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Article

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Intereconomics

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Monetary Policy in the Transition to a Market Economy: The Case of Hungary

In the centrally planned economies of Eastern Europe, monetary policy played a subordinate role, there were no capital-market institutions and the banking system was single-tier. All this has to be changed in the transition to a market economy. The example of Hungary, which abolished the traditional system of central planning as early as 1968, shows some of the pitfalls to be avoided.

In the initial period following World War II, the East European socialist countries widely adopted the Soviet model of a centrally planned economy. This holds true for the material as well as for the monetary sector of the economy. Furthermore, there was a broad consent about the role money should play in such an economic system in Western as well as in Eastern economic theory.[1]

As a basis for any economic planning, there existed an annual national economic plan, expressed in a well advanced system of material balances. This left little room for monetary dimensions, which in turn served as a mere supplement to the material planning:

☐ monetary criteria allowed the gathering together of groups of goods into only one material balance, which had become necessary for the sake of simplicity in the planning process;

☐ the socialist enterprises were to be controlled by the central planners with respect to both their productivity and their minimal production cost; this can best be achieved by a system of monetary ratios;

☐ in order to grant a minimum of personal freedom to their citizens, the central planners of most socialist economies preferred to provide them simply with money rather than distribute a specified range of goods to every individual.

The money and credit plan was typically projected with reference to the material plan, which had been completed beforehand. Each monetary transaction can therefore be seen as a mere result of a transaction in the real economic sector, determined by the material plan. This plan could by no means ever be restricted by means of monetary constraints, whatever the purpose of these constraints might have been. True, there have been numerous efforts to establish a rational structure of relative prices both in theory and in practice,[2] but the supply of money and credit continued to be more or less fully determined by those projects and real transactions the central planners were willing to bring on their way, no matter what the necessary monetary transactions eventually would amount to.

Single-tier Banking System

Since any unplanned capital allocation in a centrally planned economy is unwanted and even harmful for plan fulfilment, there had never been a reason for the existence of capital-market institutions of any kind. Thus, there had been no necessity for independent commercial banks to be put into operation. Consequently, the socialist countries established single-tier banking systems with a central bank at their top and some subordinated institutions at the lower level. In general, each of the latter was assigned to one of the industries in the socialist economy.

Each socialist enterprise was obliged to keep its accounts with only one of the subordinated institutions.

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[1] F. Haffner: Monetäre Zentralplanung und Volkswirtschaftsplanung, in: H.-J. Thieme (ed.): Geldtheorie, 2nd ed., Baden-Baden 1987, pp. 194-215.

[2] P. J. Bryson: Scarcity and Control in Socialism, Lexington, Massachussets 1976.

This helped the central bank to control the total of monetary transactions made by the socialist enterprises. Thus, in addition to the above-mentioned control by central planners, there evolved a second way of controlling the enterprises, used by the central bank. This is because all the monetary transactions are pure reflections of those expressed in real terms.

The private household sector was largely separate from the socialist economy. Private accounts were only allowed to be kept with special savings banks, which in turn were prohibited from maintaining independent business relations with the socialist economy. Furthermore, the whole range of international currency transactions was handled by special foreign trade banks, totally separate from every other monetary institution except for the central bank.

Central Issues

The strong integration of money and credit planning inside a single-tier banking system did not lead to the expected positive results for the monetary sector. On the contrary, the manageability of money supply and credit was sacrificed from the start, since monetary planning had been subordinated to material economic planning. In the socialist reality, a couple of system-specific mechanisms are to be blamed for monetary instabilities:[3]

☐ The price-inelastic quest for input by socialist enterprises. Socialist-type enterprises are typically not interested in profits, but in high inputs of wages, staff, equipment and reserves of any kind, in order to prevent conflicts with the workers and bottlenecks in production. For the same reason the enterprises make use of specific deficits in the information of the central planners. The enterprises systematically distribute distorted information in order to acquire additional input.[4]

☐ Like the socialist enterprises, the banks are not interested in profits either. For the banks, there is no incentive at all to curtail credits. Even if there were an interest in restricting further loans, conflicts would be likely to occur not only with socialist enterprises but with the central planners as well.

☐ Socialist enterprises usually are bad debt-servers. This is because they are usually not confronted with authentic bankruptcy threats that are closely connected to the enterprises' liquidity situation. Bankruptcy in socialist economies is to be regarded as a political rather than an economic question. As long as there is strong demand for the enterprises' services by central planning boards, any liquidation seems to be most unlikely. Monetary planning is always dominated by real-term planning. This holds true even if planning failures are not to be sought in the monetary sector itself, but in real-term economic planning, as is the case when substantial input overhangs are successfully acquired by the enterprises. In such cases, any rational criteria for the enterprises' contribution to the country's welfare are going to be irreversibly lost. Furthermore, depending on the relative power held by central planning boards, the liquidation of an enterprise may fail due to considerable opposition from workers or citizens. All in all, within a socialist environment there is nothing resembling a linkage of granted credits to economic criteria or, at least, a serious administrative credit restriction.

Such issues are well known as system-specific features of socialist economies. Since every additional credit in a single-tier banking system prolongs the consolidated balance of the domestic banking system, every such credit extends the central bank money by its full amount.[5] The central bank has no opportunity to control the domestic money supply independently. Money supply therefore is an endogenous variable, depending on the strength of the central plan as well as on the power and information of the central planners regarding enterprises, workers and citizens.

Reform of the Hungarian Banking System

As early as 1968, Hungary abolished the traditional system of central planning. Since then economic goals have been expressed in monetary rather than real terms, and the official objective of enterprises is monetary profit alone.[6] But for several reasons an improvement in resource allocation has not been achieved in reality. On the contrary: the distorted price system and the system-specific tendency toward monetary overhangs prevented the transition to a price-led economy from coming into operation and thus provided arguments for the bureaucrats to recentralize the competences for resource allocation. Even the necessity of a functioning capital market was totally overlooked by the reformers in 1968:

☐ Until 1987 the old single-tier banking system remained in operation, thus preventing the banks from granting

[3] I. Hagelmayer: The Causes of Inflation in Hungary and the Prospects for its Reduction, in: Acta Oeconomica, Vol. 38, 1987, pp. 1-21; K.-H. Hartwig: Monetäre Steuerungsprobleme in sozialistischen Planwirtschaften, Stuttgart 1987, pp. 76 ff.; K.-H. Hartwig, H.-J. Thieme: Determinanten des Geld- und Kreditangebots in sozialistischen Planwirtschaften, in: H.-J. Thieme (ed.): Geldtheorie, 2nd. ed., Baden-Baden 1987.

[4] J. Kornai: The Soft-Budget Constraint, in: Kyklos, Vol. 39, 1986, pp. 3-30.

[5] K.-H. Hartwig, op. cit., pp. 39 ff.

[6] J. Kornai: The Hungarian Reform Process, in: Journal of Economic Literature, No. 1, 1986, pp. 1687-1737.

credits according to economic criteria, especially creditworthiness. Hence, the amount and allocation of loans remained dependent on the political preferences for specific economic projects, no matter how expensive they were.

☐ The banks, still being nothing more than branches of the central bank, have never had any strictly functioning instrument for sanctioning enterprises that failed to repay the granted credits.

☐ Due to the lack of competition in the goods markets the enterprises had far-reaching opportunities to pass on costs to their customers.

Therefore, demand for credit remained nearly inelastic. In the context of the 1980s' reforms, economic policy gave more attention to these problems. In 1982, the legal framework for a small bond market was established, and in 1987 the banking system was formally transformed into a western-type two-tier system.

Two-Tier System

Since January 1st, 1987, the Hungarian National Bank (HNB) has represented the top of a two-tier banking system. Since this day, it has been held responsible first and foremost for an appropriate supply of central bank money. Therefore, the HNB was given the classical set of instruments that is well known in capitalist economies:[7]

☐ variation of minimum reserve requirements which have to be held on deposits;

☐ variation of refinancing lines given to the commercial banks;

☐ variation of interest rates for refinancing loans;

☐ direct influence on the domestic bonds market through open-market policy.

The second tier of the new banking system was constituted via decentralized commercial banks. These banks should operate in a profit-motivated manner, as should have been done previously by the socialist enterprises. Five fully licensed commercial banks were founded, each of them formally as a joint-stock enterprise. Notice, however, that each of them was formerly a branch

[7] L. Budavari: Das ungarische Bankensystem in der Phase der Umgestaltung, in: Südost Europa, Vol. 37, 1988, pp. 59-72, here p. 66.

[8] T. Bacskai: The Reorganisation of the Banking System in Hungary, in: Eastern European Economic Review, 1989, pp. 79-92, here p. 82; M. Köhler: Die Geschäftsbanken im reformierten ungarischen Bankensystem, in: Osteuropa Wirtschaft, Vol. 33, 1988, pp. 306-318, here pp. 307 ff.

of the HNB. In particular, the following banks were founded:[8]

□ The Hungarian Credit Bank (Magyar Hitelbank);

□ The Commercial and Credit Bank (Orzágos Keskedelmi és Hitelbank);

□ The Budapest Development and Credit Bank (Budapesti Fejlesztési és Hitelbank);

□ The Hungarian Foreign Trade Bank (Magyar Külkereskedelmi Bank);

□ The General Bank for Securities (Altalános Értékforgalmi Bank).

Since prior to the bank reform each socialist enterprise was assigned to one specific bank which was obliged to keep the accounts,[9] the old business relations have widely been maintained. Thus, the expected development of competition between the commercial banks was hindered by personal and informal connections from the day the new banking system was set up.[10]

Malfunctionings

The new banking system indeed very much resembled western-type banking systems. Yet in reality there remained a whole set of indirectly operating mechanisms largely undermining the philosophy of the new system. For instance, the profit-oriented operating of the banks has been largely undermined in much the same way as had previously been the case in socialist enterprises. Moreover, even as far as profit motivation works, a large amount of regulatory interventions by the central-planning boards prevent this profit motive from supporting a satisfactory capital allocation. Finally, the HNB could hardly bring about a more appropriate control over the central bank money supply, since central planning boards remained in a position to give their planning of the real sector priority over the needs of the monetary sector.

Each commercial bank has been obliged to examine the projects which are to be financed with long-term bank credits with respect to their social desirability. This evaluation is not to be done on the basis of creditworthiness or efficiency, but on the basis of the effects on the real sphere of the economy. Those projects that are part of the real-sector plan are to be financed with priority.[11]

Debts outstanding against illiquid enterprises have to be written off as soon as central planning boards intend to prevent bankruptcy; for the central planners there is still no serious constraint against doing so. For this purpose a special rescue-package fund has to be established in order to repay the debt accumulated by the enterprise. This fund is to be financed by government resources, but a stock of debt regularly remains which the commercial banks have to write off.[12]

Owner of the commercial banks' shares is usually the state, represented by the Ministry of Finance as well as large state-owned enterprises. Under such conditions there will always be a considerable governmental influence on the bank management additional to the above-mentioned effects from the obligation of project comparison. Moreover, the banks will show little inclination to run such illiquid enterprises into bankruptcy whose managers themselves are members of important organizational committees of the bank.[13] In 1989 some hundred small enterprises were run into bankruptcy, but not a single large one.[14]

Regulatory Interventions

Apart from some very concrete regulations concerning the determination of interest rates, there were or still are several rules which are apt to hinder efficient economic activities both on the assets and on the liability sides. As an illustration, the new commercial banks were during the initial period of the new banking system prohibited from keeping private-household accounts. Such accounts were still to be kept by the savings banks, which made it more difficult for commercial banks to acquire private capital. Similarly, foreign-account operations were reserved exclusively for the Hungarian Foreign Trade Bank.

In addition, refinancing by the commercial banks is restricted by the lack of an interbank market as well as by the fact that refinancing loans from the HNB is again attached to criteria from the planning of the real sector. Rather than general regulations for refinancing lines and interest rates, detailed rules with, especially, political and real-sector backgrounds determine the banks' opportunities of refinancing.[15] Accordingly, corresponding to the obligation to evaluate potential projects with respect

[9] K. Merö: The Role of Money and Monetary Policy in Hungary from the Establishment of the Centrally Planned Economy to the End of the 1980s, Research Report of The Vienna Institute for Comparative Economic Studies, 1990, No. 167.

[10] Cf. T. Bacskai, op. cit., p. 83.

[11] M. Köhler, op. cit., p. 311.

[12] L. Budavari, op. cit., p. 70.

[13] M. Tardos: Can Hungary's Monetary Policy Succeed?, in: Acta Oeconomica, Vol. 39, 1988, pp. 61-79, here p. 73. f.

[14] K. Merö, op. cit., p. 20.

[15] L. Antal: The Beginnings of a Capital Market in Hungary, in: C. Kessides et al. (eds.): Financial Reforms in Socialist Economies, The World Bank, Washington, D. C., 1989, pp. 133-153, here p. 143; M. Köhler, op. cit., pp. 313 ff.

to their social desirability, those banks are given priority in granting long-term refinancing loans that intend to finance projects which are part of the national economic plan.

Even though some of these prescriptions have been abolished by now, dominance of the monetary-led resource allocation could not be achieved sufficiently. This is because the far-reaching personal and institutional interdependence of central planning boards, HNB, commercial banks, and socialist enterprises is still immense.

Restricted Independence

Even after more than 20 years of economic reform intended to strengthen monetary economic indicators, the central bank's obligation to finance budgetary deficits is still valid. As the first, and until today only, socialist country, Poland abolished this obligation on January 1st, 1990. There, governmental bodies are now prohibited from utilizing credits from the Polish National Bank other than short-term lending for unforeseen events. In Hungary, the old socialist-type national bank's dependency on the government has not yet disappeared.

With almost any possible argument, the government may save illiquid enterprises from running into bankruptcy. Not only is there no restriction on supporting these enterprises, there is even strong pressure from trade unions, bureaucrats and regionally immobile citizens to support enterprises which really are, or only declare that they are, unable to survive under market conditions. The lack of price signals and malfunctioning or non-existent capital markets tend to undermine the enterprises' profit orientation so that the well-known inelastic demand for monetary input now finds its fully elastic supply in the state budget. Due to the HNB's obligation to finance budgetary deficits, most additional enterprise subsidies lead to an increasing money supply. Certainly, the government began to cut back subsidies from Forint 150.7 billion in 1986 to Forint 143.8 billion in 1987. But at the same time, the government started to operate with individual tax relief, which is hardly anything but a disguised subsidy.

In order to prevent illiquidity in times of hardening budget constraints, socialist enterprises tend to prolong each others' trade credits. In mutual conformity, deliveries which have already taken place are simply not paid for. In this manner, created and prolonged trade credits serve as a substitute for liquidity on the level of the enterprises. In economic terms, however, they increase money supply, which is harmful to price stability. Since trade credits are usually not part of money in the common definitions, they are often an unrecognized but nevertheless efficacious source of inflation.

Finally, most socialist countries lack the necessary institutional arrangements for efficient monetary policy. They have no well-elaborated capital markets and the amount of bonds is, though increasing, still too small to serve as a basis for open market policy.[16] Even interest-rate policy appears to be more or less inefficient, since credit demand is nearly totally inelastic.

As a result, the lack of profit motivation, the great intensity of regulatory interventions and rules, and the lack of institutional arrangements needed for an efficient monetary policy are apt to induce serious recentralization tendencies on the capital market and, in consequence, on other markets as well.

The disconnection between credit-granting and efficient capital utilization in the socialist enterprises, the regulation of prices and interest rates, and finally chronic tendencies towards partly open and partly repressed inflation are the main causes of stubborn disequilibria on the capital market. Though induced by half-hearted reforms and uncoordinated discretionary interventions by the central planners, malfunctionings of the market are usually blamed for causing such disequilibria. In doing so, politicians and bureaucrats run into a well-known vicious circle: market interventions lead to economic disequilibria, which in turn serve as a "proof" of market failures and, as a consequence, call for further market intervention.

Interdependencies

The fate of Hungarian reforms makes it possible to draw some conclusions regarding the interdependencies between markets and those between the monetary and the real sector.

In order to improve the supply of goods and accelerate growth, Hungarian reformers established the "New Economic Mechanism" in 1968, which meant that socialist enterprises were given greater freedom to make their own operational decisions. The creation of business relations should have been a matter of more or less autonomous enterprise decisions. But, contrary to their intention of freeing the bulk of commodity prices, the central planners kept regulating or even fixing them.[17] Even today, prices can hardly be seen as floating freely the way they do in

[16] L. Antal, op. cit.; Z. Jarai: A Growing Bond Market, in: The New Hungarian Quarterly, 1988, No. 109, pp. 123-126; Erdös: Monetary Regulation and its Perplexities in Hungary, in: Acta Oeconomica, Vol. 40, pp. 1-15, here pp. 11 ff.

[17] W. Swaan: Price Regulation in Hungary: Indirect but Comprehensive Bureaucratic Control, in: Comparative Economic Studies, Vol. 31, 1989, pp. 10-51.

Western market economies. Governmental consumer-price subsidies still amounted to some Forint 40 billion in 1990. How could this happen? In short, the reason is that real-capital and enterprise structure could not develop to meet commodity market demand:

☐ Investments, considered important, were kept under central planning until recently.

☐ Credits, necessary to finance those investments which result from autonomous enterprise decisions, could never be taken without permission of the HNB; this in turn required a checkup by central planners as to whether or not the investment was socially desirable. In fact, the bank reform in 1987 did not alter this procedure substantially.

☐ Furthermore, centrally administered interest rates and the lack of sanctions against unreliable enterprises via functioning markets require the strict control of socialist enterprises by the bureaucracy in order at least partly to avoid uncontrolled credit expansion.

Obstacles

As a result, the evolution of the economic supply structure remained more or less under central control. At any rate it was not determined by market forces. The intended liberalization of the commodity market therefore has never had a real chance to occur. Consequently, after years of struggle with bureaucratic and political obstacles, Hungarian reformers turned to more radical reforms, gradually including the tackling of problems of capital allocation and ownership. But all those steps appeared to be too small in order to really establish a functioning capital market:

☐ For the above-mentioned reasons, the commercial banks are not interested in profits; but, since they are highly interrelated with the HNB and the socialist enterprises, with respect to both capital and management, they are interested in harmony with those economic sectors. Hence, commercial banks tend to support politicians' and enterprises' goals rather than strive for efficiency of capital allocation.

☐ The HNB on the other hand is directly dependent on the government. Therefore its staff, too, is interested in political harmony rather than monetary stability. HNB staff will tend to support government aims.

☐ Finally, however, the government is interested in maintaining political power. Members of government as well as bureaucrats are those who turned themselves into effective owners of socialist enterprises in the past. Consequently, today they are held responsible for the fate of the enterprises. To refuse support for the survival of the enterprises, no matter whether this support is really needed or only pretended, means to run the risk of bankruptcies, bottlenecks in supply, internal conflicts and thus, loss of political power. The probability and danger of such conflicts tends to grow with the size of the enterprises concerned.

Consequently, nobody is really interested in efficiency and adequate economic performance. On the contrary, credits, subsidies and tax relief can best be obtained by a strong position of power in the multiple clearing process between the different economic and political sectors, organizations and institutions.[18] Instead of a capital market, it is inflation that evolves as long as reformers decentralize the economy without at the same time deglomerating the old structure, consisting of central bank, government, commercial banks and socialist enterprises.[19]

In spite of those problems, the HNB tried to cut back inflationary money supply after 1987. And indeed, in 1988 money supply declined at a rate of some 1.5%. But in the following years, the old inflationary pressure found its way back into the economy. Money supply grew by more than 16% in 1990, even though national income in real terms declined that year. In addition, unlimited mutual indebtedness of socialist enterprises rendered any control over the money supply impossible.

Elements of a Reform Programme

A prerequisite for a functioning commodity market is the existence of a capital market. A capital market in turn needs a workable two-tier banking system. But such a system can only work under the condition of functioning commodity and capital markets. Thus, a reform, aiming at one of those economic sectors, is obliged to restructure all sectors at once. With respect to a functioning monetary sector, indispensable preconditions are as follows:

☐ The central bank has to be independent not only in a formal manner, but in a way in which there are no personal and institutional interrelations between government, enterprises and the central bank.

☐ Even more than the central bank, the commercial banks have to be independent from the government, socialist enterprises and the central bank. Like the central bank, management and institutional structure has to be clearly distinct from the other organizations and from bank

[18] T. Apolte, M. Kessler: Regulierung und Deregulierung als wirtschaftspolitische Aufgabe in alternativen Wirtschaftssystemen, in: T. Apolte, M. Kessler (eds.): Regulierung und Deregulierung im Systemvergleich, Heidelberg 1990, pp. 3-24, here pp. 16 ff.

[19] J. Winiecki: Inflation under Central Planning: Sources, Processes and Manifestations, in: Konjunkturpolitik, Vol. 31, 1985, pp. 238-260.

to bank. This can only be achieved by a decentralized ownership structure and an actual threat of bankruptcy.

☐ The enterprises have to be a further independent sector, with each of them being forced to follow market signals only. If they fail on the markets, neither commercial banks, nor the government, nor the central bank should be obliged to compensate their losses. Again, this can only be achieved through efficient and decentralized control by private owners. Especially, the mutual indebtedness of the enterprises can best be cut down by private ownership, because private owners have a vital interest in having credits repaid.

☐ Under these conditions, the government will be unable to control the central bank, the commercial banks or the enterprises. Government activity should be limited to the setting of general rules, valid for all, and to some other well-defined tasks. As far as possible, this should be laid down in the country's constitution. In this way nobody can force the government to do things other than those defined there. Thus, eventually, the government gets rid of the responsibility for the enterprises and is free for its original tasks.

☐ All the above-mentioned preconditions are unable to generate functioning markets, if prices and interest rates are not freed. Only then, do efficient commodity and capital allocation become possible, and only then can a functioning monetary sector evolve as a substitute for real-sector planning.

Recent Developments in Hungary

Following the first free elections for more than 40 years in Hungary in May, 1990, a more rapid move in the direction of a western-type market economy was widely expected. However, in accordance with the wishes of the public, the new non-socialist government intended to avoid an all too drastic deterioration of economic performance during the transformation period. This may have its reasons in the reform-oriented policy of the former communist governments, which had already rebuilt the institutional framework in the direction of a market economy. People may have hoped that this would make a start from the very beginning unnecessary.

But this was obviously an illusion. After only a few months, the new government had lost the confidence of the people. A transformation programme, drafted by the government in September, consisted of only general formulations about the intended market economy, and hardly any concrete policy measures could be found there. Especially, anything able to bring hardship to the people was left out of the programme. In addition, the government was in a state of internal discord, which resulted in frequent governmental rearrangements. By the end of the year, a conceptual basis for the transition could no longer be found. As a result of this critical situation, a more severe policy was introduced for 1991.

By January 1st, 1991, more than 90% of all retail and wholesale prices had been fully liberalized. However the government still hesitates to be as radical concerning capital markets and foreign trade as with the goods markets. Interest rates remain highly regulated, and the introduction of currency convertibility is seen as a task of some two to three years. And only 30% of state assets are intended to be privatized in the next three years.

In the banking sector, some reforms intended for 1991 were introduced by the end of 1990. Taking into consideration the distorting impacts of the above-mentioned regulations on capital allocation, the principal aim of the government since then is "a uniform, i.e. neutral monetary and credit policy towards the agents of the economy".[20] This means that the differences betweeen economic agents, concerning individual power positions, the importance of the goods and services produced, or legal company status, i.e. state, cooperative or private enterprise, should not lead to differences in their treatment by the state as well. In detail, this means:

☐ that the ratio of refinancing credits which can be obtained on a market basis from the central bank will be increased substantially;

☐ that the HNB will be able to credit state budgets only up to 3% of budget revenues, and charge the current basic interest rate for such credits;

☐ that the privatization of banks will be promoted, in order to increase competition among banks; for the same reason, a unification of terms and rules is intended, following international standards.

Even though these measures seem to be more radical than those of the first month of the new government, most of them are still to be conceptualized. For the moment, it is still not clear whether there will be a rapid improvement in the monetary sector in the way that is needed for a monetarized and price-led economy. In February, a new minister of finance was appointed, from whom the government hoped a further improvement of the economic reform. Ironically, this new minister, Mihaly Kupa, had already held an important position in the communist government, and is well known as being responsible for a radical tax reform in the late 80s. Today, his task is to develop a new and complex reform programme for a faster transition to a market economy.

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[20] Hungarian National Bank: Monetary Policy for 1991, Market Letter No. 11-12/1990, p. 3.