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Burdensome Legacy

Political and Economic Changes Through the Glasses of a Financial Policy Maker

Summary: The political and economic changes 25 years ago left a burdensome legacy with an impact still felt today. This legacy includes the huge national debt and the failure to complete a price and wage reform. This study aims to dispel myths about the first government failing to request debt forgiveness and prove that making such a request was not a viable option during the first years of the changes. It shows that there were some initial ideas about implementing a wage and price reform, because wages did not include many cost items commonly integrated into them in a market economy including housing, healthcare and education. Interestingly, the study proves that it would have been possible to carry out a reform in 1990 by increasing wages and reducing contributions at the same time. As this did not happen, Hungarian wage levels remained low compared to those in Western Europe. As a result, the "reform" of large systems was confined to hard-to-implement austerity measures resulting in lower living standards.

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JEL codes: H5, H63, E31, E24

Now that in 2015 we celebrated the 25th anniversary of the political and economic changes, several memoirs were published on this subject. In this study, I attempt to present all the different approaches taken by them. It is interesting to see that people involved in the events and those who know part of them only from historical sources have very different views. I will discuss the direct and indirect antecedents of the political and economic changes, the legacy given to the first government and the way it was managed. How was this legacy managed by the new democracy? And how has it evolved to date? I will focus on some key aspects comparing other authors' opinions with my own memories and the thoughts of other people looking back to the events.

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If you ask what kind of Hungary we wanted to build after the political and economic changes, the answer would be: a social market economy. An economy similar to the one created by *Ludwig Erhard* in Germany after World War II. This was reflected by MDF's party programme and partly also by the government's programme. The extent to which this programme was implemented depended on the current environment.

What do people think now, 25 years later? How are these disruptive events evaluated now? What are the questions we most commonly ask ourselves?

One of the most frequently asked questions is related to the possibility of having done things otherwise.

Many people say, for example that we should not have destroyed our economic relations with former socialist countries. At the same time, we should not have agreed to service the debt accumulated by socialist governments towards the Western financial world. They claim that we missed the moment of grace when we had an opportunity to say no to servicing debt inherited from the old regime. Everything would have turned out differently if we had kept our export markets without a debt burden worth HUF 21bn on our national economy. Below, I outline my thoughts about these two subjects. I would also like to discuss the two important steps that we really failed to take right after the political and economic changes the adverse consequences of which are still felt today.

OPENING TO THE WEST – CLOSING TO THE EAST?

In his book of interviews recently published by Éghajlat kiadó (Patai, Parragh, Lentner, 2015), *Csaba Lentner* concludes that the Antall government made a painful mistake when it put an end to the established practice of intra-Comecon trade. He refers to a set of mistaken economic policy decisions. *"The list includes the irresponsible underestimation of the importance of debt forgiveness, debt rescheduling, the termination of the transferable ruble system and Comecon without being integrated into an alternative economic alliance…"* (Patai, Parragh, Lentner, 2015, p. 139).

The transition to payment in convertible currency was decided already by the Németh government. I was the only expert present at the meeting held on this subject by then Deputy Prime Minister *Péter Medgyessy* and the heads of economic research institutes. I still do not understand to whom our politicians wanted to export our goods if not to Russia? I wondered what would happen to the Hungarian economy whose large machinery and food industries were focused on satisfying the demand of socialist markets. Would it be possible to swiftly modernize our economy to be competitive in other markets? But where shall we get the necessary funding from? The transition from transferable ruble to convertible currency threatened with a major deterioration of the exchange ratio and price loss at least on a temporary basis. It was predictable. And it made no sense to accelerate this process. I expressed this view also at the meeting.

Later, my assumptions were confirmed by the events. Now many people from younger generations believe that this "bad structure" definitely had to be dismantled and it should not have been maintained by keeping the old system alive. But it is very subjective to tell whether a structure is "bad" or not. Being a person of practical common sense I have to say – and I said this at the meeting – that if you recognize a need, you have to act proactively, fight and be dynamic rather than surrender passively. That is, we should have modernized our economy to ensure a competitive presence in more markets, however, we should have also preserved our existing attractive sales opportunities until that goal was reached. You should not sit back and relax, but get prepared for the changes actively. The structure of our economy was not so bad that its total destruction would have been justified. Improving the quality of our products, we could have ensured continued market demand for them. We still receive inquiries for IKARUS buses from Latin America. Twenty years after the political and economic changes, these buses were still running in some urban areas of the former Soviet Union.

It is true, however, that the existing socialist mechanism based on half-baked reforms had many weaknesses. It definitely had to be replaced with a complex market-based mechanism. Nevertheless, it was rather difficult to define this new kind of market-based mechanism.

In the above cited book, *Mihály Patai* concluded the following: *"I (…) don't consider the loss of Eastern markets an inevitable must. I simply consider it to be a mistaken political and strategic decision.(…) The demise of the Soviet Union happened 18 to 24 months after political and economic changes in Hungary. And the Soviets did not refuse to buy our textile and agricultural products…"* (Patai, ibid., p. 138). Let me add, however, that they made no commitment to pay for these products either. Especially not by providing us with badly needed energy resources. We had to buy these energy resources for dollars from the Soviet Union (and then from Russia). But we could export to the Soviet Union only on credit.

László Parragh has a slightly more subtle view on this: *"It was partly inevitable, and partly due to our foolishness that we lost the Eastern market. It was inevitable, because this market fell apart..."* (Ibid., p. 138)

Other sources give a more realistic judgement. In a book by *Iván Bába* published in 2015, *János Martonyi* recalls these events as follows: "We had foreign exchange reserves sufficient for a few weeks, and faced a huge loss of market. The Soviet market simply ceased to exist. It is not true that we pulled out of this market. Just on the contrary, we continued exporting to the Soviet market when we knew that they would not pay." (Bába, 2015, p. 192). This is exactly what I want to say. The export surplus could mean two things for Hungary: inflationary pressure on the one hand, and a balance of payments deficit with the West on the other hand. In Hungary, these two things coincided.

The situation is best described by the words of *Ferenc Rabár,* then Hungary's Minister of Finance. In a volume of essays published after his death, he wrote the following:

"The collapse of Comecon (...) has accelerated so much that it created an absurd situation for the country. It was demonstrated not only by the temporary suspension of oil supplies for five or six days, but also by ignoring all contractual obligations (...). They owed us USD 700 million that the Soviet party already agreed to pay to the previous Hungarian government. This year, this amount increased to USD 1bn (…). Whether we will ever be paid that USD 1bn is doubtful, to say the least. This amount corresponds to the current account deficit now approved by the IMF for Hungary." (Rabár, 2002, p. 155)

Ferenc Rabár said the above at a conference in January 1991. (He filed his resignation as Minister of Finance in autumn 1990. After that, I headed the Ministry of Finance as Deputy Minister of Finance. As a result, it was me as Secretary of State of the Ministry of Finance who was given the task to submit the budget for 1991 to the National Assembly in December 1990.)

Rabár knew what he was talking about. And he was right. Over the next decades, we managed to collect only a fraction of this outstanding debt from Russia. (And even this fraction was offset by military fighters of a doubtful practical value... This decision, however, was also due to Budapest's refusal of Russian involvement in its underground construction project.)

The conclusion is fairly self-evident. It was Hungary's vested interest to keep its former socialist markets. It was (and still is) clear that we can satisfy our energy demand only from the Soviet Union (Russia). Over the past decades, Hungary always had a balance of trade surplus with Comecon countries. This market was of critical importance for Hungary. The government obviously was not blinded by ideology and recognized this relationship. But they had no choice given that the Soviets were simply unable to pay after 1990. They were unable to pay and they did not want to pay. It was not Hungary that did not want to export to Russia. We just could not afford to export on credit. We ourselves needed foreign loans and could not export to Russia on credit. (Hermes of Germany and French export credit insurance company Cofas could do it. Sometimes you have to use export credit insurance services to stay on a market.) In addition, Russia received major agricultural aid from the West which made it difficult for us to sell them our food products for cash as before. Western countries were afraid that Russia would fail to properly maintain its nuclear power plants due to lack of funds which could lead to a second Chernobyl disaster. Also, the EU had a surplus of milk and butter. With a generous measure, the EU got rid of its surplus which also improved the popularity of left-wing politicians. This measure, however, reduced our chances to sell in the Russian market.

Therefore, it is a misunderstanding to assume that Hungary did not want to improve its trade relations in the East due to ideology-related reasons. We would have needed some interim financing to be able to stay on those markets. But the required funds were not available in the national budget. The West and the IMF did not accept that we needed funds to manage the transition to a market economy. (And they did disregard the fact that we did not take that path voluntarily but were victims of the Yalta agreement. This basic fact should not be ignored when evaluating the events in a political context.)

The Eastern markets collapsed due to the coincidence of circumstances rather than to mistaken government policy.

Please note, however, that we could have taken some action after the political and economic changes. If not immediately in the first years, it may not have been too late later either. Part of privatisation revenues could have been used to strengthen institutions offering export credit facilities to Hungarian businesses to help them improve their competitiveness. But this did not happen later either (or only with institutions with limited capital resources). (It is an interesting historical fact that Prime Minister Gyula Horn asked a mixed group of economists including Ferenc Rabár, Katalin Botos, József Botos and Sándor Kopátsy what privatisation proceeds should be spent on. We suggested that it should be used partly for debt service, and party for the establishment of the above described institutions. It is still unclear why the government declined to follow this piece of advice. It was probably due to the strong liberal voice in the government that flatly refused any state intervention.)

THE ISSUE OF DEBT

Another typical question is the following: Why wasn't it possible to ask for debt forgiveness? People still have many illusions about foreign debt forgiveness. The man in the street often asks the following questions: Why didn't *József Antall* or Ferenc Rabár ask for debt forgiveness right after the new government was established? Why did they wait? Was it part of their gentlemanlike attitude? Or was it simply foolishness? Or was it part of a deliberate collusion with Western capitalists? There have been too many assumptions made about it.

And this is unclear not only to the man in the street but also to a major portion of educated Hungarians. They believe that the Antall government missed the initial five minutes of grace when Hungary had a real chance to ask for debt forgiveness from Western powers.

RETÖRKI (Research Institute and Archives for the History of the Hungarian Regime Change) published a volume of studies titled "*A rendszerváltáshoz vezető út*" *(The Way to Political and Economic Changes)*. (Lóránt, ed, 2015). At the event introducing this publication, Director *Zoltán Bíró*, founding member of MDF, said that Germany had the willingness to forgive Hungary's debt in 1990. He quoted a personal discussion he had with a German MP who said that they would support such a measure, but *"can do nothing now that József Antall expressed his commitment to debt payment in Germany's Parliament."*

This German MP probably did not know why József Antall had to stress this commitment at every public forum. (An average MP tends to be as ill-informed in the West as they are in Hungary. But I know the reason because I also had to make similar statements those days.)

The views of Zoltán Bíró are shared by other people, too. Some former politicians (honestly committed to serving Hungary's national interest regardless of party affiliation) outlined similar opinions in their memoirs. A dialogue book of *Imre Pozsgai* and *Tibor Polgár* published in 2003 also covered this issue. (Pozsgai – Polgár, 2003) A recently published book of Veritas Institute includes the following: *"József Antall should have discussed the debt burden issue with Western powers."* (Mátyás Szűrös) (Bába, p. 193). *"In 1989, Hungary's prestige was at its highest in the eyes of the world since 1956. This could have been used as an opportunity to point out that we would not be willing to continue with the debt accumulated by the Kádár regime" (Imre Pozsgai).* (Bába p. 202)

In reality, however, this was not a viable option. The foreign currency reserves of the National Bank of Hungary (NBH) had shrunk to a minimum level by March 1990. We did not receive much short-term deposits either. In spring 1990, before the general elections, creditors asked us to confirm our willingness to pay if we win the elections. Had we refused this request, we would have been doomed to failure even before the second round of elections is over and the new government is established. Soon we would have had market players who – as they previously suggested – would have offered a debt-for-equity swap deal to settle our debts. One such market player was *György Soros*. If this had happened, a major portion of Hungary's national assets of a great but unappraised value would have been concentrated in one hand. (Many state assets ended up in foreign hands later, albeit in a distributed ownership structure.)

So what were the things that we had to consider? Hungary was an economy heavily dependent on imports. Nearly every company and every industry was heavily dependent on imports. Without imports there would have been no exports. And without imports there would have been no manufacturing at all. Even in agriculture, machinery, components, fertilizers and energy had to be imported from abroad. And Hungary needed foreign exchange to finance its imports. However, foreign deposits were withdrawn from Hungarian banks after the political and economic changes. Hungary had zero foreign exchange reserves. It had to exclude the option of non-payment, otherwise the country would have been paralyzed by foreign creditors in a few weeks' time. IMF agreed to provide a stand-by loan to Hungary if it had committed to continued debt payment. If we had refused to repay our debt we would have been excluded from foreign money markets for a long time. The state would have gone bankrupt which would have surely lead to the fall of the government.

18 months after his resignation, that is, fairly close to the events in time, Ferenc Rabár evaluated this situation in a study as follows:

"*... Hungary did not have any meaningful external resources to rely on for implementing its liberalization and stabilization policy either in the form of donations or in the form of debt relief. Those who follow the politics and generosity of developed countries may suspect, while those who participated in the talks themselves definitely know that it was not only assumption: it was hard fact."* (Rabár, 2002, p. 170)

The government hoped that a gradual transition and a commitment to pay will enable Hungary to restructure its short-term debt into long-term debt until it can strengthen and grow its economy to make it fit for debt service. (This debt restructuring was completed by the end of the cycle. At the same time, the balance of payments deficit increased significantly as shown by NBH data.)

We know that US banks provided financial support for Mexico and Brazil several times when these countries became insolvent. But such support was justified by US interest and large-scale US investment in these countries. And the size of those markets is not comparable to that of Hungary either. This was a case when, having too much money at stake, the creditors worried more about non-payment than the debtor. A state bankruptcy in Brazil would have generated too heavy losses for creditor countries' banks. But our case was different. We were small, and creditor countries did not yet have much investment in Hungary. Consequently, they insisted on payment. They wanted to force payment at any price.

Our case was also different from that of Poland. Before 1990, Poland was also a socialist country (albeit of a much larger in size than Hungary). It also had major foreign currency debt. But most of its debt came from US government loans. Hungary had bank loans, and we usually raised funds through issuing securities. This practice made "write-offs" much more difficult. Relying on an efficient Polish lobby in the US, Poland has successfully transferred the burden of US state loans to US tax-payers. The Hungarian lobby could make no such request to the US Congress. And the Hungarian lobby was smaller and more fragmented than the Polish one, anyway. It is also little known that the Hungarian government had also made some tentative steps to find out whether it can hope for support from Germany. József Antall was on friendly terms with Helmut Kohl, Chancellor of Germany. *Kohl* said that the maximum support his country can give would be a major loan with preferential terms. If you consider that the costly process of German unification was still underway and it nearly led to the fall of Chancellor Kohl, his answer is not that difficult to understand. That time, however, this German loan was also valuable support to Hungary.

This is the explanation why Hungary missed that so-called "moment of grace".

Later, however, there were some other solutions supported also by the IMF that Hungary failed to make use of. Mihály Patai talks about them in the above mentioned book of interviews. Patai says that there was an opportunity to renegotiate debt and ask for a partial relief of interest payment. Being Hungary's representative at the World Bank, he had a good overview of the issue from the outside. I can also confirm that there were such initiatives. After a trip to the US, I reported on them to the Prime Minister myself. (It was right after I met Patai in Washington. I received no response to my report from the PM.) I have no official information about confidential talks on this subject and their interruption with the Minister of Finance in 1991. It is certain, however, that the management of the National Bank of Hungary, *György Surányi* in particular, strongly objected any measure that would have questioned our willingness or ability to pay. He said that Hungary would be worse off with such an arrangement than with low-profile restructuring that was actually performed by the central bank by the year 1994. In retrospect, however, Hungary may have gained some benefit from the proposed arrangement. If it could ask for a relief of interest payment (as indicated by Patai), such an arrangement would have been a major load off for the country. It was definitely a mistake to refuse such a proposal.

One thing is certain: over the past 25 years we have privatized national assets selling them mostly to foreign owners and used the proceeds to settle part of our old debt. Nevertheless, we could not get rid of the foreign debt burden. Foreign debt was regenerated… And this is more of an issue today than it was in 1990, as our loans are no longer backed by assets. That is, we have national debts but we have no national assets. (Regardless of the current government's efforts to renationalize some assets.)

REFORMING LARGE SYSTEMS

Reforming large systems has been on the agenda for 25 years. But it is rather difficult to define what is meant by such a reform. It is also unclear, why the reform process was not launched already by the first government after the changes.

When people hear the word "reform", they immediately associate it with some kind of austerity package. In most cases, reform means that the financing of certain tasks is transferred to the private sector. However, this is not a reform, but an increase in the burden on citizens. If these changes are not combined with higher wages, they simply lead to a reduction in living standards.

And such measures meet strong opposition any time. This is why no meaningful measures have been taken over the past twenty years. It was just part of political bickering. Whenever a government wanted to do something, it was attacked by the opposition and then undone after it came into power. As a result, there has been no progress in reforming large systems. Hungarian wages are still much lower than those in Western countries. They are at the same level as in 1990 when Hungarians earned about 20 to 25% of the Western European average. Where should those burdens have been transferred to then? (If something happened, it was always done "under cover" to minimize social tension. One such measure was the recent transfer of all health insurance costs to employees…)

The top ministry responsible for economic affairs in the Antall government knew but too well what should have been done. (This top ministry was the Ministry of Finance those days.) The Ministry of Finance was responsible for the budget, the balance of the public finances, banking supervision, planning and economic modelling, talks with international financial institutions and negotiations with social partners. The Ministry of Finance was headed by the Minister of Finance. Until 1993, I was a cabinet member myself. At this forum every major economic issue was discussed. The Ministry always had a comprehensive overview of the situation.)

High-ranking ministry officials knew that Hungarian wages and prices are heavily distorted compared to those in Western market economies. The reason was that Hungarian wages failed to include many components, such as housing, healthcare or education. (And they still do not include these components.)

"Hungarian wages are absurdly low. And this is not attributable only to the difference between the productivity of Hungarian and foreign labour as is often cited. This is attributable to the fact that Hungarian wages do not include the most basic employee needs." (Rabár, 2002, pp. 103 and 104). The difference in productivity is not an acceptable reason as our average productivity is still closer the EU average than our wage level is. It clearly meant that living standards were partly financed from the redistribution of the budget.

Such curtailment of wages was a system-specific feature of planned economies. In the socialist regime, people could cover only their most basic personal needs from their wages. They were provided housing by the state for a low rent, or they were offered heavily subsidized loans to buy their home, as in Hungary. Many people built their own houses relying on voluntary cooperative work from friends and family. Education and healthcare were practically free in Socialism. (Gratuity payment was a common practice but good quality healthcare was universal.) Higher education was free. (Although few people were admitted to university, employment was guaranteed for all young graduates.)

Pension and healthcare contributions paid by companies as part of their wage costs were introduced relatively late. Until then, they were part of trade unions' responsibilities (Trade Union Social Security Centre, SZTK). (When people had to see the doctor they went to "the SZTK".) SZTK was transformed into an insurance-based social security system right before the political and economic changes. It was then that the social security fund was removed from the general budget as a separate fund headed by a General Director with financial management rights. The amount of statutory pension contributions was increased to cover pension payments to people soon to retire in large numbers and also to finance health insurance. Both contributions were paid partly by employers and partly by employees. For some years, these payments generated surplus for social security funds. This contribution surplus provided social security with claims and assets that had to be managed. At the time of the political and economic changes, social security organizations were ill-prepared to do that. Initially, they did not have much problem with how to invest their free assets as they had a statutory obligation to invest all assets available in government securities. Social security organizations were obliged to invest free funds in Housing Fund Bonds and Housing Fund Mortgage Bonds. (The reason was that the budget was unable to finance the rising costs of interest subsidies granted to the borrowers of OTP housing loans. Such housing loans had a fixed interest rate of 3%, while inflation shortly increased to 35%. The difference that had to be transferred to OTP, then already an independent commercial bank, was a huge burden for the budget.) The social security surplus was to be used to finance pension payment to an increasing number of pensioners. (Those days, it could not be foreseen that after the political and economic changes the system will have to finance a huge number of people on early retirement or disability pension.) Demographic trends, however, were crystal clear. Unfortunately, the governments of the next two decades used this surplus to improve the competitiveness of economic players. They did not use the extraordinary opportunity of having the children and grandchildren of the "Ratkó" baby boom era still in employment and accumulating social security funds that would have been sufficient to finance pension payment. Birth rates had been falling dramatically. It can be easily calculated that in two decades from now the number of contribution payers and the total amount of pension contributions will be too low.

Getting back to the early days: the new health insurance system was also established in 1988. Until then, health insurance was fully financed by the general budget. (In the same way as healthcare development efforts were financed later.) The increase in social security contributions resulted in higher wage costs for employers. This change, however, failed to enable employees to finance a market-based healthcare or education system in the future. For this to happen, wages should have been increased. But could this have been possible without an adverse effect on Hungary's competitiveness?

Contributions included, Hungarian wage costs were (and are still) a fraction of wage costs in Westerns countries. The trade unions emerging after the political and economic changes in Eastern Europe failed to push wages to a higher, more realistic level. Employees were happy to have a job in the general turmoil.

The foreign capital invested in companies of such a wage level and wage structure, however, had kept Hungary on the periphery. Ferenc Rabár predicted this situation already in June 1990. He pointed out: if wages and prices are not adjusted to a more realistic level, foreign direct investment (so badly needed for the country) will be used based on distorted information and in a distorted structure. This is how he talked about this phenomenon in a presentation:

"…the problem is that we are attracting foreign capital to a structure generally considered to be bad and distorted. If we fail to restore price and wage levels, we will conserve today's distorted structure. This system needs to be reviewed... Nobody is saying that we can create a new system without subsidies or social policy measures... (...). We have to consider two things though. First, such an intervention will not have the slightest impact on the conditions of a market-based economy. Second, we should provide a subsistence minimum or gradual transition that would still be tolerated by people." (Rabár, 2002, pp. 104 to 105)

Documents dated 1990 do not really show how Rabár imagined this process in detail. He believed that implementing this process would have surely required a transitory period of at least 18 months. But he was not given this time. His ideas were generally ignored by everyone – except his Political State Secretary (the author of this study).

In retrospect, however, it seems that there was an opportunity for establishing more realistic wage levels. This would have required the implementation of a centrally controlled price and wage reform process. And if a wage hike had been combined with a cut in social security contributions, the changes would not have caused any problem for the general budget. (Rabár might have had something like this in mind when he talked about social policy reform. Nevertheless, he didn't outline his idea in detail.) As far as I know, this idea has never been raised either in practice or in literature. If implemented with an appropriately complex approach, it would not have been detrimental either to companies or to the national budget. That is, it would have been absolutely feasible. This option, however, could have been used only as long as Hungarian companies were in state ownership. In the post-privatisation phase it would have been virtually impossible to directly intervene in the decisions of privatized companies. But the idea was so strange and uncommon in Hungary's society on its way to a market-based economy, that it was not even raised that time.

The economic policy of the political and economic changes was passively drifting with the events. Despite developing a 3-year program in the first 100 days, there was no plan of an adequate detail for implementing this huge task. Everybody had excessive expectations about market mechanisms. Ferenc Rabár was not an exception either.

CONCLUSIONS

Looking ahead, our future is very much determined by our failure to take the above steps. In today's globally competitive environment, market players will not increase wages voluntarily in Hungary. As a result, our internal market will remain relatively small which will continue to restrict growth. Under the pressure to make ends meet, private individuals will accept jobs paying minimum wages and try to earn some extra income in the "grey" economy. This will set the foundations for their future poverty as their prospective pensions will fall short of the subsistence level. The general public is still not aware of this problem in Hungary. The disastrous state of healthcare is made intolerable by lack of funding. The only reform completed in healthcare was transferring the full amount of healthcare contributions to employees. That is, the welfare benefits provided to people by the socialist regime were cancelled.

Governments have limited room for manoeuvring now that large systems have not been reformed in a way that would have prevented recurring general government deficits. As a result, national indebtedness is (roughly) at the same level where it was in the past. And national assets provide insufficient collateral for outstanding loans. National debt and especially foreign debt reduce the sovereignty of governments. And political freedom is only half-freedom. Our economic dependency is a constraint for our economic policy. The current government is right to reduce foreign dependency, but it still has a long way to go. Yet, if we understand the underlying reasons better we can have a better chance for a social agreement and partnership which is a prerequisite to making progress in the future.

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