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Poland and Hungary are in Transition

The transition of Eastern Europe countries from centralized, planned economy toward market economy was very dramatic for every country of region; it was not only pure economic transformation but institutional and cultural transformation as well.
This paper devoted to Polish and Hungarian reforms in transition period, the countries that could be examined as the most successful in their transition to market economy among other post-communist countries.

Polish reforms

Until “Solidarity” won the parliamentary elections in Poland in the summer of 1989, the Polish economy had been, since the end of World War II, a rather typical planned socialist economic system. State ownership was dominated, and though economic reform was attempted in varying degrees at different times, little real systemic change had taken place.
In the beginning of 1990, Poland took decisive steps toward a market economy. This "shock therapy" approach was to be sudden, and in this it differed significantly from the gradualist approach being discussed in other socialist systems.
The "Shock Therapy" approach has not been without critics. Moreover, although the Polish case quickly attracted the interest of those who study the problems of socialist transition, it was viewed as unique. The reform was much more likely to succeed in Poland than in a case like Russia. But before we examine the Polish reform experience more detail, we must review what brought the Polish economy to the reform phase and how, at that point, it might be different from other socialist countries.

The Background

The organizational system of the Polish command economy was established immediately after World War II and was close to the Soviet Union’s type. There was widespread nationalization of property, central planning mechanisms were established, and agriculture was socialized.
Although Poland attempted modification of the command system as early as 1956 when collectivization was abandoned, little actually changed. Over time, private agriculture

was neglected by the state, and continuing political protests, especially in the early 1970s, signaled both political and economic difficulties.

The 1970s was a difficult decade for many countries, especially those that rely on imported oil. The Polish strategy in the 1970s and later was to stimulate the domestic economy through the importation of foreign technology. This was not an unreasonable strategy in theory, but Western economies were themselves in the centre of the energy crisis and the recession it caused. Poland's effort to expand exports failed, hard-currency debt accumulated, and the projected impact of Western technology on the Polish economy was minimal. As the 1970s came to an end, it was evident that domestic reduction would be essential — a difficult path in light of the continuing unrest among Polish workers. The 1980s began with roughly three years of militant law and an attempt to achieve economic stabilization.

After half-hearted economic reforms in the early 1980s, the rise of “Solidarity” (which had been outlawed in 1982) proved that major systemic and structural reform was necessary. Even so, and despite the fact that Polish economic performance was deteriorating badly, serious economic reform did not begin until the late 1980s.

The Polish Transition

The Polish transition from plan to market has been watched closely by a variety of interested observers. Although many of the policy and systemic changes introduced in Poland are familiar hallmarks of the general reform scene, the speed of implementation in the Polish case is unique.

There had been attempts to decentralize decision making in large state-owned Polish enterprises in the 1980s, but these reforms failed to change outcomes (a possible exception is their contribution to the wage explosion that took place toward the end of the decade). Moreover, on the eve of reform in Poland (the reform program began officially on January 1, 1990); macroeconomic conditions there were in a state of severe disequilibrium. Although the exact nature of monetary overhang in Poland (as elsewhere) has been the subject of debate, there was a significant budget deficit, wage increases were out of control, and hyperinflation had resulted. Poland's hard-currency debt position was better than that of Hungary, but the debt that had been accumulated did little to stimulate the Polish economy, the zloty was overvalued, and no debt relief from external sources was in sight.

In autumn of 1989, most price controls were lifted (on both producer and consumer goods), public spending was reduced, and the zloty was devalued. In the second stage of major reform, begun in 1990, the budget deficit was sharply cut, largely through a reduction of subsidies to state enterprises. A positive real rate of interest was to be implemented, and the market was to be used to signal changes in the value of the zloty. The latter was a critical measure, because foreign trade and the impact of this trade on the Polish industrial structure was to be a key component of the overall reform strategy. In January of 1990, the government set the exchange rate of the zloty at 9500 to the dollar (this represented a devaluation from 1989); a rate roughly approximating its value on the black market, and it established convertibility of the zloty for international trade. Many trade restrictions were eliminated, and internal exchanges were set up to handle the buying and selling of hard currencies. Although these changes resulted in domestic inflation, the initial increases proved to be short-term and the exchange rate of the zloty has proved to be realistic.

Finally, wage increases were to be controlled partly through the wage indexation and partly through a new tax on wage increases that exceeded established guidelines.

Privatization

Privatization is a major element of the Polish strategy of transition. In 1990 the Polish government passed a law creating a Ministry of Ownership Change, a mechanism to supervise the process of privatization. Privatization has proceeded rapidly, though it has been achieved mainly for small enterprises in the trade and service sectors. Industrial output in the private sector grew by 8,5% in 1990 and is reported to represent roughly 17% of total Polish industrial output

Though privatization has been very successful for small-scale enterprises, the picture for large state enterprises is quite different. Privatization of these enterprises has proceeded very slowly. In addition, the economic position of these enterprises worsened as the state took decisive measures to introduce a hard-budget constraint. In addition to price changes and wage limitations, subsidies have been ended and protection from foreign competition has been sharply reduced. This new setting has encouraged enterprise managers to reduce costs by restricting unnecessary output and reducing the labor force. However, the strong commitment to rapid privatization was reinforced in June of 1991, when it was announced that a major portion of state industry would be privatized through creation of stock funds, with the population receiving vouchers. Beyond these changes in the state sector, new guidelines have been introduced to monitor enterprise performance. Furthermore, a new Industrial Restructuring Agency will consider how remaining state enterprises should be handled, to what extent privatization is possible, and what restructuring should take place for those enterprises that are not viable in the new setting. These new arrangements are designed to ensure a rapid transformation of the Polish industrial structure, to make it similar to and competitive with market economic systems, and to achieve this result quickly and as openly as possible.

It is clear that economic reform in Poland has been radical and has moved sharply and quickly away from the plan toward the market. In addition to the expanded influence of market mechanisms, decision making has been decentralized, private property introduced, and incentive arrangements changed. By most standards, the initial results have been encouraging.

First, stabilization measures cut the rate of inflation sharply from a reported 40-50% per month at the end of 1989 to roughly 4-5% per month in 1990. At the same time output fell, though supplies of consumer goods in stores increased. Employment in industry declined by 20% during 1989 and 1990, although it is reported that only a relatively small portion of this reduction in the labor force was caused by forced layoffs. The unemployment rate was reported to be 6,5% at the end of 1990.

Another major positive aspect of the Polish reform experience has been the foreign trade sector. There has been a significant expansion of exports, especially to hard-currency markets. This expansion resulted in part from the devaluation of the zloty to market-clearing levels and in part from the reorientation of trade away from the Soviet Union and other East European trading partners. At the same time, as a result of restrictive policy measures and the higher domestic cost of these imports, import demand declined.

A third qualified success has been privatization. Although the first steps of privatization were rapid, this early privatization was largely that of small-scale enterprises in the area of trade and services.

Hungary

Until 1968, Hungary applied the Soviet model of centrally planned socialism in a typical way. But then, in 1968, Hungary began to introduce the most radical economic reform attempted in Eastern Europe (with the exception of Yugoslavia).

Although the reform program in Hungary met with only partial success, the problems that have arisen (for example: conflicts of objectives, and difficulty in persuading participants to change their ways) are fundamental to the reform experience of planned socialist systems.

Hungary shares many features with other Eastern and Southeastern European countries, such as Yugoslavia. It provides a refreshing contrast to the Soviet Union, which in some important respects is atypical. Hungary is a small country heavily dependent on foreign trade. The Hungarian experience with reforming foreign trade, and in particular its efforts to become integrated into the world economy both East and West, is prototypical. The difficulties of reforming the foreign trade mechanism are crucial to the Hungarian economy as well as to the economies of many other systems of Eastern Europe.

The Background

The postwar reconstruction of the Hungarian economy began quite modestly in 1945. Before the implementation of a three-year plan in 1947 (1947-1949), the main policies included stabilization of the currency, changes in the nature of rural landholdings, and the beginnings of nationalization. The first three-year plan was designed primarily to bring the economy up to prewar levels of economic activity.

During this time, a planning mechanism was created and the share of national income going to investment increased sharply. The changes were not radical, however, and balanced development was envisioned.

The era of balanced development came to an end with the introduction of a five-year plan in 1950. The share of national income devoted to investment was increased substantially, and the bulk of new investment was directed toward heavy industry. This policy was partially reversed toward the end of the plan period, but it was reaffirmed in 1955-1956.

A number of economic trouble spots cried out for attention. There was an observed need to improve industrial labor productivity, especially through the development of a better incentive system to offset the declining supply of labor from rural areas. Supply/demand imbalances were growing increasingly severe. Waste and imbalance in the material-technical supply system created the need for a substantially modified coordinating mechanism among enterprises.

In addition, excess demand for investment led to substantial amounts of unfinished new construction and to the neglect of old facilities. Some mechanisms for the more rational allocation of capital investment had to be found. The adoption and diffusion of technological advances were seen as inadequate. Technological improvement was considered crucial for continued development of the economy.

This background seems familiar: a small country, the Soviet (Stalinist) model of industrialization, overcentralization, emphasis on extensive growth, rigidities of the plan mechanism, incentive problems, and the resulting difficulties. Against this background, the New Economic Mechanism that proclaimed in a party resolution in 1966 was put into, practice in 1968. Over twenty years later, it remains one of the most important reform programs of planned socialist systems.

The New Economic Mechanism

There is a disagreement about the importance and effect of the Hungarian reform program. The New Economic Mechanism (NEM) has generally been interpreted as leaving the power to control the main lines of economic activity (volume and direction of investment, consumption shares) with the central authorities, while relying on the market to execute the routine activities of the system. The NEM called for substantial decentralization of decision-making authority and responsibility from upper-level administrative agencies to the enterprise level.

The objective of NEM was to combine the central manipulation of key variables with local responsibility for the remaining decisions. The first change was a significant reduction in the number and complexity of the directives firms; for large state-owned firms, the traditional problems remain. Valuation is difficult, especially in loss-making enterprises. Moreover, it is hard to find buyers for these types of enterprises, let alone to arbitrate the potential rights of past owners. And just as elsewhere, privatization in Hungary is likely to become slower and more difficult as the focus shifts to the less attractive, large enterprises.

In addition to privatization per se, Hungary has addressed the creation of infrastructure (for example, a stock market) and new rules designed to change the guidance of enterprises. Accounting procedures have been refined and bankruptcy laws strengthened so that state subsidies can be diminished and hard budgets introduced into large state-owned enterprises.

Hungary has also pursued a variety of stabilization measures and has liberalized policies in the sphere of foreign trade, though to a lesser degree and certainly more gradually than Poland. Domestic price controls have been substantially removed, and enterprises are permitted to enter into and benefit from foreign trade transactions. Although there are limits on the holding of foreign exchange, the Hungarian forint is substantially convertible for business purposes. However, the Bank of Hungary has maintained controls such that it has access to foreign exchange earnings to serve as repayment of the Hungarian hard-currency debt. (Hungary has a per capita hard-currency debt roughly twice than in Poland). Hungary has followed a tight monetary policy designed to create a balanced budget and also to exert financial pressure on enterprises.

Hungary has very liberal laws regarding foreign investment, including the possibility of full foreign ownership with permission. Moreover, repatriation laws are liberal. Not surprisingly, Hungary has been considered as a leader in the quest to attract foreign investment.

The initial results of the transition process in Hungary have generally been positive. At the same time, it is proving difficult to sustain popular support as the inevitable costs of the transition process take their toll.