Support for Adjustment in Hungary

The Bank's First Structural Adjustment Loan to Hungary ($200 million, approved June 1990) supported the first stages of Hungary's economic transformation from a form of "market socialism"—still characterized by central planning, administered controls, and state ownership of most resources—toward an open and competitive market economy with largely private ownership of property. A recent audit by OED analyzes this successful operation and offers lessons for adjustment assistance in countries in transition.

Background

After World War II, Hungary's economy became a command economy with state ownership of the means of production, collectivized agriculture, central planning, and emphasis on development of heavy industry. External trade was oriented to the CMEA countries.

Reforms over two decades, 1968-89, led to some decentralization of decisionmaking, partial freeing of foreign trade and domestic prices, limited and small-scale private sector activity, and the establishment of parts of the institutional and legal framework needed in a market economy. Large hard-currency borrowing served to maintain consumption as well as to finance investment. The reforms put Hungary ahead of other East European countries on the path toward a market economy. But in 1990 its economy was still largely state-owned and managed, highly distorted and inefficient, and heavily indebted.

Political change

Hungary's main national goals in 1989-90 were democratization, stabilization, structural adjustment, and privatization. While the SAL was being prepared and appraised, in late 1989 and early 1990, the government was still led by the Hungarian Socialist Party (the communist party). But because this government had agreed to hold free, multi-party elections in the spring of 1990, it was in effect a lame-duck government. The democratic elections in the spring of 1990 brought to power a coalition government committed to comprehensive and radical reforms.

Balance of payments crisis

The preparation of SAL I coincided with the emergence of a liquidity crisis in the balance of payments that by early 1990 was worsening by the minute. The proximate cause was commercial creditors' nervousness about the political and economic uncertainties in Eastern Europe at the time. This led them to reduce their exposure in Hungary by withholding new and rollover loans.

Rather than seeking debt rescheduling, the government resolved to deal with the balance of payments crisis by:

- Cutting substantially the current account deficit (i.e. the convertible currency or non-ruble deficit) through a stabilization-cum-adjustment program.
- Obtaining official capital to make up for the restricted availability of commercial capital.

- Promoting direct private foreign investment (DFI).

Program design

Radical economic reforms

The adjustment program launched by the interim government was a radical departure from past policies. This was the first Hungarian reform program to emphasize private property rights, promise large-scale privatization and downsizing of government, and welcome foreign ownership. The new economic strategy sought to integrate Hungary as fast as possible into the European Community and other Western institutions. It recognized exports as the leading sector, and relied on direct foreign investment to bring to Hungary not only needed foreign exchange but also new technologies, management skills, and access to new markets. The reform program was geared to effect major changes not only in policy but also in legal and other institutions and, most fundamentally, in behavior patterns.

The SAL I program incorporated stabilization measures supported by

*"Performance Audit Report, Hungary: Structural Adjustment Loan", Report No. 12103, June 1993. OED reports are available to Bank Executive Directors and staff from the Internal Documents Unit and from Regional Information Services Centers.
The Bank and Hungary

Hungary joined the World Bank in 1982. Between then and 1990, the Bank extended some 27 loans totalling almost $2 billion and issued some 37 economic and sector studies on Hungary. These intellectual and financial investments served to build up generally good working relationships and a foundation of Bank knowledge of the economy.

The Bank's assistance strategy for Hungary in the 1980s supported efficiency gains through technological improvements, enterprise autonomy, and other reforms—so as to make Hungary's "market socialism" work better, rather than encouraging fundamental reforms such as large-scale privatization or breaking from the CMEA trading system. But over the years, Bank lending supported an increasingly broad agenda of structural and macroeconomic policy reforms. It evolved from an initial emphasis on project lending for infrastructure, to hybrid lending for industrial restructuring and selective policy reform, to quick-disbursing adjustment lending in the context of a comprehensive reform program.

the IMF as well as the adjustment measures emphasized in the SAL, and went into effect in July 1990. It was designed to:

- Help launch the government's adjustment program.
- Help assemble a financing package that would enable Hungary to manage its balance of payments crisis and strengthen its creditworthiness.

The loan conditions were well chosen. They addressed a combination of key policy and institutional reforms, including:

- elaboration of an ambitious privatization plan;
- pricing and import liberalization measures;
- subsidy reductions;
- procedures to liquidate several large state farms and other state enterprises; and
- reforms in major social programs, including designing and putting in place an adequate social safety net.

Preparation

SAL I was well prepared. It was founded upon generally high-quality economic and sector work and grounded in a mutually respectful policy dialogue between the Bank and borrower. The Bank was correct in not seeking to force a strategy of shock therapy but rather in supporting solutions tailor-made to Hungary's conditions.

Hungarians who were involved at the time credited the Bank with helping to formulate the detailed subsidy reduction program, the trade liberalization policy, and the corporate restructuring program. The SAL process was also credited with helping the government pull together the multiple strands of the comprehensive reform program.

The 1990 adjustment program was, however, very much a Hungarian program (see box). Further, it was "owned" not only by the government and political leadership, but also by the main opposition parties contending in the 1990 elections. The Bank facilitated this broad ownership by engaging opposition parties not only in the policy dialogue but even in the formal negotiations of SAL I (see box).

Timing

Important attributes of the SAL were its timeliness and the willingness of Bank management to accept the risks associated with mounting the operation even before the new elected government was in place. The behavior of commercial lenders created a burden-sharing problem. Though these factors led some Bank advisers and managers to advocate delaying the SAL, it is clear now that the Bank was right to have proceeded with it. Even a short delay would likely have led to default on the debt service, rescheduling, a postponement of some reforms, and probably a smaller flow of DFI in 1991-92.

Results

SAL I was a successful operation. In combination with the IMF standby arrangement, it helped launch Hungary's new reform program on a sound footing. Hungary experienced severe shocks while the loan was in progress, owing to a drought and the demise of the CMEA system (the latter is believed to have caused at least two-thirds of the 4 percent decline in GDP

Continuity and Radical Change

An important strength of Hungary's 1990 reform program was that it was very much a "home grown" product, grounded in the realities of many years of partial reform. The program's design reflected both continuity and radical change.

The continuity was partly reflected in the "gradualist" approach most evident in the phasing, over several years, of Hungary's price and trade liberalization measures. It was also reflected in the process of program design, a process characterized as one of uneasy compromises. Such compromises are more characteristic of democratic than of autocratic processes, and Hungary's history of finding compromises (uneasy or otherwise) should be seen as favorable to its prospects for successfully pursuing a political transformation along with its economic transformation.

The radical parts of the 1990 program were the total abandonment of the central planning concept and the adoption of the goal of turning Hungary, within a few years, into a fully functioning market economy, on the western European model, eligible for integration into the EC. This entailed changes totally out of bounds in previous reform efforts.

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in 1990 and the 10 percent decline in 1991. Yet all the performance targets/ceilings of the IMF standby arrangement were met and the SAL I loan conditions were satisfied on time.

The SAL and the IMF standby arrangement were the catalysts for other official flows, including $200 million equivalent of cofinancing for the SAL from the Export-Import Bank of Japan, and they also served to enhance Hungary’s commercial creditworthiness. These developments in turn made Hungary more attractive to foreign investors.

The balance of payments improved more than expected: the external balance (current account) went from a deficit of $1.4 billion in 1989 to a surplus of $100 million in 1990 and $300 million in 1991. This was facilitated by:

- creditable implementation of the 1990-91 stabilization program;
- a remarkable redirection of exports from collapsing CMEA markets to convertible currency markets;
- a fall in import demand in response to the recession, which was caused partly by the 1990 drought but mainly by the CMEA collapse.

Meanwhile, the capital account was strengthened by the inflow of official capital, the stabilization of net private flows, and a surge of direct foreign investment from $200-300 million in 1989-90 to a yearly average of $1.5 billion in 1991-92 (see chart). Hungary’s external reserves grew by several billion dollars (from about one month’s imports in 1990 to 6 months’ in 1992). The debt service ratio fell from 46 percent in 1990 to 30 percent in 1991.

Social costs

The reforms and shocks have had substantial social costs. Unemployment rose from near zero in 1989 to 12 percent in 1992; the number of people below the poverty line rose from 750,000 in 1987 to 1.3 million (12 percent of the population) in 1992. A social safety net that provides unemployment benefits and social assistance is now in place, but much more needs to be done to rationalize social expenditures in general and to better target them to the needy.

Sustainability

Among the more difficult challenges facing Hungary’s policymakers are the fiscal/budgetary problems, the social dimensions of adjustment, and the interrelated problems of how to deal with the largest loss-making public enterprises and at the same time strengthen the balance sheets of the banks. Much progress has been made since 1990 to put in place the policy and institutional frameworks geared to a market economy, but in the areas of budget reform, privatization and enterprise restructuring Hungary still has a long and difficult road ahead.

Even so, the reform program seems likely to be sustainable:

- Hungary seems to be set upon a basically sound course of adjustment;
- policymakers have shown commendable pragmatism in adjusting the course as circumstances warrant; and
- there seems to be a broad and deep consensus in favor of staying the course.

Lessons

- Timeliness and risk taking: Timeliness can be a critical aspect of a project’s impact and importance. When a historic moment presents itself, as it did in Hungary in 1989-90, both stakes and risks may be high. The Bank needs to call upon its sense of history, as well as its best technical skills, in seizing the moment.

- Complexity and difficulty of the dual transformation: Adjustment takes time, whether to restore creditworthiness, to privatize, or to generate a supply response. It is now clear that the transition from socialism to a fully functioning market economy is more complex, difficult, and time consuming than it seemed in 1990, even for a

![Selected Economic Indicators](chart)

OED Précis
Building Ownership through Multiparty Dialogue and Negotiations

The process by which SAL I was prepared and negotiated served both to build the borrower-country's ownership and to expedite the program's approval and implementation. The Bank faced a dilemma in early 1990: pending the free, multi-party elections scheduled for the spring of 1991, delaying SAL I could have been too undesirable because of the balance of payments crisis and the need to launch an adjustment program as soon as possible. But it would also have been highly undesirable to move ahead with a program that might be disowned by the winners of the coming elections.

Bank staff thus took the step before the elections and in the latter stages of loan preparation, of engaging the main opposition parties in the policy dialogue and involving their representatives in the formal project negotiations. This served to ensure that the reforms would be "owned" and implemented, however the elections turned out. There were few precedents in the Bank for such a multi-party negotiation of a SAL.

This course of action involved some risk that the program would be too much weakened by the compromises necessary to satisfy the different parties. There were important reasons why it worked.

- All the parties agreed that Hungary's circumstances required a strong and comprehensive program, and disagreements were largely on tactics, not strategy.
- Bank staff arranged seminars and discussions with representatives of the multiple parties well before the negotiations to avoid surprises and help establish consensus.
- There was general respect for the judgment of the leader of the Hungarian negotiating team.

Because behavioral change is the most fundamental kind of change to be effected in the transition, increased attention is warranted to analyzing and understanding these interrelated institutional and behavioral dimensions of adjustment.

- Sequencing and pacing: Hungary's reform strategy as it evolved through 1989-91 had similar goals to those of neighboring countries, but differed from them in the pace and sequencing of reforms. Especially in countries that are attempting both economic and political transformation at the same time, the pacing and sequencing of reform is largely a matter of feasibility, which varies greatly from case to case. Hungary's exchange rate and relative domestic prices were much less distorted than those in neighboring countries, so its 1990-91 stabilization and price liberalization reforms could be comparatively gradual. Nor did Hungary face the hyperinflation that required other countries to adopt "shock therapy". Hungary's strategy was adapted to Hungary's initial conditions, but it might not have suited countries with greater distortions, inflation, and imbalance or with less experience of market mechanisms.
- Institutional development: Hungary's recent experience points to the critical role of legal and institutional reforms in bringing about behavioral changes that are basic to the transition from socialism to a market economy. It has taken some years to accomplish, but Hungary now has in place many of the institutional arrangements needed to effect the transition.

The combination of accounting, banking, and bankruptcy laws is beginning to make enterprises behave like those in market (rather than socialist) economies. The discipline of having to pay one's bills or be taken to bankruptcy court, for example, is seen to be salutary. The combination of financial discipline imposed at the firm level and fiscal discipline at the macro level (as represented by a hardened budget constraint) is going a long way to make inter-enterprise arrears disappear and adjustment happen.

- Projections, indicators, and contingency planning: Projections and scenarios for countries in transition are bound to have wide margins of error. Moreover, current statistics and indicators do not reveal much about what is really happening in the burgeoning informal economy, or about how much real adjustment—structural and behavioral—is taking place in enterprises and households. Hence more attention should be given to defining and measuring appropriate performance indicators, particularly at the micro level, and better risk assessment and contingency planning is needed to cope with the new complexities and uncertainties.

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