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ECONOMIC COMMITTEE

ECONOMIC REVIEW OF EASTERN COUNTRIES: HUNGARY

Note by the Chairman

The attached paper is based on the Summary and Conclusions of the report AC/127-D/445, 29th June, 1973, submitted by the United Kingdom Delegation, and on the views and suggestions put forward during the discussion of the document on 11th October by experts from capitals and members of the Economic Committee.

2. The Economic Committee may wish to consider whether or not this paper should be sent to the Council.

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N A T O C O N F I D E N T I A L

ECONOMIC REVIEW OF EASTERN COUNTRIES: HUNGARY

Report by the Economic Committee(1)

1. Hungarian economic growth has accelerated slightly in recent years and currently exceeds Five-Year Plan rates despite continuing problems. There has been a strong rise in agricultural output and a limited increase in industrial efficiency stemming in part from the application of the New Economic Mechanism (NEM), an experiment with a partial decentralization of the economy launched in 1968. Industrial output has been growing less rapidly than in the past, however. The NEM has encountered a number of problems such as over-investment, a considerable trade deficit, difficulty in controlling price increases in some industries, and increasing income differentials. Much of the NEM mechanism still remains intact, though in 1972 a considerable number of central controls (e.g. on investment) were strengthened and imports were reduced.

2. A number of problems face the Hungarian economy in the medium term - a tightening manpower situation, the need to strengthen labour productivity, considerable reliance on imports (particularly of Western technology) and a relative shortage of the foreign exchange necessary to finance it. While Hungary remains heavily dependent on Soviet energy and raw material resources and on COMECON trade and economic co-operation generally, the resources of her Allies in these fields are limited. Budapest is accordingly showing increasing interest in material resources of developing countries, in Middle East oil, and in participation in international economic organizations. Hungary, which has been active in industrial co-operation with Western companies for several years, seems at present to be taking stock of its experience with this form of East-West economic relationship.

National income

3. Hungarian national income - net material product - has been increasing at a faster rate since 1968 than before. The average annual rate for 1961 to 1967 was 5.2%, whereas from 1969 to 1972 it has been running at 6.4%. Industry is now the major component of national income. From contributing about one quarter of net material product in 1950, it is now responsible for a little under one half, whereas agriculture has fallen from a position of contributing one half to only 17% over the same period. About three-quarters of national income presently goes to consumption - both private and public - and about a quarter into capital formation.

(1) A more detailed report on the subject is being issued as AC/127-D/445(Revised)

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Population, Manpower and Employment

4. Hungary's population of 10,415,000 at the end of 1972 was the smallest of the East European countries except Albania and Bulgaria. In the last fifteen years the natural increase in population (live births, less deaths) has been very small, with the result that in the immediate future, Hungary can expect a gradually diminishing availability of manpower. This will put a premium on raising labour productivity, which is one of the weaknesses of the Hungarian economy, and which it was one of the main aims of the NEM to increase. Inevitably, this will mean developing a more capital-intensive industrial structure and perhaps an increasing use of Western technology in the years ahead.

Agriculture

5. Agriculture in Hungary now employs about 25% of the labour force and provides 17% of national income, a proportion that has declined slowly over the years. Output has risen strongly, due to the much greater productivity of labour in this sector. There is little doubt that this development is attributable to a significant extent to the NEM which involved an increased acceptance of profits as an indicator of success, a greater reliance on market forces, and decentralization of responsibility for planning and management. The improvement has been uneven, however, grain output rising strongly, but great difficulties being experienced in increasing cattle breeding and the production of fruit and vegetables. This has largely been caused by inadequate price levels for farmers, and in the long run the Hungarian consumer will have to pay more for a large proportion of his food. The prices of milk and milk products have already been raised, and the price of meat is due to be increased after 1975. However, the Government will have to tread carefully in this respect in order not to antagonize consumers - particularly the industrial workers - too much. Experiments have recently been made with a more technological solution of animal husbandry problems - highly mechanized capital-intensive approaches such as the "Closed Production System" and related fodder equipment imported from the West. Although dependent on skilled manpower and foreign exchange (both of which are in short supply in Hungary), the system has had considerable success on a small scale to date.

Industry

6. Industrial growth has slackened since 1968 despite slightly faster growth in output per man-hour, which would seem to reflect a more efficient use of labour during this period. Industries which have improved their performance in this respect are vehicles, chemicals and precision engineering. At the other

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end of the scale, output per man-hour has been declining in the mining, paper and textile industries, while the building materials industry has continued to give a poor account of itself. The slowdown in expansion of overall output is attributable partly to a tight labour market and a new stress on product quality instead of quantity. But the main factor has been the failure of the NEM to override factors hampering labour productivity in terms of output per man. Working hours have been reduced; some enterprises have been moved to areas of lower productivity; and the authorities have maintained their policies of absolute priority for full employment and economic privileges for the industrial working class.

Investment

7. In 1968, the scope of investment based on enterprise self-finance was broadened, and a larger rôle allotted to bank credit. Following this readjustment, the economy experienced an investment boom in 1969 which continued until 1971, when the Government intervened and introduced measures to limit the growth of investment. Many new projects were started, often of an uneconomic nature, completion periods lengthened, and the construction sector became strained. The chief reason for the boom seems to have been a miscalculation by the Government as to the size of the profits that would accrue to the enterprises in 1968 following the adjustments and the introduction of the NEM, rather than from any real surrender of basic control over investment by the central authorities. Nevertheless, the Hungarian Government seems to have no desire to repeat the experience, and are apparently determined to maintain for the time being the various administrative and financial sanctions introduced since 1971.

Prices

8. The major innovation in pricing policy introduced by the NEM, was the decision to allow some enterprises to fix the prices they charged other producing firms. Because the Hungarians retained strong monopolistic elements, unjustified increases in producer prices were common and a strong inflationary trend was introduced into the economy. Firms that could not increase prices were discriminated against, and necessary capital-intensive investment was made extremely expensive by these inflationary costs. Consequently, a number of measures were taken by the Government in late 1972 and mid-1973 to increase central influence in prices policy. There was to be no increase in the price of basic goods or the proportion of free prices before 1975, stricter pricing control was to be introduced generally with the compulsory

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reporting of price increases; enterprises were made liable to prosecution for "unjust profits" resulting e.g. from abuse of a monopoly position. Despite these modifications of the pricing system, the Government's official aim is still to evolve a consumer price system proportionate to value and last January it accordingly raised prices of tobacco and spirits 15% to 25%. However, the Government has also admitted that the achievement of this aim is proving to be much more difficult than had been expected, and that its realization will take at least two or three plan periods.

Earnings

9. Between 1955 and 1971, earnings in Hungary virtually doubled, but the increase was uneven and varied strongly from one sector of the economy to another. The major feature of the period has been the way in which the industrial wage has fallen from a position of pre-eminence to one of relative inferiority, vis-à-vis the economy as a whole. In 1955, industrial earnings were as much as 30% higher than wages in the state sector of agriculture. Gradually this gap was narrowed, and in 1968 when the NEM was introduced, industrial wages fell below the average wage level for the first time, while wages in agriculture leapt ahead. Earnings have also increased more rapidly in the co-operative sector than in the state sector since 1968. Consequently in terms of earnings and general standard-of-living, it is the peasantry and workers in co-operative industry that have gained most from the NEM, and the workers in state industry, the least. This became an important ideological weapon to conservative opponents of the NEM, and at the end of 1972, a series of measures were introduced by the Government which aimed to redress the balance. They included a special 6% to 8% wage increase for industrial workers in the state sector over and above the normal annual increase, and although price increases should ensure that agricultural incomes do not stagnate, it seems likely that at least in 1973, the tendency for peasant incomes to rise faster than those of industrial workers will be reversed.

Planning

10. The NEM has involved an increase in detailed economic planning by enterprises and a shift - from direct towards indirect controls - in the method of regulation of the economy by the central authorities. Experience with the new system, however, has revealed a number of ambiguities and uncertainties that interfered with co-ordination and communication between the ministries and their enterprises. Significant modifications in the NEM planning scheme have accordingly been introduced during the past year. A recent Government decree calls for tighter control by the party, Government and ministries over the economy and the planning process. This development does not necessarily imply a return to centralization, however, since in Hungary more depends on practice than on theory.

Foreign Trade

11. Hungarian dependence on foreign trade is considerable. Some 67% of trade is currently conducted with Communist countries (over half of this with the USSR), and well over a quarter with the industrial West. The NATO countries' share in 1971 was over 20%. The balance of trade in recent years has been generally adverse, particularly with the developed countries, and in 1971 Hungary's trade deficit with both Communist and non-Communist countries increased considerably. Consequently, the reduction of the deficit has become a central aim of Hungarian trade policy. In 1972 the external imbalance was eliminated with Communist trading partners and was reduced vis-à-vis the West.

12. The 1971-1975 Plan places renewed emphasis on trade with CMEA countries. With the GDR, in particular, Hungary's trade has grown because of the increase in co-operation in the industrial sphere, and she has also emphasized the need for CMEA specialization in the engineering sector. Security of energy and raw material supplies is also a key factor in Hungary's continued economic development. In this respect Hungary is dependent on the Soviet Union, imports of such items being regulated on the basis of long-term agreements. In the latter half of the 1970s, it appears doubtful whether the USSR will supply the total oil requirements of Hungary, which may thus be compelled to turn to hard currency purchases in the Middle East. The proportion of raw materials coming from the USSR may decline slightly, and Hungary will be expected to contribute towards raw material exploitation on Soviet territory with other East European countries. The recent law on foreign investment may also improve the prospects for co-operation. This law applies to both Communist and non-Communist countries, and allows for the establishment of joint enterprises, particularly in research and marketing, and would serve the products of industrial co-operation.

13. The Hungarians will continue their aggressive pursuit of Western technology, though probably not through the new foreign investment mechanism, which they are clearly reluctant to utilize with Western partners except perhaps in joint marketing ventures abroad. They have signed more Industrial Co-operation Agreements (ICAs) with the West, than any other Communist country. These agreements, which are of a wide range and variety, are primarily aimed at improving the quality of goods produced both for internal consumption and for export. The Hungarians, who are considered to be among the most capable financial managers in Eastern Europe, have also received credits to cover major purchase of capital equipment from NATO countries, but

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consistently on a smaller scale than most other members of CMEA. They have relied mainly on Eurodollar borrowing in London, and loans raised since 1967 total over \$250 million excluding the two Eurobond issues which raised \$75 million. Hungary also recently acceded to GATT, reportedly agreeing to lower its tariffs about 50%.

GENERAL

14. The New Economic Mechanism (NEM) has now been in operation for over five years. The mechanism has been attended with some successes - a slightly faster rate of growth of national income, a better performance in the agricultural sector (arguably the major achievement of the NEM), an increase in output per man-hour, etc. - but it has also encountered a number of deep-rooted problems, which have slowly compelled the government to take a more interventionist rôle and draw back somewhat from the original NEM principles.

15. The problems that arose were chiefly those associated with the introduction of a limited economic freedom in a highly centralized economy - namely, the appearance sooner or later of personal and collective inequalities, resulting from the different opportunities which people had to make use of these new freedoms. Some firms could raise prices more easily than others, while still others were not allowed to raise their prices at all. As a result, some workers - usually those in the smaller enterprises and the co-operatives - reaped higher rewards than others - usually those in the large state firms. The agricultural co-operative benefitted considerably from the higher prices and greater marketing freedoms which the NEM gave them, and peasant incomes grew much more quickly than industrial earnings. The traditional chief beneficiary of Communist society - the worker in the large state industrial enterprise - gained the least from the relaxation of central control.

16. As the problems developed, the general political climate - both domestic and international - in which the NEM had to operate, gradually changed as well. When the NEM was introduced in 1968, the international situation was favourable for such an undertaking. The Soviet Union had been involved with reforms of its own, and seemed well-disposed towards the idea, and Czechoslovakia had already introduced its "new economic model". Since then, the picture has changed. The concept of "integration" within the CMEA has replaced "reform" as the dominant economic concern of Eastern Europe, and the Czechoslovak reform has been eradicated by the Soviet invasion.

17. This change in the political background to the NEM meant that the problems which had been generated or brought to the surface by the new system, were tackled on the basis of increased central control and administrative edict, rather than by a development or extension of NEM principles - measures that might well have been feasible in a more optimistic and relaxed political climate. While this climate remains unaltered, the main task of the supporters of the NEM will be to keep as much of the policy intact and in operation as they can, rather than seeking to extend it.