

THE DILEMMAS OF HUNGARIAN ECONOMIC POLICY

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Introduction¹

I would like in this study to place the current problems of the Hungarian economic policy in a wider economic perspective. The point of departure is the package of stabilization measures announced on March 12, 1995, which consists of three main elements:

1. There was an immediate, radical devaluation of the Hungarian forint, and a further course of steady devaluation was announced in advance right up to the end of the year. In addition, a significant import surcharge (supplementary customs duty) was introduced.

2. A substantial fall in budgetary spending was prescribed. This extends to numerous estimates, including several items of welfare spending. The alterations will cut the budget deficit to a substantial extent in 1995 and still more in 1996.

3. The government wishes to curb the rise in nominal wages and earnings. Strict limits were accordingly set for personal incomes paid by the budget-financed sector and for wage rises in

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enterprises in majority state ownership. The program assumes that this conduct by the state sector will curb the rise in wages in the private sector as well.

As I write, three months have passed since the announcement, and the government's intentions have become manifest, initially in a succession of government measures and later in the Stabilization Act passed by the majority of the parliament. To this extent, the stabilization program of March 12 has joined the facts of Hungarian economic life, exerting a strong influence on the future course of events.² But this does not mean the program will henceforth determine the path of the economy. One question to be considered concerns the extent to which the government's measures and the stabilization legislation will be implemented and the consistency with which this will be done. Another is what other factors beyond the stabilization decisions will exert an effect on the economy. What goes on in the Hungarian economy does not depend solely on the government and parliament. It also depends on the apparatus of state, the organizations representing various interest groups, the employers and employees, and not least on the outside world, governments, international organizations, foreign banks, and companies, all of which will react in some way to the March 12 measures. The future path of the economy is full of junctions, where the actors in the economy will have to choose between alternatives. Connected with each

² Examination of the March 12 stabilization program from the constitutional point of view is in progress. The constitutional court has already quashed a number of points and intends to continue the review process in the autumn. At the time of this writing, it is being reported in the press that the government will set about making up in other ways for the revenue and savings sacrificed in the review by the constitutional court. The study rests on the assumption that the parliamentary majority and the government are committed to carrying out the macroeconomic policy expressed in the stabilization program. The future course of events will tell whether the assumption is justified.

choice there are dilemmas, and I would like to examine a few of these more closely.

This study deals mainly with macroeconomic problems. Clearly there are many dilemmas that present themselves on a micro level, and there are numerous other problems to do with the transformation of institutions and property relations. These fall outside the range of this exposition.

Under the circumstances of the post-socialist transition in Hungary, three grave and burdensome tasks have perpetuated themselves: 1) securing or at least improving the external equilibrium; 2) securing or at least improving the domestic financial equilibrium; and 3) deciding how to prevent the fall in real production and what to do to promote a recovery of production and lasting growth in the economy. One of the fundamental dilemmas is to establish the relative importance of these three tasks in relation to one another; in addition, each of them separately poses a succession of dilemmas of choice. The study takes these three great problems in turn. Finally it deals with dilemmas of another type—connections between political and economic stability, and interaction between politics and economic policy.

The External Equilibrium

I take the view that for now and the immediate future the problems of the external balance—the trade balance, current-account balance, and foreign debt—should receive the largest relative weight in considerations of short-term economic policy.

I would like here to make a short subjective diversion by addressing the question of whether the statement I have just advanced does not constitute inconsistency and abandonment of the economic principles I have previously published. In my view it does not. A distinction has to be drawn between the ultimate goals of economic efforts—the underlying, permanent objectives, the general values serving as the basis for the position taken—and the interim goals and operative targets. As far as the former are concerned, my position is unaltered in this respect; I might say my "economic philosophy" is unchanged. I am convinced

that the prime objective of economic policy is to ensure lasting economic growth. Only this can enable a lasting, systemic rise in material welfare for all. Lasting growth is a requirement for modernizing the economy and living conditions and enhancing the competitiveness of the country's production. It offers far more favorable conditions for the kind of structural changes that can prevent the reproduction of grave imbalances and make the debt servicing easier to bear. It is another matter to decide what should be done at present to promote this unaltered general objective and what relative weights should be attached to the various interim targets. In my view this has to be tailored to circumstances. What could (and in my view should) have been done, let us say two and a half or three years ago, can no longer be accomplished now in quite the way I recommended at the time. This is partly because the last government was neglectful of some tasks for several years, and the new government elected in 1994 has been neglectful of some in the last nine months. A car driver can decide on a destination to drive to, but cannot decide for good and all to prefer the accelerator to the brake or left turns to right. The question of whether to accelerate or brake, or to turn left or right, must depend on the traffic conditions, traffic lights, and so on.

Let us return to the external equilibrium. Why did I think, even in August of last year, that this was a problem at most equal in rank with the others, and why do I think it is the primary problem at present? When there were only the figures for a single calendar year to suggest the unfavorable situation in this respect, it remained possible to consider weighting the tasks in a different way. But once similarly poor results had been reported for a second complete calendar year, it seemed impossible to avoid intervening primarily on this count, and doing so radically.

The main figures appear in Table 1, which shows exports growing strongly again in 1994 after a sharp setback in 1993. Unfortunately, the growth in imports hardly slackened, so that the balance of trade in both 1993 and 1994 was strongly negative. This was the main reason why the current-account deficit in two

Table 1
Hungary's Foreign Trade, 1990–1994

Indices	1990	1991	1992	1993	1994 ^a
1. Exports					
<u>1a</u> USD bn	9.6	10.2	10.7	8.9	10.7
Change over previous year:					
<u>1b</u> Volume index (%)	-4.1	-4.9	1.0	-13.1	16.6
<u>1c</u> Value index (%)	5.7	24.3	10.4	-2.8	20.1
2. Imports					
<u>2a</u> USD bn	8.7	11.4	11.1	12.5	14.6
Change over previous year:					
<u>2b</u> Volume index (%)	-5.2	5.5	-7.6	20.9	14.5
<u>2c</u> Value index (%)	4.1	53.9	1.6	32.3	21.5
3. Balance of foreign trade					
<u>3a</u> USD bn	0.9	-1.2	-0.4	-3.6	-3.9
<u>3b</u> % of GDP	2.7	-3.8	-1.1	-9.4	-9.5

Sources: 1990–1993 foreign trade: National Bank of Hungary [1994, pp. 207–208]; 1990–1993 GDP: National Bank of Hungary [1993, p. 60], Central Statistical Office [1991, p. 60], [1994a, p. 103], and [1994b, p. 107]; 1994 foreign trade and GDP: preliminary estimates by Hungarian Ministry of Finance on the basis of customs statistics.

Notes: The figures include foreign trade on both the convertible and nonconvertible accounts. The 1993 figures also include the arms imports from Russia delivered as repayment of earlier debt.

^a Preliminary figures.

successive years attained and then exceeded 9% of GDP (see Table 2). This figure is unfavorable to an almost unprecedented extent, and it means the country has entered a danger zone. It was primarily this signal, along with the postponement of devaluation and other corrective measures, that was behind the deterioration in Hungary's credit rating in the eyes of international finance. Although Hungary so far has met all its financial commitments in full, potential lenders see this as proof of goodwill, not of real solvency. If a country overspends to such an extent over a lengthy period, potential creditors start to worry lest the debtor, in spite of good intentions, becomes simply unable to pay.

This brings us to the first dilemma. Every statement that can be made about Hungary's payments position is provisional and conditional. Luckily so far there has not been a catastrophe to prove conclusively that the external equilibrium really is the primary problem today. Those less concerned by it may argue that export performance has improved and Hungary has sizable foreign-exchange reserves. So they still question whether it would not be more expedient to allow the debt burden to remain at its present level or even accept some further deterioration, and help to stimulate production by drawing in outside resources to a greater extent.

This argument cannot be refuted directly with facts from Hungary's experience. No one can say precisely how far we could go with the earlier practice in handling the balance of payments. It will have to be taken into account when deciding the dilemma that the international financial world has always been subject to unexpected, unpredictable events. For instance, there may be a sudden, hysterical turn away from some country or other, a lightning loss of confidence, a panic capital flight, or a speculative attack on the country's currency. The destructive effect of such chains of events are apparent from the debt crises in Latin America.³ Suddenly the channels of credit are blocked

³ On the Latin American debt crises, see Larrain and Selowsky, eds. [1991], Sachs, ed. [1989], Sunkel, ed. [1993],

Table 2
Hungary's Current-Account Balance in Convertible Currency

Year	Balance on current account (USD mn)	Balance on current account (% of GDP)
1991	267	0.9
1992	324	0.9
1993	-3 455	-9.0
1994	-3 911	-9.5

Sources: 1991–1993 current-account balance: National Bank of Hungary, [1994, p. 265]; 1991–1993 GDP: Central Statistical Office [1994a, p. 103], [1995a, p. 107], 1994 GDP and current-account balance: based on preliminary data from Hungarian Ministry of Finance.

and foreign direct investment stops, so that the reserves swiftly run out and the country becomes unable to meet its payments. That gives it a worse name still and plunges it further into the payments crisis. There is a grave fall in imports, which drags production and exports down as well. The recession may even reach 10–15% and last one or two years, which rapidly drives up unemployment.

The prime task for the stabilization package is to avert a grave upheaval of this kind. Although it will be some time before anything certain can be reported, the chances of avoiding a debt crisis can already be said to have substantially improved. Let us sum up the measures that will tend to make a substantial improvement in Hungary's external balances.

1. The radical devaluation and prior announcement of the future course of nominal devaluation will stimulate Hungarian exporters and curb imports.

2. Domestic and foreign experts debate strongly the advantages and drawbacks of various "exchange-rate regimes." The regime now chosen by Hungary's financial authorities—the "pre-announced crawling peg"—has certain advantages, above all that it makes the intentions of the policy makers plain and clear. It makes a prior commitment to keep the actual exchange-rate within a designated band. This tends to take the edge off speculation and forestall the extra imports engendered by devaluation expectations. To this extent, if successfully applied, it will contribute to improving the trade and current-account balances. But such an exchange-rate regime entails dangers and risks as well. It ties the hands of the monetary authorities, reducing their room for manoeuvre. It stands or falls on whether events largely independent of the monetary authorities, notably the speed of inflation, remain consistent with the exchange-rate trend announced in advance. (I will return to this later.)

3. A fall in imports is being encouraged not only by the exchange-rate alteration, but by the customs surcharge on imports and a few other measures as well. This concurrently improves the

Williamson, ed. [1993].

competitive position of Hungarian production compared with imports. Let me note here that the question of what factors are causing a substantial growth in import intensity in every area of domestic absorption has not yet been analyzed sufficiently. The exchange-rate adjustment and customs surcharge will presumably not suffice in themselves to halt and partially reverse this trend.

4. By restricting domestic demand, the stabilization package steadily induces producers to show export-oriented behavior, in fact almost obliges them to do so.

5. The curb placed on rises in wages (and the levies proportionate to them) will improve the competitiveness of Hungarian products on the home market relative to imports, and on foreign markets relative to rival countries.

6. The opportunities of convertibility have grown in the corporate sphere. The change encourages enterprises more strongly than before to keep their money in Hungary, and not to feel induced all the time to part with their forints, since they can be easily converted into foreign currency at any time. So the holders of money are less tempted to turn their forints into foreign exchange and if possible keep it abroad.

7. It is now easier for banks and firms to raise foreign loans independently and directly. This decentralization will improve the composition of Hungarian debt and ease the problems of the government and the central bank.

8. Exports are receiving stimuli and assistance in numerous forms. For instance, financial institutions specializing in foreign-trade credit have been formed.

International experience shows that devaluations and other measures affecting foreign trade normally exert their influence only after a lag of several months. It can be hoped that the March 12 package will be benefiting the external equilibrium by the second half of the year. If it should turn out that the change is not strong enough, there should be no hesitation, in my view, about taking further measures. Ultimately, it will be a year or two before completion of the kind of profound structural change in Hungarian production, investment,

consumption, and foreign trade that can permanently improve the position of the trade and payments balances. For my part, I would not set numerical macroeconomic threshold values beyond which the country's external equilibrium situation could be called reassuring. Qualitative criteria should be designated instead:

The debt crisis must be given a wide berth, not just narrowly avoided. Full confidence in the country's creditworthiness must be restored. The country's credit rating, along with the assessment of the business prospects for investments in Hungary and of the risk entailed in loans to this country, must be restored to a level no worse than it reached in its best years from this point of view in the last decade.

Internal Financial Equilibrium

The price to be paid for improving the external equilibrium will be a deterioration in other extremely important macro variables. The devaluation and import surcharge will hitch up the price level. It is too early to measure the effect, but dearer imports must certainly be expected to raise costs and thus to spill over through to prices. The first dilemma that arises here is to assess the relative importance of the tasks. Is a likely improvement in the external equilibrium worth the burden that a likely rise in the price level will place on the economy? The answer in my view must be affirmative, since the first serves to avert a grave catastrophe, while the inflation rate, even if it rises somewhat, will still fall far short of catastrophic hyperinflation. It is still affirmative even though it is clear that some acceleration of inflation will cause losses to very many citizens and bear heaviest on those least able to defend themselves. Of course, the assessment also depends on how great the inflationary thrust will be, and still more on whether the acceleration, i.e., the increase in the speed of inflation, continues or not. That would be a serious problem. A view of the course of inflation so far is given in Table 3. It would be desirable if the rate of inflation were to slow down after the initial push delivered by the devaluation.

Under prevailing conditions in Hungary, the permissible

Table 3
Consumer Price Indices in Hungary, 1988–1995

Year	Average annual change (%)
1988	15.5
1989	17.0
1990	28.9
1991	35.0
1992	23.0
1993	22.5
1994	18.8
1995 January–March ^a	24.5
1995 April ^a	29.2
1995 May ^a	30.8
1995 June ^a	31.0

Sources: 1988–1994: Central Statistical Office [1995a, p. 40], 1995: Central Statistical Office [1995b, pp. 31 and 37], and information from the Central Statistical Office of Hungary.

^a Compared with same period of previous year.

measure of inflation is limited by the commitments made by the government and the central bank concerning the exchange rate. The financial authorities announced in advance precisely what the forint exchange rate was going to be up to December 31. This exchange-rate policy will only achieve its purpose if the buyers and sellers on the Hungarian foreign-exchange market, which is fairly open and free, acquiesce to it not just verbally, but in the exchange-rate terms appearing in their transactions. Without going into the technical details, I would like to emphasize the implications for inflation. The planned trend in the exchange rate is based on a forecast concerning the widening of the gap between Hungarian inflation and inflation in the foreign currencies playing the main part in Hungarian foreign trade. According to the calculations of the Finance Ministry and the National Bank of Hungary, the preannounced exchange-rate course leaves room for the following normative limit on inflation measured in terms of the consumer price index: The consumer price level at the end of the year may exceed the price level at a similar point in time last year by a maximum of 28–29%. This sum constitutes a normative requirement, not a forecast. It is an upper limit that must not be exceeded if the preannounced exchange rate is to be maintained.

Should Hungarian inflation turn out to be faster than this implicit inflation, a real appreciation of the Hungarian forint would take place: The National Bank of Hungary would have to give more dollars or marks for forints than they were really worth. When the currency market sensed the real appreciation, it would start expecting a devaluation sooner or later, a greater devaluation than was previously announced. So devaluation expectations would revive, which is just what prior announcement of the exchange-rate trend was supposed to avoid. One of the key issues in Hungarian economic policy is not to allow inflation to overstep the permissible limit. (If inflation should be less than the upper limit set by the exchange rate, that would have a favorable effect, of course.) Whether inflation can be retained within this band depends mainly on two factors: wages and the budget deficit.

Wages. Hungary has experienced for many years an inertial inflation, in which expectations of price rises have fueled wage increases, and the increase in wages and other cost factors (or expectations of such an increase) have induced price rises. The question is whether the increase in the price of imports will filter through fully or to a large extent onto wages. Devaluation usually meets with success where this is successfully impeded, at least for a while.⁴ For this it is normally necessary to have a formal agreement between the government on the one hand and the employers' and employees' organizations on the other. No such agreement has been reached in Hungary. Can this requirement be met without a formal agreement? Can it be forced by a narrowing of domestic demand, fear of higher unemployment, and recognition of the difficulties of the economic situation? It seems the answer differs from sector to sector. The wage pressure is far lower where the firm is close to the market, i.e., in the competitive sphere making tradable goods. The wage pressure is stronger, however, in the branches where there are no rivals competing, and where the wage rise need not be endorsed by the market, but simply demanded from the government. Among cases that can be listed here are the monopoly or near-monopoly branches currently in state ownership, such as the railways and electricity generation.

If wages start to swing, the devaluation will become almost ineffectual, and this country, like others, may be caught up in a mindless, destructive vortex, a vicious circle of devaluation, inflationary surge, and further devaluation.

All employers and employees, and also employers' associations and union leaders, must respond conscientiously to the choice dilemmas relating to wage policy. One factor needed for there to be responsible behavior is the availability of clear information about macroeconomic policy, including the relationship between exchange-rate policy and wage policy. Those

⁴ This was one of the reasons for the success of the Israeli stabilization in 1984. On the stabilization in Israel see Bruno [1993], Fischer [1987], Razin and Sadka [1993].

concerned can rightfully expect not only to receive enlightenment on the general macro relations between these, but for the relations to be conveyed to them in a transparent, numerical form.

The budget. A budget deficit normally fuels inflation. There are exceptions to this—combinations of internal and external circumstances that allow a lasting budget deficit to coincide with a very low rate of inflation.⁵ Hungary is not one of the exceptions: There is a strong connection between the budget deficit and inflation.

One possible connection arises when the budget deficit is covered directly by the national bank in the form of credits. This is customarily called financing the deficit by "printing money." Hungarian legislation sets an upper limit to this form of financing, although to some extent this can be treated flexibly, since the limit can be temporarily raised by passing occasional legislation. Whatever the case, the inflation-stoking effect can be exerted up to the set limit.

The deficit can also be financed if the state raises credit not from the central bank, but by issuing government securities and selling this to investors at home and abroad.⁶ This has increasingly become the main source of financing the deficit in recent years. (See Table 4, which presents the size of the budget

⁵ This situation pertains in the United States, for instance, above all because domestic and foreign holders of money have so far been willing to invest their savings in gilt-edged American securities. In fact, the state debt, having swollen to vast proportions, is a big problem even there, and the question of cutting the budget deficit has come into the political forefront.

⁶ From the macroeconomic point of view, a precisely equivalent procedure is when a loan is taken up directly by the national bank from a foreign creditor and lent on as credit to the budget.

Table 4
Indices of Public Debt

Indices	1991	1992	1993	1994
1. Increase in gross public debt ^a (current prices, HUF bn)	415.3	244.1	1 040.0	641.3
1.1 To domestic creditors	63.4	217.7	467.3	202.2
1.2 To foreign creditors	351.9	26.4	572.7	439.1
2. Increase in monetary base (current prices, HUF bn)	179.9	188.3	172.1	178.6
3. Proportion of deficit financed by increasing public debt to financing of total deficit (%)	69.8	56.5	85.8	78.2
4. Proportion of deficit financed by broadening of monetary base to financing of total deficit (%)	30.2	43.5	14.2	21.8
5. Total domestic debt of consolidated public finance ^b as proportion of GDP (%)	71.1	74.9	84.5	83.2

Sources: Borbély and Neményi [1995, pp. 139 and 145], and further calculations by Neményi.

^a State debt calculated by adding the gross debt of the budget and the National Bank of Hungary.

^b Including devaluation debt. For an explanation of the devaluation debt, see Borbély and Neményi [1995, pp. 142–143].

deficit and the sources for financing it.⁷) It differs from "printing money" in not directly increasing the money supply (or more precisely the monetary base, which is the main force behind expansion and contraction of the money supply), but it has several other effects which can contribute indirectly to maintaining and even accelerating inflation. Let us ignore here the foreign loans, which were mentioned earlier. The domestic public debt has also grown to a threatening extent in recent years, which in itself deserves special attention (Table 4). When the budget makes a very large demand on the domestic credit market, the price of credit, interest, is pushed up. The high nominal rate of interest then will be built in to the inflationary expectations, keeping inflation high (or even speeding it up in the case of a mounting deficit).

Another dangerous vicious circle has arisen. The high rate of interest raises the interest burden on the public debt, which comes to form a growing proportion of the budget deficit. The growing deficit, on the other hand, encourages the raising of new loans, and promises of yet higher interest to satisfy the mounting demand. This again pushes the interest rate up, with a reciprocal effect on the deficit, and so on.

There is nothing alarming in itself about a country having a sizable public debt. This is customary not only at lower or medium levels of development, but in many mature market economies. What has to be avoided is a mounting rate of increase in the state debt—a vortex of debt. This will ensue if the increase in the ratio of public debt to GDP is accelerating. In this case, it is obvious that tax revenues will sooner or later be unable to cover judicial, public-order, and defense costs, and welfare spending, since they will all go on financing debt repayments and interest, and beyond a certain point they will not even suffice for those. Hungary has not reached that stage, but

⁷ Pioneering work with retrospective processing, classification and analysis of the data on Hungarian public debt was done by Borbély and Neményi [1994], [1995].

several simulation calculations have shown that if the trend before March 12, 1995, had continued, the country would have entered such a debt vortex in the foreseeable future and careered on toward financial ruin.⁸

We cannot resign ourselves to a vicious circle of budget deficit, high interest rates, and mounting state debt. But slowing it down and eventually halting it will require a whole range of measures. The credit demand from the budget is not the only factor affecting the interest rate, of course. A lot depends on the interest policy of the central bank and the commercial banks, on the efficiency of the banking sector, on institutional reforms to encourage personal savings (such as developing a system of voluntary pension and health-care funds), and on several other circumstances. I will not go into these now. What can be said in any case is that reduction of the large budget deficit is a necessary condition for easing the demand pressure on the credit market. This will entail a great many changes on both sides of the budget.

On the expenditure side, the March 12 package can be considered a forceful initial step. As such, it was a brave deed for the government and the majority in parliament to take this first step in the face of so many kinds of opposition. There was a need for the radicalism and forcefulness of the initial moves, to show that the government and the majority in parliament had ceased their hesitation and postponement of hard tasks and committed themselves to action. They had the courage also to tackle such "taboos" as state welfare spending. This marked a turning point in the history of Hungarian economic policy.

Unfortunately, when choosing the measures of the first package, the following selection criterion was not applied: how to achieve the necessary savings, with the minimum sacrifice and

⁸ Long before the present stabilization program, the theoretical connections and numerical simulation of these processes were dealt with by Oblath and Valentinyi [1993]. More recent calculations can be found in the document of the World Bank [1995].

consequently the least public resistance. The stabilization program was published in a way that failed to explain sufficiently clearly and convincingly what its motives and likely results were. At the time the package was announced, the government had no reform program of economic and social transformation looking a long way ahead, and to this day only the initial steps have been taken to work out one and initiate broad debate. So the March 12 measures were merely concentrated on overcoming the strong momentary concerns. They were not integrated into any deeper, more comprehensive long-term plan of reform.

Let us hope the part of the stabilization package dealing with the budget is only the start of reforming the whole system of public finance. Although at this stage in the discussion I have only raised the question of government expenditure in relation to inflation and the budget deficit, in fact there is a deeper dilemma involved: How great should the role of the state in the economy and society be? Before the March 12 package, Hungary was devoting the highest proportion of GDP to budgetary expenditure of any country in the post-Socialist region (see Table 5). Let people decide for themselves whether they approve of keeping this "leading role." Although I would not join those taking an extreme libertarian view, seeking to reduce the state's role to the minimum, I consider the role the state performs today (and still more yesterday) to be strongly out of proportion. A less centralized and more efficient administration is required.

This need for a smaller, cheaper, but more efficient state that can be supported on less tax should be the guiding idea behind the reform of public finance, in my view. One constituent of the reform is an overhaul of the welfare system. I would not recommend a complete "withdrawal" by the state. As I have underlined also in earlier writings, I certainly do not subscribe to any idea of "demolishing" the welfare state. The development of the welfare state is one of modern civilization's great achievements, which has to be preserved; but it would be worth

Table 5
 General Government Expenditure as a Percentage of GDP:
 An International Comparison

Country	General government expenditure as a percentage of GDP (%)		
	1991	1992	1993
Bulgaria ^a	50.7	43.9	41.7
Czech Republic	54.2	52.8	48.5
Hungary	58.3	63.4	60.5
Poland ^a	48.0	50.7	48.4
Romania	40.4	42.2	31.0

Source: EBRD [1995, pp. 138–142].

Notes: The figures for general government expenditure include central- and local-government expenditure and expenditure of extra-budgetary funds. The figures reflect the consolidated budget; expenditure includes interest payments but not debt repayments.

^a Spending does not include interest payments due, but not yet paid.

reducing its sphere and adding other mechanisms of provision.⁹ I take the view that the role of centralized state participation in the welfare sphere financed from compulsory taxation should be reduced to more modest proportions, not ended. Welfare redistribution by the state needs augmenting to a far greater extent by nonprofit insurance and welfare service institutions based on voluntary employer and employee contributions. For those prepared to pay for them, there should be wider and more closely monitored services and insurance schemes available on a commercial basis. There is no room here to treat the reform of the welfare system in detail. I just wanted to point to the macroeconomic aspect of it, for this great and difficult social-policy problem has a strong bearing on the question of overcoming the budget deficit.

The parts of the stabilization package concerned with public finance, including welfare spending, seem especially open to the criticism made earlier about the package as a whole that the regulations have not been incorporated into a comprehensive plan of reform. It would be worth preparing much more thoroughly for the subsequent measures, by paying close attention to the experts and representative organizations in specific fields and choosing much more carefully which spending items to reduce. Each cut raises a whole succession of specific dilemmas; it will take many tough decisions to outline the sphere of the direct losers and winners. When the regulations are being drawn up and a time-table decided for introducing them, it is not enough just to aim to cut the budget deficit. The prime consideration has to be how best to dovetail the alterations into the overall reform of the welfare sector. The reduction in the state's obligations, the drop in taxes and the compulsory contributions to finance them,

⁹ This is also emphasized by the Swedish economists critical of the excessive dimensions of the welfare system in the country that epitomizes the welfare state. They propose reforming the system, a considered reduction in the state's welfare spending, along with other measures to make up for it, not a merciless elimination of it. See Lindbeck et al [1994].

and the establishment of new organizations based on voluntary payments should all take place concurrently, complementing one another in a coordinated way. The greatest care has to be taken to minimize the sacrifice accompanying the process and ensure that it takes place as tactfully and humanely as possible. Citizens need to feel that in the longer term, even though the range of entitlements guaranteed by the state will be narrowing, the tax burdens will also be less, so that the sovereignty of the individual and family grows and a higher proportion of income is at their disposal instead of the state's. It has to be explained with great patience, compassion, and understanding that the reform of the welfare system will do a great service to the long-term interests of the whole of Hungarian society. Regrettably, these requirements were not met when the first group of measures to alter the welfare system was devised and announced. The omission contributed to the outcry and widespread opposition they encountered.

On the other side of the budget, tax revenues must rise. Development of the fiscal system has been one of the weakest points in Hungary's post-Socialist transformation. In the struggle between tax evaders and tax officials, the former have proved much the sharper and more resourceful. For every change by the tax authorities, new loopholes have opened and new tricks have been found by citizens intent on avoiding tax. The sections of the stabilization program dealing with taxation contained too much improvisation and sabre-rattling and too many empty promises. Spreading tax burdens produces "losers," just as withdrawing welfare services and benefits does. No one disputes in theory the principle of sharing tax burdens fairly. The arguments start when it comes to deciding specifically who pays more tax or pays tax on a hitherto untaxed item of income or wealth. I would recommend first and foremost broadening the tax base. The sphere of tax exemptions and concessions must be reduced and tax gathered from those intent on avoiding it.¹⁰ This

¹⁰ It is widely thought that the payment of tax and compulsory contributions is refused mainly by the "black"

will make it possible on the one hand to cut the deficit and on the other to lower the tax rates. Here at last a "beneficial" circle can emerge. If tax morality improves and the tax base widens, tax rates can be lowered. For it is above all these almost insupportably high rates that have prompted people to evade tax and lurk in the "gray" economy. So rate cuts will broaden the tax base.

The question is often put as to what division of labor there should be between fiscal policy and monetary policy in dealing with inflation. Some say the monetary policy should be far more restrictive, to make sure inflation is kept down even with an unchanged deficit. In my view this procedure is too costly, and if I may use the expression, too brutal. A Draconian cut in the aggregate money supply and one of the main methods of doing this, a radical rise in the prime interest rates set by the central bank, would have a detrimental effect on production and investment. It would weigh not only on loss-making, inefficient, nonviable enterprises, but on profitable, efficient, viable ones as well. In my view the course of not simply controlling but dramatically restricting the credit supply should be treated as an emergency brake for a case where inflation suddenly speeds up inordinately or a process of this kind threatens to get out of control.

This leads to the next subject, the prospects for real production.

economy. I would prefer to keep the term "black" for those who can be called real criminals in the legal and moral sense, and pay no tax anywhere in the world, of course. The big problem during the transition is with the "gray" and "off-white" spheres of fundamentally honest citizens, who would actually like to live legally, but withdraw some of their income from taxation, or at least connive in others doing so. It would exceed the bounds of this study to look at how to turn this stratum (which I suspect covers the majority of society) into consistent, law-abiding taxpayers. I would like to note, however, that it cannot be done solely by policing methods.

Recession or Recovery and Lasting Growth

There has been widespread debate in recent years, in Hungary and internationally, about the causes of the recession that has developed during the post-Socialist transition and the conditions required for short-term recovery and for lasting growth.¹¹ I have a personal observation to make. Two and a half years ago I hoped the time for recovery had come. It was too early. The government of the day confined itself to popular acts that would stimulate the economy, setting about expanding the credit supply and aggregate domestic demand in general, for instance, while failing concurrently to take necessary but unpopular measures. For example, it did not carry out the currency devaluation many economists (including myself) were recommending and actually continued a policy of real appreciation of the exchange rate. This was among the factors behind the appearance of ambivalent phenomena in the economy in 1994. Though the factors tending toward recovery strengthened, and there really was growth for the first time in many years, as mentioned earlier the equilibrium tensions heightened as well.

The debate over the question of contracting or expanding real production continues. Two extreme views can be found. One is to see a need for drastic contraction of production as the only way of curbing the import hunger and setting the trade and current-account balances to rights. Its adherents consider the contraction of production not as a negative, possibly inescapable side effect of a combined therapy, but as the therapy itself. The view at the opposite end of the spectrum can be heard as well—that the present (or even higher) level of budget deficit must be accepted along with a further deterioration on the current account, for the sake of speeding up, rather than

¹¹ For the debate in Hungary see Balassa [1994], Békesi [1995], Csaba [1995], Erdős [1994], Kopits [1994], Kornai [1993], [1994], Köves [1995]. Of the foreign writings I would pick the following: Berg [1994], Calvo and Coricelli [1993], Holzmann, Gács and Winckler, eds. [1995], Koločko [1993], Saunders, ed. [1995].

throttling, the recovery of production.

The March 12 stabilization program, or at least the published quantitative projections, eschew both these extremes. It does not contain immediate measures to promote directly an upswing of production. Instead, for the time being, the program is content, due to the gravity of the foreign-trade and financial tensions, with far more modest production goals than could have been undertaken if the macroeconomic policy of the last two or three years had been more balanced. It aims at no fall in GDP, even, if possible, a continuation of last year's growth of 1-2%. At this production level it envisages a restructuring in the utilization of production, with the shares of exports and investment rising and that of consumption, especially collective, budget-financed consumption, falling. As far as the origin of total domestic absorption is concerned, there should be a growth in the share of domestically produced products and services and a fall in the share of imports ¹² (see Table 6). The speed and depth of restructuring depends on several factors, among them the measures presented in the study so far. Experience will show how fast the restructuring can take place. I do not wish to disguise the fact that I have many worries and uncertainties about this. Will the measures not overshoot the target, causing a sudden, excessive fall in aggregate demand? Will this not be accompanied by a bigger contraction in production than expected? If this happens, will it not lead to a fall in tax revenues that undermines the original objective of reducing the budget deficit?

Another cause for serious concern connected with the

¹² The requirement of rapid restructuring within a growth target already set at a more modest level was one of the fundamental ideas running through the article I published last summer [Kornai (1994)]. So far as I can judge, the March 12 program is very close in this respect to the proposal I made then. Another idea in the article also found a place in the program's rationale: the need for parallel concurrence of moves to improve the equilibrium and measures to support growth. More will be said on this later.

Table 6
Utilization of Gross Domestic Product

Indices	1991	1992	1993	1994 ^c	1995 ^d
	As % of GDP				
1. Household consumption	68.6	72.8	74.0	73.6	71.2
2. Collective consumption ^b	9.4	12.0	14.4	11.7	10.4
3. Total final consumption ^{a, b}					
(1+2)	80.6	84.8	88.4	85.3	81.6
Of which: consumption financed out of the budget ^b	36.7	42.3	43.9	—	—
4. Total investment	20.4	15.5	19.9	21.5	22.1
5. Domestic absorption	101.1	100.3	108.2	106.8	103.7
(3+4)					
6. Balance of foreign trade	-1.1	-0.3	-8.2	-6.8	-3.7
Exports	—	31.5	26.5	28.7	32.7
Imports	—	31.8	34.7	35.5	36.4

Sources: 1991: Central Statistical Office [1994b, pp. 72 and 73]; 1992–1993: Central Statistical Office [1995a, pp. 107 and 108]; 1994–1995: based on data and estimates by Hungarian Ministry of Finance.

^a The sum of total final consumption in 1991 includes the bank dividend not distributed between households and the state budget, for lack of a source of data (HUF 64.4 bn, or 2.6% of GDP).

^b Including arms imports from Russia in repayment of earlier debt.

^c Preliminary data.

^d Forecast.

contraction of production is the conflict of short-term and long-term thinking. Hungary has to be navigated today under extremely difficult conditions. As it has emerged from the study already, the country has to be steered between several Scyllas and Charybdises at once. The danger is that the leaders responsible for the economy will be almost entirely taken up with the short-term problems. This is a practice that cannot be accepted, if for no other reason because constant postponement of the long-term tasks is what has led to the present accumulation of troubles. There is a range of tasks that have to be done now so that they can contribute to lasting growth after a longish gestation period. It is most important to assess every urgent task today not simply from the "fire-fighting" point of view of averting catastrophe, but in terms of deeper, systemic, transformation-oriented reforms and lasting growth, so that decisions are reached after weighing up "short term-long term" dilemmas. Here are a few examples:

1. Present-day budget revenue is a major factor in reaching decisions on privatization, but it cannot be the sole criterion. No less important are the commitments a potential new owner will make to increasing capital, accomplishing investment projects, and bringing in new technologies.

2. In developing the financial sector, it is worth bearing in mind how the banks can contribute to resolving today's problems of external and internal equilibrium. But it is not less important to establish the institutions for long-term lending and expand the credit available for production and housing investment. This ties up with establishing the conditions required for long-term deposits to become widespread, building up a network of voluntary pension and health funds, and developing more active investment activities by these funds and private insurance companies.

3. While attention must go to reducing state spending, it would be worth increasing the proportion within such spending of the sums expended on investment.

4. However tough the measures required for reducing the budget deficit, the lesson of precisely the most modern growth

theories must not be forgotten: Among the most important factors behind growth are research designed to assist production, enhancement of the skills of the workforce, and modernization of professional knowledge. The development of these factors, however, requires constant finances, and these must not be constricted even temporarily.

Moreover, stress on such long-term considerations can help to win political acceptance for the stabilization program. Though the radicalism of these measures and their speed of introduction arose mainly out of a need to avert the short-term troubles and a still-greater trauma in the future, this argument remains incapable of persuading millions to accept great sacrifices causing woe and suffering over a long period. If they are willing to accept this at all, it will be in the hope of a better future. Yet any convincing presentation of such a future has been almost wholly absent from the arguments in favor of the stabilization program.¹³ But this leads to the last problem area covered in the study, the relationship between the economy and politics.

Economic and Political Stability

The sections of the study so far have dealt with dilemmas over conflicts among different economic requirements. They covered trade-offs of a kind where the more one economic criterion is satisfied, the greater the concession that has to be made on another. There is, however, a still graver dilemma: conflicting requirements of economic and political stability.

Once the democratic political system in a country has consolidated and the economy taken a course of lasting growth,

¹³ The prime minister publicly announced in May of this year that the first draft of its medium and long-term program of reform had been prepared. Yet this remains unknown even to the narrow profession, let alone to the wider public. It was a grave omission to postpone this task for so long. It would have been far more fortunate if the country could have learned simultaneously about the short-, medium- and long-term programs and it had emerged they were integrally related.

it becomes possible to overcome this conflict, so that the economic and political stability mutually reinforce each other. Conflict between these two requirements, however, is all too common in the world of post-Socialist transformation. When the economy stagnates or even shrinks while society almost writhes in convulsions, the conflict can be dangerously heightened.

As shown earlier in the study, the political leadership spent decades "buying off" the public's goodwill, or at least tolerance, with economic concessions. In response to signs of discontent came concessions: loosening of wage discipline, a soft budget constraint to save loss-making enterprises, and transfers or entitlements at the state's expense. This practice was the initiator and constant generator of the process of inflation, indebtedness, and budgetary disequilibrium.

This is what the Kádár regime did in its quasi-liberal, reformist phase, and the same practice was pursued by the governments gaining power in free elections, right up to March 12, 1995. Hungary was earlier seen as a paragon of political stability by the experts of comparative economics, the staff of international agencies, and diplomats and journalists from abroad. So it was, but we are now paying the price of that political calm of old.

The program of March 12, 1995, marked a break with the practice of constantly giving way to redistributive demands. I have already mentioned what a shame it is that the contents of the package were not sufficiently well chosen from either the political or the economic point of view. The program was presented clumsily, sometimes in an almost uncompassionate, insulting way, and neither the motives nor the likely effects of the program were sufficiently explained to society. But even if the program had been compiled more cleverly and presented in a much more convincing fashion, that would not have changed the fact that it really does cause tangible losses to very many people indeed, by reducing their present standard of living and undermining their sense of security. So the great opposition to it is unsurprising. Here I refer not only to the opposition protests in parliament, which are normal occurrences in a

parliamentary democracy, but to the intense extraparliamentary protests of various kinds. Almost every stratum and interest group in society has already protested against or at least sharply criticized the program. The last few weeks have given us a taste of almost every form of mass protest, from public condemnations on television and in the press to street demonstrations and deputations to parliament, and from strike threats to the first real strike. An article in the press of the radical right wing outside parliament urged the public to resort to civil disobedience and withholding of taxes. And this may have just been the start, for implementation of the program has yet to have an appreciable effect. So the question arises whether the stabilization package is feasible at all—not economically, but politically.

Tough, strict programs have been successfully carried out in the past by tough, strict military dictatorships or other authoritarian regimes, like Pinochet's Chile or pre-democracy South Korea. Some democratically elected governments have also managed to apply restrictive measures, like Mrs Thatcher's Conservative government, but in that case the government had received a mandate to do just that from an electorate fed up with the deterioration of the British economy under the previous Labour governments. Thatcher began to implement her program by clamping down on the unions. Similar success crowned the implementation of a Draconian program in the early 1990s by the Solidarity government of Poland, but for doing so it had seized the historically unique moment of first euphoria at the change of system, and it still had mass support at the time.

Will the Socialist-Free Democrat coalition government of today's Hungary prove able to carry out a strict program, of which we are still only at the beginning? And will it be able to do so while preserving the achievements of parliamentary democracy intact, as the parties in power have made an express commitment to do? A curious reversal of roles has now taken place in Hungary. To simplify somewhat, the Socialist Party, having won the elections emphasizing its social sensitivity, is now implementing a "Thatcherite" program. Meanwhile, politicians of

the forces that describe themselves as right-of-center conservative have brought out social democratic arguments in favor of the distended welfare state and the wage demands of the employees. How long can both sides keep up this reversal of roles?

I do not know, and I do not want to make a forecast either. Instead, in line with the title of this study, I state the dilemma.

Hungarian society, in the first phase of implementation of the stabilization program, provides an almost classic example of the case known to game theory as the "prisoner dilemma," to which there are two solutions in theory.

One is the noncooperative solution. In the game-theoretical model, each prisoner wants to assert his own interests, and this has a self-destructive effect. If each stratum and interest group in society wants to escape the burdens and retain or even improve the financial position it has enjoyed so far at the expense of the other strata and interest groups, then everyone together does worse. The equilibrium cannot be restored and production cannot grow. The country's reputation will fall further. Neither creditors nor investors (whether foreign or Hungarian) will believe that this country racked by mass protests and strikes is a good place for their money. The political instability leads to further destabilization of the economy. The more strenuously and effectively each group struggles for its own interests at the expense of the other groups, the more destructive the combined consequences of the struggle will be.

Game theory (and day-to-day common sense rising above group interests) clearly points to an alternative, cooperative solution. In the prisoner dilemma, the prisoners have to agree with each other. Each has to make a concession. None gets what is best from his own point of view, yet together they do better than they would by noncooperative behavior. All Hungarian citizens are prisoners of the current situation. Is every affected group, profession, branch, and region capable of conceding something, making a sacrifice, resigning itself to the loss or reduction of certain privileges and benefits, and not

just expecting others to do so but doing it themselves? Are we mature enough to choose the cooperative solution? This is a dilemma to which all the parties, movements, organizations, and individuals in society have to respond for themselves, as their own consciences dictate.

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