9
Construction [a]	8.0	3.2	0.9	4.1	−0.9	−3.2	−4.9
Transportation and communication	3.2	3.6	4.6	5.7	2.9	1.5	2.2
Trade	8.3	6.3	2.6	4.1	0.5	0.0	2.8
Housing	0.9	2.0	2.0	2.0	1.9	1.8	1.5
Government and services	3.7	3.5	2.8	2.6	2.9	2.6	2.1

[a] Growth rates of construction reflect trends in investment.

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exports to developed countries demonstrates the continuing failure of Hungary's reforms to foster efficient, competitive industries capable of adapting to tougher selling conditions. Despite the goal of shutting down unprofitable enterprises, the system still draws off resources from competitive firms to subsidize inefficient producers. Furthermore, Hungarian enterprises continue to enjoy a protected home market and thus are able to ignore stiff competition from the West.

The decline in exports and a simultaneous tightening of credit have forced Hungary to reduce hard currency imports over the past two years. Cutbacks in imports of energy, industrial materials, and food products in 1981 more than offset increases in purchases of consumer goods, machinery, and equipment. In January-June 1982, purchases of food products were down by 30 percent compared with the same period a year ago while imports of industrial materials and consumer goods have fallen by roughly 5 percent. Only machinery and equipment show a small increase.

Mounting Financial Woes

Despite the increased payments deficit in 1981, Hungary suffered a liquidity crisis only when East-West credit relations deteriorated. Western bankers applauded Hungary's determination to restore external balance through austerity and market-oriented reforms and were encouraged by good results in 1979-80. However, rising debt service obligations left Hungary vulnerable to the collapse of bank lending to Eastern Europe that followed the Polish and Romanian crises.

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Hungary's ability to raise new credits eroded rapidly after mid-1981. After obtaining $550 million in two syndications early in the year, Hungary failed to secure a third major loan and was forced to cover its cash needs in late 1981 largely through reserve drawdowns and shorter term borrowing at higher interest rates. In the first months of this year, Western banks withdrew some $700 million in short-term deposits placed with the National Bank of Hungary while CEMA and OPEC banks pulled out $450 million. The Hungarian National Bank provided data to Western banks in May showing that Hungary had to reduce its reserves from $1.9 billion in 1981 to $374 million at the end of March 1982 to cover these withdrawals and other obligations.[3]

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[3] The reserve drawdown involved the liquidation of both Hungary's deposits in Western banks and some of its gold stock. Senior Hungarian bankers have told US Government officials that Budapest sold nearly half of its 75-ton gold stock and pledged much—if not all—the rest as collateral for loans. Statistics from the Bank for International Settlements (BIS) show that Hungary's deposits in Western banks fell from $890 million to $470 million in the first quarter of 1982. The reasons for the discrepancy between Hungary's reported reserves of $374 million and the BIS statistics are not clear.

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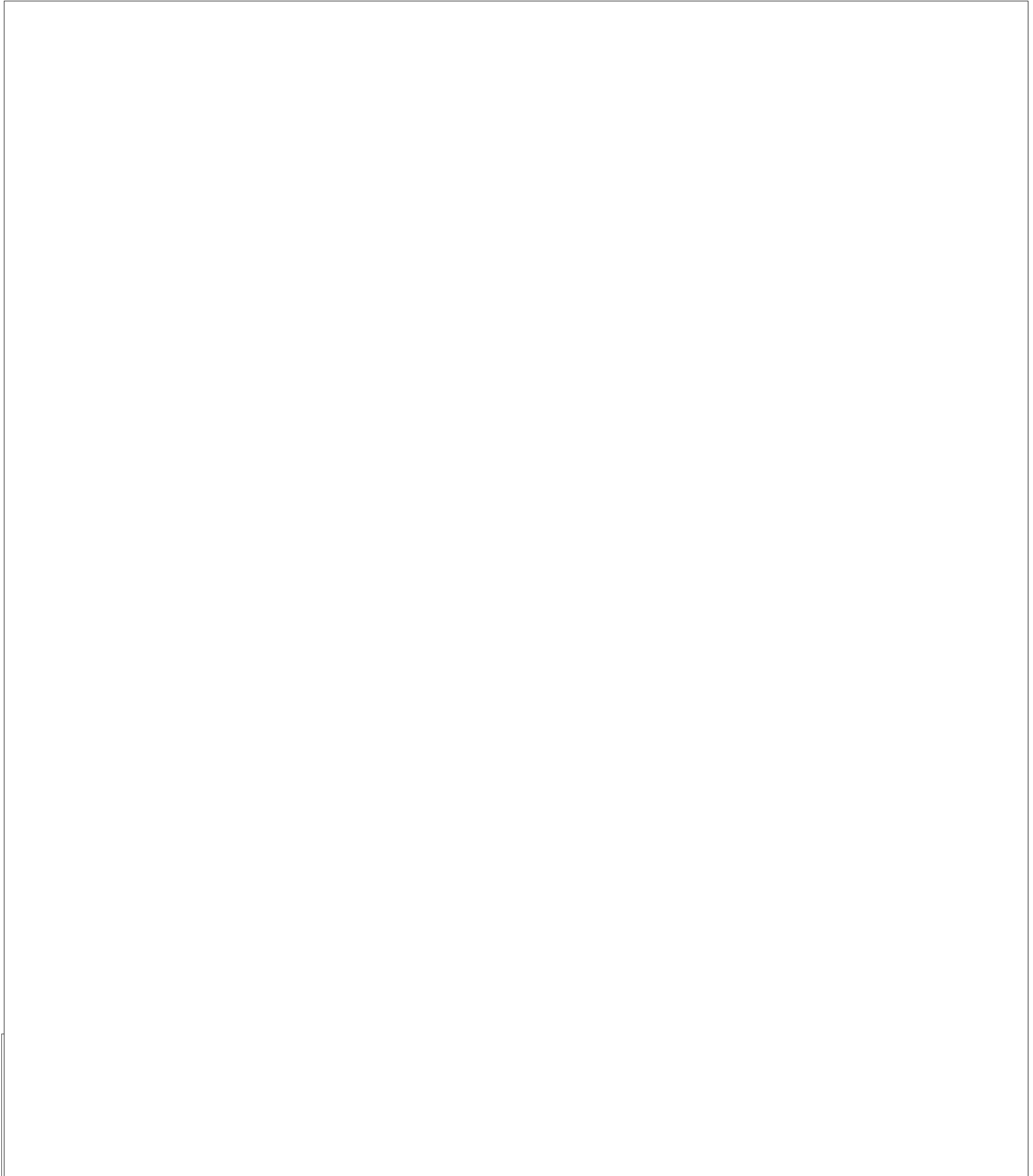

A senior Hungarian banker told US Government officials more recently that Budapest had raised $500

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million in credits (including supplier credits but excluding BIS funds) by midyear. While press reports indicate that Budapest received a $100 million short-term credit from Swiss banks against gold collateral, we believe that most of these "credits" represent short-term extensions on loans falling due and payment delays to suppliers.

Financial Prospects

After much delay, Hungary has begun to raise some of the needed credits, but it is still far short of its goal. If they fail to raise these funds, the Hungarians will have difficulty meeting their obligations late this year and may have to request debt relief from their creditors:

- A group of 15 major commercial banks provided a $260 million medium-term loan to the Hungarians in August. Press and US Embassy reporting indicate that the loan was on the verge of collapse until pressure from British, French, and possibly West German authorities convinced West European banks to participate. According to these sources, West European central banks and governments feared that failure of the loan would lead to a debt rescheduling that would threaten Hungary's program of economic liberalization.

- The willingness of leading international banks to cooperate on the $260 million loan should improve chances for additional funds from other private lenders. However, some bankers involved in the medium-term credit have told US officials that they are skeptical about Budapest's chances of reattracting the $300 million in short-term deposits it projects.

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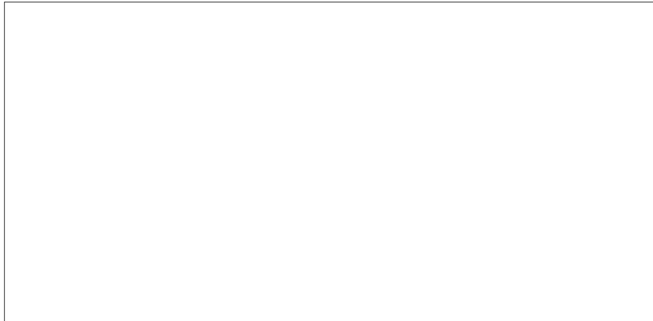

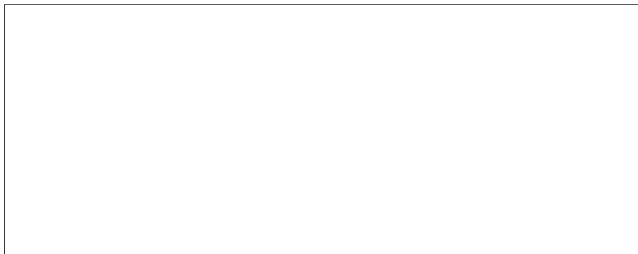

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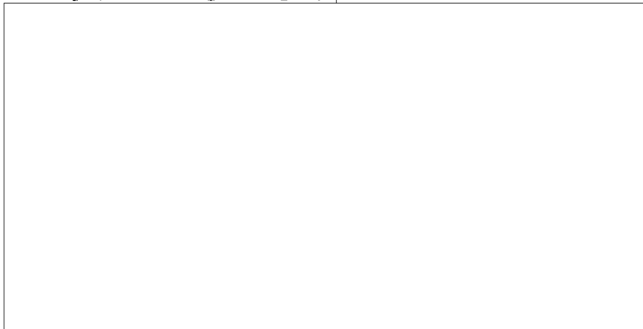
With only a small increase in reserves at best and rising debt repayments, Hungary's financial position will remain tenuous next year. Hungary projects a borrowing requirement of $1.5 billion in 1983 to be covered by credits from commercial banks and suppliers. However, the Hungarians apparently fear that their borrowing needs may go higher or that they may fail to raise adequate funds from private sources because they plan to obtain—and hold in reserve—an additional $500 million in IMF credits. Failure to reach current account balance this year may heighten the reluctance of commercial bankers to advance more funds and probably will prod the IMF into imposing stiff conditions for its credits. To win support from the banks and the IMF, Hungary will have to reduce its financing needs, particularly by cutting imports more. If it fails to improve trade performance sufficiently and if borrowing conditions do not improve, Hungary could require debt rescheduling next year.

No Help From the USSR

In addition to the financial squeeze from the West, Budapest faces more difficult economic relations with the USSR. There are signs that the Soviet Union's worsening economic situation has induced Moscow to become tougher in its dealings with much of Eastern Europe, including Hungary.



Hungary must also contend with worsening terms of trade with the USSR (approximately a 6- to 7-percent deterioration in 1981) and with the Soviet regime's insistence that soft currency trade deficits with the USSR be reduced. Because of rising Soviet prices, the pressure to balance trade with the USSR, and a falloff in imports from Poland, Hungary suffered a 4-percent decline in real imports from CEMA in 1981 while raising export volume by 4 percent. This trend in CEMA trade has increased Hungary's need for imports from the West and possibly reduced the amount of goods available for sale in Western markets. Hungary must also anticipate that it will earn less cash in its hard currency trade with the Soviet Union if the Soviets insist that more hard goods be delivered to offset deficits in soft currency trade.

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Moving Toward Greater Austerity

Mounting economic pressures from Western creditors and the USSR leave the Hungarian Government with little choice but to accept a further slowdown in growth and to back off from its policy of maintaining living standards. We believe the regime almost certainly would prefer to assure sustained popular support by continuing to favor consumption over investment. However, the need to ensure long-term growth by improving the international competitiveness of Hungarian industry limits the scope for more cuts in investment and in imports of Western technology.

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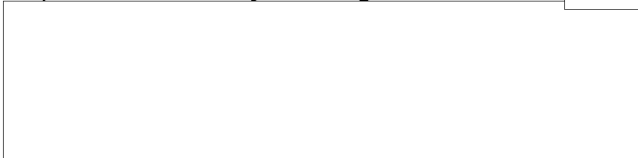
After temporizing through the first half of 1982, the leadership now is beginning to accept the need to impose more austerity on Hungarian consumers.



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As with earlier price increases, the regime has explained its recent actions and is warning that more austerity measures are likely. Officials stress publicly that maintaining living standards will be increasingly difficult given the need for external equilibrium. Hungarian economists have told the US Embassy that the leadership is resigned to some decline in living standards.

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Implications for Hungary

Hungarian officials have warned Western governments and banks that a financial crisis could force abandonment of reform and closer integration with the USSR and CEMA. These warnings seem designed to win Western help rather than to indicate policy change. The leadership appears convinced that decentralization and adjustment to world economic forces—not greater reliance on the USSR—are the only solutions to Hungary's problems.

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No major steps toward centralized management or reimposition of administrative controls have been taken, as in the mid-1970s. The recently imposed import restrictions involve some tightening of existing controls but do not reverse already enacted reforms. The US Embassy in Budapest sees no significant faction advocating recentralization and and we believe that changes in the party and government leadership in late June probably have strengthened party leader Janos Kadar's hand in pursuing reform. Furthermore, Western creditors would insist that Hungary continue its reforms in return for their help if Budapest had to request debt relief.

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Hungary's economic problems, however, have renewed public debate about accelerating reform. Some liberals, such as the NEM's architect Rezso Nyers, argue that the government must speed up the introduction of planned measures in order to improve the economy's efficiency more quickly. Finance Minister Hetenyi has urged an expansion of managerial authority and a reduction in subsidies for unprofitable enterprises even though "social pressures" may tempt leaders to put off difficult decisions. By contrast Janos Berecz, editor in chief of the party newspaper, contended in an article published in August that economic difficulties may require plans to increase enterprise authority and independence to be delayed. Party Secretary Havasi has also stressed that more rapid

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relaxation of central controls and elimination of subsidies would worsen inflation, unemployment, and balance-of-payments problems.

The regime's public insistence on maintaining living standards and the caution of some officials about speeding up reform underscore the leadership's concern over the political consequences of the country's economic problems. This summer's price increases have not provoked serious discontent, and the carefully orchestrated explanation of Hungary's problems will probably win continued public acceptance of the government's actions. Nonetheless, the party may have received some criticism from the rank and file for not consulting adequately on its recent actions. The party newspaper has acknowledged that Hungary's "exceptional situation" requires the adoption of measures without full debate and a consensus. On balance, however, the frank discussion of Hungary's economic shortcomings and the open debate about policy options argue that the regime remains confident about its control and the credibility of its policies.

Implications for CEMA

The economic burden of Hungary's problems on CEMA would seem small. The major threat is debt rescheduling, which would further dampen the willingness of Western bankers to lend to Eastern Europe. Cuts in Hungary's hard currency imports would be of little immediate significance to CEMA partners. These countries are already slashing their own imports from the West because of the credit squeeze and are suffering an economic slowdown. The Hungarians have not indicated that their difficulties will prevent them from meeting their export commitments to CEMA partners. In fact, Hungary's deliveries to CEMA have continued to increase during the first half of 1982.

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A possible rescheduling would tarnish the image of Hungary's reform but would probably have little impact on economic policymaking within CEMA. All CEMA countries are contending with serious economic problems and any reform measures will be designed to address their own situations. We have no evidence that Hungary's financial problems have prejudiced decisionmakers elsewhere in Eastern Europe.

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