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CONTENTS

REVIEWS

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THE GREAT SHIVERING AROUND THE MILLENNIUM

L. CSONTOS—J. KIRÁLY—G. LÁSZLÓ

Recently several studies and essays have been published in Hungary which are devoted to the "distorted" development of the financial system, and the excessive influence of "money and finance". The purpose of this study is to detect the components of the everyday fears and to confront them with some insights of monetary economics. The study is divided into three parts. In the first one, we analyse the theoretical, methodological problems of the "money dominance proposition", particularly the strong version thereof, and its normative background. The second part reacts to statements which stress the detachment of financial intermediaries from the "real" world, the quantitative explosion of financial intermediaries and monetary aggregates, and their existence as "an independent virtual reality". This section describes the factors that affect financial innovation most strongly, and the functions of techniques and transactions that are often depicted as having a diabolical nature. Explicitly or implicitly, critiques of the financial system often call for stricter regulation or state intervention. Therefore, in the third part we attempt to outline the potential reasons for, and likely consequences of financial regulation—not only the supposedly positive side-effects but also the negative ones.*

A recurrent topic of essays and studies on the international economy has been the shivering vision of mankind's destruction and mental degeneration. In the second half of the 20th century, such an apocalyptic vision was presented in a report of the Club of Rome. This projected slower economic growth, faster population growth, and thus the tragic over-reproduction of humanity. It was followed by denials, then denials of the denials and so forth. Recently, the greatest shiver has probably been triggered by the "virtual financial world" which is organised in a "global phantom structure". According to *Korten* (1996) financial institutions, as economic entities having been originally created to channel resources into productive investments, have turned into a global financial system which is dedicated to robbing taxpayers and the productive economy, and is ruled by exploitation, risk induction and speculation.

It is not at all difficult to find similar quotations, since the topic is among the most popular ones in contemporary essay-writing. Laymen and economists, promi-

*Three of us began to write this paper—however, by the time we finished, László Csontos had left us forever. He could not read the final version, therefore all responsibility falls on the two of us. A shorter version of the study was published in the July issue of the *Beszélő* under the title "Has the financial system degenerated?"

The authors would like to thank László *Antal*, Iván *Csaba*, Erzsébet *Gém*, László *Harmati*, András *Huszár*, Ferenc *Karvalits*, György *Lengyel*, András *Mikolasek*, Péter *Pete*, Zoltán *Szántó* and Balázs *Vedres* for their valuable comments and assistance.

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nent authors[1] and journalists from countries expelled from the world's financial centres, resigned philosophers and enthusiastic activists cover the dead-end development of the financial system. In Hungary, critical voices concerning the financial system's development, the new financial instruments and the excessive influence of the financial world have become especially loud in the past two years. This can be partly explained by the recent and lasting crisis in Hungarian banking, the successive bank scandals and the consolidation. However, the often rather passionate wording is possibly linked to the disappointment they feel over the process and the perspectives of the "Great Transition". Personal grievances, excessive emotions and a belief in the moral finality of criticism often reduce the objectivity of the debate. This approach has entered popular magazines and Sunday supplements, thus it should not be long when most "men-in-the-street" will also blame the money and finance, the bankers and the stock exchange for any worsening in their situation.

Fears and suspicion about the social institution of money are not novel: in the first book of *Politics*, Aristotle discussed when money use turned dangerous for the public. The debates about usury and unrestricted money-money transactions in the Middle Ages, and the writings of modern philosophers about money and freedom, money and equality are all predecessors of the recent "great shivering". Yet, debates about money have always had more than one layer: worries and criticisms of certain financial techniques such as the use of paper money or the termination of the role of gold in international finance often hide a critique of contemporary society, in fact the refusal of modernisation (see, for example, *Frankel* 1977; *Schumpeter* 1955; *Lowry* 1979).

This study attempts to detect the components of the fears, and to confront these with a sort of academic approach. It is divided into three sections. In the *first section*, we will deal with the "financial dominance" proposition. The "*weak*" version of it claims that the actors of the finanacial superstructure are mostly able to assert their interests over those in the real economy, whereas the strong version states that the players in the "real" economy make decisions and act subject to money markets, obeying "the wills and commands of finance". This part will focus on the methodological problems of such explanations and their normative background.

The *second section* will examine one of the pillars of the dominance proposition, notably the statement which claims that the financial system has broken free and become self-ruling. Here, we will generally react to statements which stress the detachment of financial intermediaries from the "real" world, the quantitative explosion of financial processes, and its existence as "a virtual reality living an independent life". We will describe the factors that affect financial innovation most

[1] *Galbraith* (1995) (See *Tamás Bácskai*'s book review (1996)). Keynes, the most influential economist of the century, also had grave reservations towards some, then new developments of money and the capital markets. (*Keynes* 1965, pp. 180–181.)

strongly, and the functions of techniques, and transactions that are often depicted as having a diabolical nature. The presentation of the economic background of these processes is important because, though the debate is long-standing, the analytical tools available have greatly increased in number over the past decades.

Explicitly or implicitly, critiques of the financial system often call for stricter regulation or state intervention. Therefore, we will attempt to outline the potential consequences of regulation—not only the supposedly positive side-effects but also the negative ones. Barriers raised by regulation have made a significant—and often forgotten—contribution to the development of the financial markets, so one must briefly examine these before lifting new barriers. The *third section* will attempt to do this.

We believe that a sorting and a thorough analysis of statements on which debates about the weight and role of the financial system are based should help us to acquire a deeper understanding of the topic. The stable and effective operation of financial intermediaries is crucial for economic development and equilibrium. This fact, as well as the rapid emergence of new financial instruments, do indeed impose regulatory tasks on the government, yet the state's role and the solution itself are far from being unambiguous. However, it has very rarely been so—consequently, these issues require explanation rather than mystical treatment.

The "dominance" propositions

The critics of the financial system largely agree that money and the financial intermediation system have lost their original function, and turned into a "self-ruling", "virtual" world. Some would even add that "economic activities—preserving humanity, and its natural and cultural environments—obey financial power." (*Lányi* 1996)

The proponents of this view insist on asserting that money and finance rule over the real sector or the "real" world in the market economies at the end of the 20th century.[2] Such statements will usually be messy: they do not identify "who" or "what" rules over "who" or "what"; therefore, what we call the *dominance proposition* has a number of potential interpretations. Here, we will examine one interpretation of the above quotations, notably that the rule of the "financial world" over the "real world" involves the sub/superordination of particular actors or groups of actors. The weak version of the theory is seen in the statement that on account of their position, actors in the financial world are generally able to assert their interests against those in the "real economy", even if the latter try to resist such

[2] "In our world, it is the international money market that orders what should happen in a particular industry, country or household." (*Almási* 1995). Similar thoughts appear in *Spitz* (1996) and *Salins and Villeroy de Galhau* (1996).

interests. On the other hand, the strong version of the theory claims that agents in the "real" world are subject to money markets; therefore their decisions and acts reflect the "wills and orders" of the financial superstructure.

We think that the strong version can be neither verified nor refused with empirical or theoretical arguments. There are no such observations, nor can they possibly be produced, which would prove that consumers, farmers, managers of manufacturing companies, civil servants or government members—who should all belong to the "real world"—would always act upon the orders of money and finance. Just like that of the "real world", the composition of the financial world is also rather heterogeneous: even the narrowest definition would include commercial and investment banks, brokerage houses, stock and commodity exchanges, foreign exchange markets, insurance companies, treasury departments of domestic and international firms, institutional investors like pension funds, trust funds, and international multilateral financial institutions (World Bank, IMF, EBRD, etc.).[3] Obviously, temporary relationships do exist between members of these two groups—some important, some less important—but their number and intensity do not verify the "strong" theory. Neither does it follow from theoretical economic considerations that the strong version of the dominance proposition must or should be valid; the advocates of this theory would, in fact, blame mainstream economists that their models do not explain the basic issues arising from the domination of the financial "phantom structure".

The theory of collective decisions offers a possible and coherent theoretical methodology for studying the relationships between financial institutions and political institutions, and between bankers and politicians. This theory, *inter alia*, argues that the conspiracy hypothesis is not really supportable for large latent groups—and the international financial community is certainly one. Such groups are either not able to realise their common interests, or are lucky beneficiaries of changes which have been brought about by other groups (*Olson* 1997). Thus, when attempting to examine *cui bono*? type situations on a solid methodological basis, theoretical reasons must also warn scholars to be extremely careful with the conspiracy theory, which assumes intentional joint action.

If we intend to give rational treatment to views which cannot be criticised with empirical or theoretical arguments, we have to explore the normative background and the methodological roots of the given opinion in order to create the possibility of understanding and rational discussion.

The normative evidence for the dominance proposition employs an attempt to modify the consequences of competition and free market mechanisms by using ethnic, religious, moral, political or other value criteria. This involves the need to adjust the formal-calculative rationality of these markets according to value

[3] A broader definition would also include millions of small investors, who hold deposits, bonds and shares, and are frequently very active participants in the process.

rationality. The ideological roots of the attitude which is suspicious and hostile towards markets and money range from utopian, socialist theories based on value principles through various versions of romantic anti-capitalism, and to the large world religions, particularly to systems which include their economic ethical rules.

Briefly, the formal structure of the problems looks like this: under an important but mostly covert presupposition of economic theory, the preferences of market players satisfy the so-called Archimedes axiom.[4] However, there are preference relations which are different—for example, the so-called lexicographic ordering.[5] Actions based upon value-rational principles mean actions according to lexicographic preferences. In our opinion, the normative support and the rational core in the views of essayists and social scientists who are horrified by the expansion of the "financial world conquering the real world" or at market conditions in general are, in most cases, that they direct attention to the dangerous consequences which result from the apparently unstoppable advance of one-dimension utility calculation, and the corresponding reduction in the possibilities of value-rational action.

This "classic" thought is expressed perhaps most eloquently by a now less frequently quoted author, the young Karl Marx: "Finally, time came when everything that people had previously considered inalienable became an object of exchange and haggling, thus turning alienable. This was the time when even the things which had been shared but never exchanged, given but never sold, acquired but never bought—virtue, love, conviction, knowledge, conscience, etc.—went into trading. This is the time of general corruption, universal venality, or—to use the terms of political economics—the time when everything, whether intellectual or material, bearing a commercial value, is taken to the market so that their exact value can be assessed." (*Marx* 1959)

The same idea is reflected András Bródy's criticism of monetarism: "Therefore, my basic and most incisive objection against monetarism is that it wants to measure everything with money through the mediation of prices. By doing so, it too often ignores the very central issues of mankind." (*Bródy* 1996)[6]

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[4] If the relation "better than" is marked with R, and interpreted as the goods baskets which contain various quantities of goods x and y, then the expression $(x_1, y_1)R(x_2, y_2)$ means that the individual examined prefers goods basket (x_1, y_1) to goods basket (x_2, y_2). The Archimedes axiom states that y has such a y^* $(y^* > y_2)$ value for which $(x_2 y^*)R(x_1, y_1)$ applies. In other words, the direction of the original preference relation can be reversed by manipulating the value of y.

[5] This is defined as follows: we say that vector $(x_1, x_2, ..., x_n)$ is preferred to vector $(y_1, y_2, ..., y_n)$ lexicographically if there is an i for which $x_i R y_i$ holds true, and for every $j < i$, x_j is at least as good as y_j. We can see that in this case there is no conversion between types of goods within the given goods basket; there is no "currency" (money, power, influence, ...) which can be used to compensate the actor for a reduction in the quantity or value of the other good.

[6] The lectures delivered at the conference "Monetarism: Past and Present, Deviance or Normality", which was jointly organised by the Debrecen Branch of the Hungarian Academy of Sciences and the Friedrich Ebert Foundation in Debrecen 31 May to 2 June 1996, indicate that most

If the above reconstruction of the normative background of the "dominance proposition" is valid, then the following question can be formulated: how can one create institutional guarantees which ensure that the presence of economic rationality in the world of law, religion, politics, science and the arts, or even business does not go together with the unlimited predominance of the Archimedes axiom; in other words, where and how can one save some scope for individual action that is based on value-rational preferences? However, we think that this question must be clearly separated from the problem of a general restriction, regulation, or termination of the markets in the name of value-rational principles. The latter problem has a number of different "solutions", ranging from Islamic fundamentalism through "national socialist" ideas to the ideology of a "social market economy", which have, of course, a varying degree of attractiveness for us.

Now, turning from the normative support of the strong version of the dominance proposition to its methodological background, our greatest objection is that the proponents of the view seem to ignore the basic methodological requirements of economic analysis. Economic theory is actually based on methodological individualism, which means a proper economic analysis does not contain—or only as a sort of conceptual shorthand—statements like "money markets don't like, in fact, often don't tolerate that governments exercise their former ... rights", "money markets do not like inflation", or "the money market expects to have certain privileges". (cf. Lányi 1996, p. 6) Personalising entities like markets, bank capital or the international financial world, and empowering them with the ability to act and assert their interests, and with the ambition to seize power frequently rest on a false conclusion. The conclusion claims that any change which is useful or beneficial for a particular group is brought about by members of that group through some concerted action.

Thus, the logical structure of this false conclusion looks like this:

1. y has happened as a result of behaviour, etc. x, which is typical of members of Group A,
2. y is beneficial for members of Group A', which is different from Group A;

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3. so, people belonging to A have been persuaded by members of A'—individually or jointly—to bring about y

Consequently, if the deterioration of the market position of a Hungarian bank is good for competitors, certain political groups or the international "hawk capital", then, according to the above pattern of thinking, one must see the bank run as the result of cooperation or conspiracy of the rival banks, the political opposition and the international hawk capital, no matter what the real reasons for the collapse are.

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presenters—similarly to András Bródy—interpreted the concept of monetarism as the "domination of the money-world", which is in stark contrast with the term's content and its conventional usage in international economics.

The greatest methodological shortcoming of the dominance proposition is—as we see it—exactly this process of thinking—notably the uncritical acceptance of the conspiracy theory of social action.

Korten's study (1996), quoted above, attempts to lay down the foundation of the strong version of the dominance proposition. He claims that one must be aware of the way with which the issue of economic globalisation[7] has been put—or rather manoeuvred—on the political agenda, almost completely bypassing social dialogue. According to Korten one should not think of a secret meeting of a narrow élite, who contrived a plan to conquer the world, It is more like a process of establishing a network or a common culture, where we can observe the emergence of alliances between individuals and groups. That is, Korten asserts, that there is no conspiracy at all, though the consequences seem to point towards the existence of one.

Korten attempts to provide his statements with a more precise theoretical basis. However, the text eventually concludes that the foundations of the rule of the "cloud-walkers" and "hawk capital" are to be found not in concrete interactions or bargains—as methodological individualism would require—but merely in the existence of a common culture and common interests. However, as long as Korten's statements cannot be deduced as voluntary or involuntary consequences of human actions, the categories he uses cannot be interpreted logically or empirically. Since the institutions or the agents of joint action and joint interest assertion cannot be identified precisely, the only and methodologically wrong solution is backward deduction from presumed common interests and benefits.[8]

The proponents of the weak version of the dominance proposition formulate their conclusions in a less general form. Examples for this version may be found in several economic sociological studies, which usually examine the rule of banks or bankers. Some of these satisfy our methodological requirements, and may well complement economic analyses, yet we have not come across any writing that would have reasonably verified the weak version of the theory—notably, that the actors

[7] "Economic globalisation is the basis on which the new capitalist colonial empires are built. The proponents of capitalist libertarianism argue that economic globalisation is going ahead as driven by unchangeable historical forces, and we have no option but to adjust to the situation and to learn to compete with our fellow human beings. This is a bold lie, which brazenly denies the well-organised, generously funded and ambitious efforts of cloud-walkers (Korten's metaphor to denote the architects and the beneficiaries of the new economic world order—*The authors*) at demolishing national economies, and erecting the institutions of a global market. (...) we will examine how they imagine this process and how they have taken to its implementation." (Korten 1996, p. 143)

[8] Kamilla Lányi writes: "(the money market) expects to have certain privileges, (...) wants or is able to impose its interests on others (even by making others find out its desires), and (...) it cannot be held responsible." (Lányi 1996, p. 6) It is not far then to interpret news about corrupt bank managers or the renewed bank consolidation as proofs of the overall rule of the money-world.

of the "money-world" can mostly assert their interests against other actors, even if the latter try to resist.[9]

The branch of economic sociology which deals with relationship networks examines the allegedly central position of banks within economic institutions. The hypothetical central position exercised through ownership or delegation of officers was proved in some countries but not in others. Using figures available about today's Hungarian economy, the existence of such a central role cannot be clearly supported as Hungarian banks primarily tend to delegate officers to each other.[10] Neither does any evidence of central network position mean control or regularly imposed bank intentions but only a large number of concentrated relationships.

Research into social structure, more specifically into the economic élite, also provides interesting data for the verification of the dominance proposition. The analysis of the position of Hungarian bankers indicates that while there is no denying of the privileged position of bankers, there is no evidence which would also confirm the dominant power position of the group. (*Lengyel and Bartha* 1997) These economic sociological research works do not support the validity of the dominance proposition, even though they attempt—several times applying appropriate methodology—to identify the networks and the cultural elements in which the authors who we have quoted earlier seem to discover the overall rule of money and finance.

The selection of top managers of banks in state ownership or under state control is strongly subject to politics. In some countries such as Austria, an implicit but acknowledged tradition divides control over banks between various political parties. This structure, which has plenty of disadvantages, may simplify the observation of how parties compete for funds and influence. Yet this is exactly the reverse of the dominance proposition, with political power gaining economic influence.

A divided, or scattered ownership structure may improve the manoeuvring opportunities and the interest assertion ability of bank managers. Here, owners have difficulties in coping with the already mentioned failures and traps of collective action. If the management successfully stands up for its interests, stalemate

[9] *Mintz and Schwartz* 1985; *Swedberg* 1989. A frequent misrepresentation in sociology and literature is the description of the borrower as the defenceless man-in-the-street and the lender as the dominant partner. However, many of those who are exposed to the bank are depositors themselves—that is, lenders to the bank. One must also mention the dislike that well-known novels and films teach us from childhood onwards which, in their description of the privileged and dominant position of bankers, usually stress their unavoidable mental distortions or some blemish in their previous lives. Take, for example, Shylock from Shakespeare's *The Merchant of Venice*, or Baron Danglars in Dumas' *Count of Monte Christo*. This is what explains the extraordinary success of *Ogger*'s *Bankers* (1995) both in Hungary and Germany. Typical chapter titles are: Account Robbers, Money Abductors, Fleecers.

[10] See *Vedres* (1997). Incorporating lending conditions should improve the explanatory power of these empirical studies.

situations may emerge—that is, politics and the managers of the particular bank may end up grasping each other's throats.[11]

The actual interest-asserting, influence-seeking and rent-seeking activities of individual banks can be empirically verified with case studies and anecdotal evidence. Several Hungarian and foreign examples indicate that the concrete explanation for the sizeable influence of particular banks and bankers usually lies in the practice of unjustified advances, or the dispensing of funds—which may target political parties, the media, etc.,—or, in a broader sense, in the bank's ownership structure or its decisive share in the money and capital markets ("too big to fail"). Reciting the dangers of a "global phantom structure" may well serve to distract attention from things that are happening right in front of our eyes.

The myth of the unrestrained monetary world

A typical description of money and finance becoming virtual and unrestrained argues that "the flow of money has become entirely detached from the flow of goods: it has an independent life, a circulation separate from the world of goods, which is much larger than the value of goods volume"; where the money market "is a superstructure above the economy and the society: it has broken loose from the world of goods, the production of goods and services satisfying human necessities." (Almási 1995, p. 39)[12] These ideas show that explanations of autonomy or self-rule usually raise hazards associated with dimensions, the dematerialisation of money and the inoperativeness of the real economy.

The increased autonomy of the financial sector is a fact of life which, in our opinion, can be explained by the increased importance of the basic functions of the financial intermediation system, and the inevitable failure of certain regulatory attempts. The process follows from structural changes that have taken place in modern economies over the past few decades. Therefore, this chapter will deal with the evolution of money and the financial intermediation system, the hypothesis about the changed nature of money, and its background. Our examination will focus on intermediation and transactions—that is, whether the intermediation of goods, resources, services, or information is something that we consider crucial for understanding the financial world. In our opinion, the basic function of the financial system is, on one hand, to facilitate the allocation of resources, and, on the other,

[11] *Várhegyi* (1996). See *Laffont and Tirole* (1994) Chapter 17 and *Dewatripont and Tirole* (1993) on the role of ownership types, and the games between managers and owners.

[12] Mária Augusztinovics expresses a similar thought: "An oversize parasite financial structure rules over the economy. The production of goods and services has become of secondary importance, where capital can move across borders quietly but fast, seeking cheap labour." (*Augusztinovics* 1996)

to allow the flow of information over space and time. It alleviates conflicts within the economic system, reduces social deadweight losses, and creates social value by increasing efficiency. The main elements of the financial system are: money itself, the payment system, money markets and capital markets. (*Tobin* 1992a, *Merton* 1990). We will deal with these components in the following paragraphs.

Evolution of money: the standardisation of money functions and the dematerialisation of money

In the earlier stages of social development, money functions were often fulfilled by separate tools and activities. The evolution of money from goods money through money substitutes up to modern money has actually been the history of the standardisation of money functions—that is, the emergence of a single tool (*László* 1997, *Kohn* 1997). Numerous writings on economic history, economic sociology and anthropology have studied archaic economies which use money not in its today's form and only to a limited extent. Although such studies aimed at the analytical presentation of cases where unusual but operative "human" integration forms, behavioural rules and norms existed; these studies mostly focused their attention on static societies and economic systems which had a limited capacity to develop.

Identifying money functions posed a great challenge for "modern" economic theories.[13] It is easy to see that money is not needed in a completely friction-free society. In Walras' equilibrium theory, money did not have any significance or value: the models only incorporated it as a unit of account. The theory of liquidity preference—based on Keynes and Hicks—treated money as an asset with zero nominal interest rate risk. In this sense, other functions of money have lost importance, and the price of money solely depended on the demand and the supply of the given asset

Since the 1960s both conventional approaches have been under fierce attack, with critics arguing that the concept of money will become empty if its basic

[13] The story of the "two Robinsons" is one of the best-known fables for demonstrating the essence of money. Living on the same island, the two Robinsons agree to take turns in cooking dinner. As they are absent-minded, they often forget who is cooking next. Finally they find a nice opal stone, and agree that the guest will always leave the stone with the host, who can use it the next day to prove that he is the guest. The story contains an imperfect information situation (there is no reliable information about who the next cook is), a temporal transaction friction (you can only pay for today's dinner with tomorrow's dinner), and, as a solution, something that might even be called money, which simultaneously acts as a unit of account (1 dinner = 1 stone), a medium of exchange and a means of payment (given in exchange for dinner) and store of value (up to the following night). Its introduction into the model economy has reduced transaction costs (time used for quarrelling is saved), and everybody attributed a positive value to it. (*Ostroy and Starr* 1990). The study provides an almost full picture about the development stages of money theory, detailing the conflicting features of money theory models.

functions—particularly as a medium of exchange and means of payment: that is, transaction costs—are ignored (Tobin 1992b; *Weber* 1986; Kohn 1988). Different approaches with respect to the theory of money usually assume different constraints and frictions in an attempt to prove the necessity of money with positive value. The arbitrary assumptions of earlier approaches could be best corrected by modifying the information structure of the basic model: it can be proved that imperfect and asymmetric information distribution are necessary and sufficient assumptions for the existence of money with positive value. The next stage in the development of the theories was the incorporation of "non-standard" explanations such as adaptiveness and animal spirit. Thus, the development of the theory of money is nothing but an increasingly precise and sophisticated answer to—using Armen Alchian's words—the question of "why money?", and this process is unfinished insofar as there is no final agreement on the exact nature of money functions and their interrelationships.

In the above approach, it does not at all matter whether money is an opal stone, a piece of paper or a computer record. We can completely agree with Miklós Almási: "Money has turned into a token. Token money is only a metaphor; as a matter of fact, money has become an electronic sign, which appears at various points of the screen as a number." (Almási 1995) However, while Almási sees this transformation as the "death" of "real" money,[14] we would rather agree with the American future researcher Toffler, who thinks that the essence of 21st century money is that it is becoming what it really is, namely information: "The money of the Third Wave is a physically non-existing thing created by electronic impulses. It allows immediate registration, ongoing control and undelayed reaction, and it exists almost exclusively on computer screens. Yes, .. the money of the Third Wave is the Information itself—the basis of knowledge". (*Toffler* 1993)

Economists are also concerned with issues related to the technical development of payments and the dematerialisation of money. Still, the hypothesis of the separation of "real" and "fictitious" money refers to a relevant monetary theory problem that has been created by the historical evolution of money—notably, that the value of money was separated from that of the money's material. We all know that medieval monarchs tried to channel the wealth of their subjects towards themselves not only by minting but also by curbing money. The transformation of money into a money sign has been a natural consequence of the more effective operation of money functions, and the reduction of the transaction costs. One of the oldest and most fundamental questions of the theory of money does, in fact, arise from this problem: if the value of money is separated from the value of its material, what guarantees that anyone who accepts it can exchange it later? One possible answer

[14] "... but it has already lost all of its original qualities ... This metamorphosis, or hermaphrodite fictitious real money is the most important and the most dangerous invention of new capitalism." (Almási 1995, p. 41)

points to the power of the state: the state may order that a medium must be used as a means of payment. The other possible answer builds on the trust of the society, the individual decision-makers: "I will accept the money because I trust that others will also accept it". Today, money is issued by government through central banks, yet we cannot neglect the second criterion. Paper money issued to finance wars in the 19th century, for example, generally ended up causing hyperinflation and devaluation. In these cases, governments, in the absence of proper guarantees, were not able to continuously enforce the use of the given legal tender because economic actors did not accept or use it for economic or other considerations. These situations also showed that economic actors themselves will solve their problems of payment, exchange, or settlement—at higher welfare costs though—if governments fail to effectively manage "money".[15]

The transformation of money into a monetary signal and the development of financial institutions have also raised the problem of whether the different money functions need to be united in one object in the future; thus the unit of measurement or account and the general medium of exchange may be linked, or these functions may break away from each other (White 1996). In the 1970s, Fischer Black and Robert Hall outlined a future financial system in which the financial intermediaries competed with their services, including the issuance of means of transactions. In their system there is no "outside money" whose exchangeability is guaranteed by the central bank or the government, only the *numeraire* is fixed centrally. Here, money in the traditional sense disappears completely, some of its functions cease to exist, and others are taken over by other means, just like in the visions presented by the critics quoted above.[16]

This idea may be doubted from various aspects. One may show the higher information and transaction costs of such a system. If somebody tries to sell their bond in this system, what will be the qualities or functions the media accepts in exchange or as payment? Further on, analysts may arrive at the conclusion that since this theoretical system is based on market conditions, the market, moving towards increased efficiency, will eventually reintegrate money functions into "money". Another argument may focus on the evolution of money, showing that

[15] This issue is linked to another very old debate, which questions the justification of the money-issuing monopoly of the state. (*Goodhart* 1985, *White* 1984).

[16] In his study published in 1970, Fischer Black examined what would happen to payments and money use if state regulation over the banking system were abolished. In his hypothetical exchange economy, the unit of account is the dollar, but this dollar has been fixed with a goods basket. Later, the means of payment can also be determined in this unit, but not necessarily. Following in the footsteps of Black, Robert Hall analysed the price changes of earlier decades so that he could identify the goods basket of the most stable value to fix the *numeraire*. (White 1996).

outside money is unlikely to die out in the foreseeable future as decision-makers cannot be realistically expected to make such a decision. (White 1996)[17]

The numerous functional and empirical differences between today's money and money, say, fifty years ago are indeed remarkable, and it seems reasonable to analyse changes in money functions along these lines. At the same time, we think that the distinction "virtual-real" is misleading. The primary distinction between today's money and that of earlier times is not its material or "realness" but, for example, the rich variety of media and mechanisms fulfilling money functions.

Not only average people but also financial statisticians find this abundance difficult to manage. This is the reason why another argument is closely intertwined into monetary theory debates, which questions the "realness" of today's money on the basis of its insufficient statistical consideration. The theoretical debate about which instruments must be considered as money has been going on since the 1950s. The debate is based on the assumption that if we cannot exactly measure what people use as money, the regulatory authorities will not be able to operate its regulatory function, therefore its monetary policy will be inefficient. However, this debate has little to do with functions of money and the nature of financial intermediation.[18]

Financial intermediation and the evolution of financial markets

The authors who enlist the dangers of the the "financial superstructure" do not generally focus on money but on other important structures of the financial system, such as the financial markets, the financial intermediaries and the derivative markets.

The traditional functions of money and capital markets include the pooling and distribution of resources, the transformation of maturities and risks, and the reduction of the transactional and informational costs of economy. The efficient operation of money and capital markets is not only a precondition for stable, long-term economic growth but, in a modern market economy, it is inseparable from the giving of answers to the most basic problems of the most average people. There are three fundamental problems in human life:

[17] The theory of collective action has, of course, been able to show numerous suboptimal situations; however, in this situation it is probably the inertia inherent in the actions of large latent groups that ensures the survival of the more efficient state. As long as no drastic intervention is made in the operation of the market system—and this would contradict the purposes of these authors—attachment to external money continues to exist, as do the benefits that arise from the fact that money simultaneously fulfils the functions of a medium of exchange and the unit of account.

[18] As long as the monetary policy begins to act after "getting familiar" with figures.

1. old-age security, which is impossible without long-term savings and autonomous pension funds;

2. housing, which requires long-term loans—that is, mortgage lending;

3. education, which requires the incorporation of long-term loans into financing higher education.

Economic theory has long been debating what performs these tasks better: the market (which is perpetually reallocating resources), or the state's control (which is based on some "social contract").[19]

The allocation mechanism of financial markets usually produces efficient distributions. The deeper and "more fragmented" the markets are, in other words, the more media there are available between the two end-points of the same mediation chain, the lower social costs, and the smaller deadweight loss these solutions entail. A good example is the recent changes in the structure of mortgage markets. In an economy without capital markets, people build or buy houses using their own personal savings. In the initial phase of the development of the capital market, such resources were provided by mortgage loans, financed from the savings of families in the given community. Following the development of the mortgage markets, today, loans for buying houses in some developed market economies are made available by financial intermediaries outside the banking system, and these intermediaries are financed by investors whose activities focus on the mortgage-backed security market. This process—which leads to a reduction of social operating costs through the grooving of the market and the multitude of available paths—does, indeed, appear as an increase in the autonomy of the financial world, where events on the secondary mortgage market are apparently not linked to the people who wish to solve their housing problems.

Mária Augusztinovics is certainly right in arguing that "... you have the impression that the economy consists of Dow Jones and other indices jumping up and down, and running electronically around international stock exchanges from New York to Frankfurt, from London to Tokyo. Production, technology, construction, consumption and similar negligible matters are hardly mentioned. It is shattered currencies or large scandals on the money markets that become news." (Augusztinovics 1996) The explanation of this phenomenon is that the operation of these—seemingly oversize and self-contained—markets generally reduces the social costs of production, technology, construction and consumption. Anyone who wishes to restrain the emerging institutions or their operating mechanisms must remember

[19] Summaries of this theoretical debate are provided by Augusztinovics (1987) and Király (1989). However, even the criteria of qualification (what is "better"?) are subject to discussion: the problem which was shown by a contrast of value-rational criteria and the Archimedes axiom in the previous section resurfaces. Here, the actual dividing line runs between the acceptance of Pareto optimality, a basic criterion in economics, and efficiency, and its rejection. The authors—as it might by now have been noticed—see Pareto optimality and the corresponding efficiency as practicable criteria.

that, apart from the expected favourable consequences, the damage done to these functions results in higher social costs and a larger deadweight loss.

The emergence of ever newer segments in the financial markets is not an end in itself but a development intended to increase the efficiency of the real economy. Due to large-scale deregulation, financial innovations, the explosive development of information technology, and the appearance of new products and new actors in recent years, similar processes can be observed in all segments of the financial world. A common feature of these developments is the removal of national borders and barriers between financial "industries" such as insurance and banking, and commercial and investment banks. Functions which used to be fulfilled by banks only are partly being taken over by other business organisations; regional financial markets are being replaced by virtual markets existing on computer networks; moreover, with gradually expanding possibilities of arbitrage and speculation, and increasingly sophisticated risk management techniques, essentially information and contingent claims are traded on the global financial markets.

Economics has provided four main explanations for the financial innovation process:

1. the demand for the completion of the market, which is aimed at the elimination of barriers and gaps in the spreading and consolidating of risks, the regrouping of resources over time and space, and the introduction of new, stop-gap institutions;

2. the possibility of reducing direct transaction costs;

3. increasing the liquidity of certain instruments and the position of their holders;

4. the possibility of reducing "principal-agent"-type information costs and frictions; these are costs which arise from the asymmetrical information situation, and the observation, supervision of the other party involved in the transaction (Merton 1990; *Allen and Gale* 1994; *Diamond* 1996; *Fama* 1996).

While the instruments of financial markets reduce transactional and information costs and alleviate the frictions of the economic system, they inevitably bring about new types of friction, arising from the imperfect and asymmetric information situation of market players. While the intermediary organisations on the financial markets such as banks, mutual funds, investment banks, etc. seem to increase intermediation costs with their interests, fees and faults, they actually reduce these information inequalities, and the social deadweight loss resulting from non-optimal observation. This manifests itself for the individual decision-makers—for example, small investors who face lower risks with respect to decision-making.

To understand the essence of derivatives or futures markets (which are so often blamed by the critics of the financial system), we must return to imperfect information provision: the point of the futures markets is that they efficiently transmit future prices to today's decision-makers, thereby reducing the risks involved with decision-making. These instruments were not invented by theoretical

economists or mathematicians as, contrary to popular belief, derivatives are not at all new: option contracts, similar to the present ones, were widely used at the Amsterdam stock exchange back in the 17th century.[20]

The instruments of the derivative market also allow the individual decision-maker to reduce the risks of a certain decision-making situation. Again, we should think about solving the most everyday problems of the most average people. During their lives, people are continuously accumulating wealth which imposes limits on their possible decisions. If the value of this accumulated wealth is fluctuating because of market price movements, the lack of full information about the future makes the decisions suboptimal. Essentially, derivatives allow decision-makers to reduce fluctuations in the value of their accumulated wealth and to "cover their positions". Thus, the derivative markets perform the same function as financial intermediaries: they increase the grooving of the market, thereby reducing the risks of individual decisions. While in the new situations new, different risks will inevitably emerge for individuals, institutions and communities, the question is: what is the relationship between benefits and costs?[21]

The financial evolution cannot obviously be considered a monotonous process since, from time to time, it has been interrupted by institutional changes which have brought about deep changes in the operation of the financial system. Each of these changes, such as the appearance of money substitutes, the end of the gold standard system, and the removal of the dollar's convertibility into gold, caused much concern. Today, it is mostly the expansion or the dominance of derivative transactions that gives rise to concern and towards which criticism is aimed. Earlier, we have said that the basic function of money and financial intermediation was to reduce the information and transaction costs of transactions at different points of time, production and the selling processes. It is this function in which derivative transactions complement traditional money use.[22]

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[20] See Allen and Gale 1994, p. 13. This stock exchange operation gave birth to the generalisation of the general equilibrium theory model, and its temporal extention: if a friction-proof situation is supposed both in space and time, all spot and futures markets of all products will operate efficiently, and can perfectly transmit information on the basis of which economic actors can create a Pareto optimal distribution state by making optimal decisions. By giving up the friction-proof state, the temporally single world falls into sequential partial economies, which already necessitates the introduction of "money" to reduce temporal information imperfectness. (*Hahn* 1971)

[21] For example, imposing the requirement of deposit insurance (which is mostly justified) may cause depositors to devote less energy to observing their bank (which can lead to management abuse). (*Harmati, László and Zsámboki* 1997)

[22] The institutional economic revision of futures transactions, money-money transactions and money functions in general, is an important task. With regard to this issue, readers are advised to consult Allen and Gale (1994) and *Richter* (1989).

Quantity of money and the size of financial transactions

The authors who have called attention to the dominance of the financial world do not think that the emergence of the institutions is the most dangerous factor, but rather its size. In their opinion, it exceeds the optimal level. As Kamilla Lányi writes: "It is true that contemporary economies would not be able to operate without financing, savings, financial intermediation, but we have already shown that the dimension of money markets is far larger than the economy would need." (Lányi 1996)

The expansion of the fianncial and monetary world is a fact, though not only a fact of these days. Based on figures from 1900 to 1949, Gurley and Shaw, who researched the financing capacity of the economy and the nature of money in the 1960s, pointed out that the total value of financial assets had grown one and a half times faster than the national income, and the value of financial assets owned by financial intermediaries also rose by one and a half times within total financial assets. A fast expansion of banks, and an even faster development of non-banking intermediaries are evidenced by the fact that "the banks were growing faster than the national wealth and the national income, but lagged behind the general development of the financial sector". (*Gurley and Shaw* 1955, 1960)

In 1984 R. W. Goldsmith, the best-known statistician of American wealth accounts, found that the economy's real wealth was $ 13,500 billion, while financial wealth—including the actually real capital and shares not representing debt—amounted to $ 14,800 billion. (*Goldsmith* 1985). Considering these figures, we may conclude that it was not the size of the market created by the appearance of derivative markets that is remarkable but the rate of expansion was high: the notional value of the stock exchange derivative market rose from $ 620 billion in 1986—roughly at the time of Goldsmith's research—to $ 9,200 billion in 1995. Thus, while in 1995 the total stock was still below U.S. real wealth of 1986, the average growth rate was 35 percent—higher than any earlier growth rate of the stock. However, growth potential expressed in the growth rate is deceptive. Today, we already know that after the initial soar, which was a natural consequence of the small quantity, growth slowed down to merely 3 percent in 1995. (*Table 1*).

The figures quoted in the previous paragraphs are often compared by the critics to the GDP[23] of the country, or even that of the world, pointing out how many times larger is the monetary turnover of the "useless" monetary economy than production actually requires. Two optical illusions may be discerned in these comparisons.

One remarkable fact is that GDP only measures the value added created in the economy in the given period. The annual total output of the economy—i.e. the total value of the economic transactions in one year—is a multiple of the GDP.

[23] We could use GNP instead of GDP, however, this distinction is irrelevant here.

Table 1

Selected derivative financial markets (notional value, in billions of USD)

	1986	1990	1994	1995
Interest rate futures	370.0	1,454.5	5,757.4	5,863.3
Interest rate option	146.5	599.5	2,623.5	2,741.6
Foreign exchange futures	10.2	17.0	40.1	37.9
Foreign exchange option	39.2	56.5	55.5	43.2
Stock index futures	14.5	69.1	127.3	172.2
Stock index option	37.8	93.7	238.3	326.9
Total	618.3	2,290.4	8,862.5	9,185.3

Source: *Szalai* 1996

If we compare trading figures to GDP (which are closer to total transactions—for example, the annual number of contracts in the derivative markets), we will naturally find that they are multiples of GDP. In the case of stock exchanges, the problem is even aggravated by the fact that the number of transactions involves cumulation: trading and positions are recorded for each of the participants in the transactions.

The second optical illusion, which influences public opinion much more, arises from the comparison of flow and stock variables. It does make a difference whether one measures the size of the banking system as the share of total banking assets to GDP (it is roughly 200 percent in developed countries), or as the share of GDP generated by the banking system to total GDP (which is below 20 percent). If, then, we conclude from the first ratio that the banking system was too large compared to GDP and consequently must be restricted, we make a rather serious mistake. Probably due to their imprecise wording, this is exactly the mistake that critics of the money-world have made: according to their argumentation, a flow variable—GDP produced in one year—should constitute a kind of ceiling to the excessive growth of a stock variable (market size). Market size is an asset-like variable and, if seen from this perspective, only a portion of total assets is embodied in assets produced by the money-world. Due to the growth of assets, this does indeed account for an ever larger share of annual GDP.

We assume that the real problem of the critics is the internal restructuring of wealth: indeed, an ever larger share is represented by financial, rather than real wealth, and the weight of wealth embodied in derivative products within total financial wealth is rising. However, comparing a term deposit or a share position and a derivative position is not without problems either. If we are to measure precisely, wealth should include not the notional value for derivatives but only the value of the capital at risk. Following on from the market's net settlement principle,

it is the market value, or the reproduction value of the position, which is estimated at 5–15 percent of the notional value.[24]

Based on what we have said in the previous section, we consider the shift of wealth towards financial wealth to be a positive phenomenon, rather than negative—that is, negative for those who see dangers in the process. It is a positive phenomenon because it means the increased efficiency of market intermediation and a reduction in total social costs. Furthermore, the main argument of critics is that the money-world is "too large". They seem to think that there is an "optimal" size which has already been exceeded by the burgeoning money-world, thus becoming self-contained and siphoning off power from the real economy. We should admit that we cannot ascertain optimal dimensions. We do not know what size an optimal banking system is. We do not know what size an optimal derivative market is. We believe that these magnitudes are more like signs: they do not tell whether something is "much" or "little", that it is functional or dysfunctional.

The problem of the quantity of money and the size of financial intermediation is not new in the history of economics. The best example is the debate about the determination of "optimal quantity money". Early economic studies often dealt with the level or quantity of money accumulated in a country. The authors, labelled mercantilist, liked to stress that increasing the money supply in a country must be a key political objective, while Smith and his followers saw this as a narrow-minded approach.

Later, the issue of optimal quantity of money was connected to the question of inflation. The theory which links the value of money not to its production and selling costs but to its quantity—called the quantity theory of money—has existed for centuries. Attempts at regulating the optimal money supply are frequently found in 20th century theoretical writings as well, but every constructive rule has generated problems.[25] The development of the theory has finally produced a negative result: no constructive rule can be provided for determining the necessary quantity of money, and there is no such controllable mechanism which would guarantee the regular release of the necessary money supply.

Later, monetarist economics gave up trying to determine the optimal quantity of money, and rather it attempted to identify the supposedly optimal equilibrium level by forecasting money demand and money supply. Apart from monetary aggregates, monetarist economics tried to forecast monetary processes through prices and liquidity, and their ever finer measurement.

The critics of the financial world usually employ direct indicators, and their writings suggest that there is "useful" money and "useless" money. By continuing

[24] For example, according to a BIS survey, the nominal value of contracts on the OTC markets was $ 40,700 billion in March 1995, while the gross market value amounted to $ 1,700 billion only.

[25] One of the most recent was Friedman's rate X rule.

in this direction, one may well arrive at the basic question arising from the methodology of socialist political economics, namely "Do or do not tills contribute to the increase of the national income?" We do not think that this approach will lead to positive answers.

Lower intermediation costs, margins and fees will only appear in liquid, sufficiently deep markets; these, in turn, require growth in market size. If the depth of a market is measured by the number of offers or bids below or above current market price, then new information which shifts the price from the current level will result in large price swings in "shallow" markets. This is because there are few offers or bids near the current market price. Price changes are hardly noticeable on international foreign exchange markets, which suggests that the market has depth.[26]

The global foreign exchange market is probably one of the world's most liquid[27] and thus most efficient markets, where information flow is free and transaction costs are low. A change in the price of futures products on this market reflects information about the future, and is independent of present price changes (unless they carry information about the future as well). Information which will be new tomorrow, and which will determine prices tomorrow cannot be forecast with great certainty in a scientific way; as a consequence, an efficiently working market cannot possibly be influenced.[28]

One or more speculators would stand a good chance of influencing future prices if they could move around such a purchasing power on the given deep market which guarantees them a dominant position. On account of the dimensions of the foreign exchange market, rarely has a single business group had the chance to do that. The other possibility to influence prices is if several actors have identical expectations, and they make transactions accordingly. As a consequence of difficulties in coordination and cooperation, this has mostly happened in the recent decades when governments have tried to stabilise the value of the target foreign exchange detached from its real value at a higher level, and the action finally put an end to this artificial situation. This indicates that the markets of such financial

[26] The global foreign exchange market is the world's most liquid market, which means that positions can be opened or closed at the fastest rate without affecting the current market price. Anybody can initiate transactions 24 hours a day in all major currencies. Although multi-million dollar transactions are quite frequent on the global foreign exchange market, the market is so large that these transactions do not exert a significant influence on current exchange rates either.

[27] Kamilla Lányi writes: "In 1995 the daily trading volume stood at USD 1,300–1,500 billion." (Lányi 1996) Essentially, this market only includes foreign exchanges whose conversion is free, and which are relatively unrestricted and cheap to move.

[28] The logical impossibility of such a forecast was indicated by a famous jazz musician who, answering the question "Where do you think jazz will be in twenty years", said "No idea. For if I knew, I would already be there."

liabilities cannot be fundamentally and permanently separated from the operation of sectors whose products or assets these liabilities directly or indirectly refer to.[29]

The expansion of the market size is generally accompanied by an increase in efficiency, and market liquidity reduces the volatility and distortions of market prices. Price volatility is a reliable signal of market size: large volatility is likely to signal a shallow market, and insufficient liquidity. However, there are certain barriers to the increase of the depth and efficiency of the market parallel to market growth.

One problem is "if market actors do not recognise the positive benefit of increased liquidity that their market entry would induce, they will possibly not enter the market in fear of illiquidity. Thus, a "shallow" market cannot become a "deep" market even though the market entry of actors would improve Pareto efficiency" (Hahn 1990). So, actors are caught in a trap, and only intervention or learning can lead to increased efficiency.

Another problem results from the method of gaining information. Keynes ironically remarked that Americans active on the stock exchange were trying to acquire information not about the object of investment but about what the others would like to see, just like judges at a beauty contest (Keynes 1965, p. 181). However, the direct acquisition of information on the securities market does not pay off for some actors, so they like to resort to prices, and obtain a free ride from those who invest in information. Thus, prices not only contribute to market cleansing, and the coordination of demand and supply, but also provide information (*Grossman and Stiglitz* 1976). The new actors can be either information investors or ones who do not want to spend on this, so their entry does not necessarily deepen the market.

Problems may arise when the growth of the market size makes it profitable for some actors to apply product differentiation—thus the market becomes segmented, with exclusive positions emerging. Moreover, on markets with information inequalities, where the ability of actors to process and evaluate information is limited, any growth in the number of actors may worsen communication, leading to fragmentation and increased price volatility. On a smaller market with similar conditions, actors would have fuller information, their relationships would entangle the market better, and thus price volatility would be reduced. (*Baker* 1984)

In terms of liquidity growth, it is important that such actors should enter the market who refuse risks less, are willing to take on extra risks in the hope of high returns—in other words, speculators appear on the market. The emergence and the expansion of speculation increase market liquidity (and thus its efficiency)

[29] This balancing function of speculation is mentioned by Miklós Almási (Almási 1995, pp. 34–35). Obviously, appropriate tools, international regulation and intervention agreements must and can be used to fight speculation which points in a reverse, unhealthy direction. We also have to add, however, that over-regulation might prevent the occurrence of the balancing itself.

and reduce social costs; while, on the other hand, due to the greater propensity of speculators to take risks,[30] the market becomes more fragile, with a greater probability of speculation bubbles emerging (*LeRoy and Gilles* 1990). The speculation bubble is the appearance of a factor in the market price which cannot be explained by fundamental factors such as expectations concerning the present value of future returns. The size of the price bubble is "justified" by its future value—in other words, prices are high because the actors expect them to be even higher.[31] Thus, the bubble is swelling in a self-induction process.[32] Today, the "bubble theory" can determine certain special conditions as to when arbitrage abolishes bubbles, or when a bubble converges to an equilibrium state; however, these results are not sufficiently robust. Our current knowledge about the birth and survival of bubbles is rather little, even though a survey of these would also be required for the economic analysis of financial instruments. We know of price bubbles, but we cannot even show them precisely (because the measurement tools are wrong). We know that bubbles will "burst" under certain conditions, but we cannot precisely determine the necessary and sufficient conditions.

With market fragility the probability of price bubbles may increase parallel to the growth of the market size. Such bubbles may cause problems in an increasingly autonomous and self-ruling financial system. The question is: how serious are these problems and what social costs do they entail? Then there is another big question: what regulation tools are necessary to avoid them? However, before dealing with the dilemmas of regulation, consideration must be given to the impacts that financial processes have on the real economy.

The impact of the operation of the financial system on other economic sectors

"The real economy suffers from a capital shortage, while the financial sector has excess capital", writes Miklós Almási. This means that the financial world has not only lost its original function of transferring capital from economic areas

[30] Fear from speculation is not new either: in the *General theory*, Keynes expressed similar thoughts: "As long as businesses are progressing favourably, speculators will perhaps not cause larger damage than the bubbles. The situation turns serious if the business becomes a bubble in the vortex of speculation. If the development of a country's capital becomes the by-product of the operation of a gambling casino, speculation would not really do a good job." (Keynes 1965, p. 181).

[31] Expressed formally (simplified): $p_t = NPV[E(d_{t+j}) + b_{t'})]$, where $NPV[E(d_{t+j})]$ is the net present value of future return (dividend) expectations, b_t is the price bubble which is described by the following stochastic difference equation: $b_t = E(b_{t+1})/(1+r)$.

[32] The bubble is not a product of modern markets. For the description of the world's most significant bubbles—such as the infamous Dutch tulip bulb bubble or the South Sea Company bubble—used as a standard textbook example, see *Kindleberger* (1978).

with excess capital to those with a capital shortage, but it is actually functioning in a contrasting way: it hinders economic financing by spending the funds, which are sources of this financing, on maintaining its own self-ruling operation. As a consequence, actual, real economic needs are left unsatisfied due to the absence of financing. It is an illusion to think that resources appearing in the financial system can be converted to other places because they are primarily market products, created by the market itself. Channelling may be possible in command economies (though in a fragmented way only) but not in market economies. The resources used for this purpose are likely to be lost by way of an administrative restriction, to say nothing of the welfare costs arising from the absence of unfulfilled functions.

Following the development described in the previous sections, the theoretical description of the relationship between the financial sector and the real economy, the so-called "transmission mechanism", was also in constant transition.

In the Keynesian theory, money affects the real economy indirectly through the interest rates.[33] In the monetarist description of the transmission mechanism—since institutional factors make the velocity of money foreseeable in the long run, and since the real economy's performance is basically determined by technological factors—changes in money supply will principally result in price changes. The monetarists stress that factors which determine the long-term growth rate of the real income are independent of the long-term growth rate of the money supply as long as the economy is following the normal routine. "A close link between a change in money supply and a change in other economic variables does not tell anything about their origins or the direction of influences. Monetary variables may dance to the tune of independent changes in other economic variables, but changes in the income and the prices may equally well dance to the tune played by independent monetary changes; the two may be interactive, while both (...) dancing to a tune whistled by a third group of effects." (*Schwartz and Friedman* 1963, p. 48) If several time series move together, the question of which enjoys relative freedom is a reasonable question for the purposes of the forecast and the analysis of rational economic action. The monetarist and the new classical schools have made the most significant contributions to the analysis of this relative independence. As a result of the economic political consequences, the proponents of the dominance proposition see "the attack of the money-world" as an "attack of the monetarists", even though the theoretical economists wanted to say something completely different.[34]

[33] As his perhaps greatest critic put it: "Keynesians think that the interest rate is the only link between monetary and real income changes. The more inflexible the investment expense and the savings are in relation to the interest rate, the less a change in the interest rate will affect y." (Friedman 1986, p. 125) See also Keynes (1965).

[34] Friedman's argument suggests a sort of "dancing will be done to the piping provided" dominance, yet it simply tries to provide a visual expression of what is called exogenity in time series analysis. To put it very generally: money's weak exogenity is accepted in models belonging to the monetarist school of thought, but there is no strong exogenity, i.e. no good opportunity in

Contemporary research increasingly stresses the significance of certain channels of finance, the new financial instruments and intermediaries.[35] Financial crises may directly influence real economic processes through changes in the liquid financial assets available, the obstruction of financial channels, and the interest rates. An increasing number of analysts emphasise the endogenity of the financial sector, and the importance of internal substitution processes which, in developed and diversified financial systems, allow the satisfaction of the economy's need for financial assets. Gurley and Shaw (1955, 1960), or more recently *Bernanke* (1983), *Stiglitz* (1993) and *Blinder and Stiglitz* (1983) criticise the division of financial assets into two extremes (which was very popular among both Keynesian and neo-classicist economists), since, in reality, bonds as well as money have plenty of better or worse substitutes, and the shares of these are rising every year. However, if the monetary policy tries to narrow liquid assets in the economy, or influence the interest rates, and if it does so by heeding only bank liabilities defined as money, it seems to forget that economic actors will—even by incurring higher transaction costs—create money substitution means and mechanisms, and will activate the credit channel in addition to the money channel (*László and Zsámboki* 1995).

The critics of the increasing autonomy of the financial system essentially stress the uncertainty appearing at the national economic level and the higher social costs which result from rational micro level decisions. However, increasing autonomy may also be evaluated from a radically different perspective. Accordingly, increasing autonomy allows the financial sector to become more or less independent from real economic cycles. In critical situations, financial intermediaries can offset contractions within the banking sector; thus, for example, a bank crisis triggered by a real economic crisis will not necessarily turn into a factor which strengthens or expands the real economic crisis. At the same time, transition economies have provided plenty of examples for the high social costs of such substitution processes. Both financial queuing or pilot games are unusual financial institutions whose uncertainty-raising effects and social costs probably exceed their individual benefits. As a consequence, any one-sided general evaluation is misleading.

On the degree of uncertainty and the need for restriction

Due to financial innovation and the removal of certain regulatory barriers, the independence of the financial markets has indeed grown in recent years. We have so

economic policy to be seized by the government. Causality does not follow from weak exogenity. The empirical research findings in the early 1980s did not confirm the hypothesis that a change in money supply essentially determines the development of real economic output. Thus, if "the money-world is attacking", the monetarists are attacking the least.

[35] The tools available to manage information problems have also grown in number, which has facilitated model-making with the new approach.

far tried to prove that increasing autonomy is, in most cases, not an end itself but increases efficiency and thus welfare. At the same time, increasing autonomy also enhances risks since the state's intervention power is *per definiotionem* shrinking.[36] Several analysts believe that regulation is not a risk-reducing and crisis-preventing factor but it can actually propagate the crisis. Milton Friedman and Anna Schwartz argued that the financial crises during the Great Depression were, for the most part, caused by the Fed (when it exploited the opportunities available badly), and it did not try to offset the liquidity crunch arising from the real economic crisis, and the change in expectations.[37]

An outline of reasons for banking regulation

A popular topic of theoretical and empirical research is the analysis of bank runs and bank crises, and the definition of the governments' consequential regulatory role. From a theoretical point of view, the banking system has two equilibrium states: one is when, based on client trust, banks can finance their illiquid assets from liquid liabilities because the depositors will not rush to withdraw their money and there are no bank runs or banking panics; the other is when people's opinions about the bank change and they want to have their money immediately; this triggers bank runs, or even a series of bank failures. Unfortunately, the favourable equilibrium is fragile, with the inherent possibility of a shift.

Bank runs may be caused by some public information about the bank, the banking system or even the whole economy which shatters people's confidence: this is called an "information-based" panic. In an information-based panic situation, banks are run in the wake of some concrete public information: a worrying indicator in the annual report, the spectacular intervention of the banking supervision or state authorities into the bank's activities, information published about a significant withdrawal, or a piece of news about the economy suggesting future failures, which suddenly make a bank or the banks look more risky. This is the point when the analysis of bank crises is linked to the analysis of macroeconomic cycles.

A popular approach holds that financial crises will break out as a consequence of the decision of rational depositors in an attempt to maintain their consumption level. Therefore booms lead to excess savings which are used up in times of economic decline. Bank failures due to deposit withdrawal are most probably at the bottom of the crisis (*Gorton* 1988). A large-scale bank crisis with a series of bank runs may quickly ripple through the whole banking system, ruffle the economy's

[36] The authors quoted consider these risks too big, but they do so without considering their benefits.

[37] We especially recommend this thought to those who perforce see monetarism as restriction (Schwartz and Friedman 1986; László and Zsámboki 1995).

financing system and deepen the recession. The proponents of this approach attempt to present the simple nature of the indicators with the help of which clients used to observe the operation of the financial institution (Gorton 1988; *Park* 1991, pp. 271–286; *Williamson* 1988, pp. 25–44). However, if the crisis is the result of the observation by clients, regulations can also prepare for the situation and, if need be, intervene. The question is whether they can and want to take this step.

Another group of economists argue that the fragile equilibrium may also be shattered by an incident, a seemingly insignificant event, a sort of "sunspot activity"; this is where the term "sunspot panic" comes from.[38] In such a panic, there is no concrete, direct cause, no public information that would shape public opinion, and depositors run on banks as a result of practically incidental influences, mostly as victims of a mass hysteria. The panic occurs because depositors expect it to happen, so depositors run on banks not because, for example, the bank's assets do not provide sufficient cover but because their individual expectations have suddenly changed. If this is true, regulations are mostly powerless, or they should initiate institutional changes—for example imposing deposit insurance—which will put a brake on expectations turning in the wrong direction (Kindleberger 1978; *Diamond and Dybvig* 1994; 1986).

The critics of the development of the financial system—openly or covertly—see stronger state intervention and regulation as a means of lessening risks. However, the financial system is already well-regulated in comparison with other areas, and few would doubt the necessity of the regulation of this area.

In the case of a particular financial regulation issue or a concrete state action, economic policy-makers will generally enlist the following injuries done to public good:

— risks increasing as a result of financial innovation and expansion of the financial system,

— general disorders occurring in the efficient allocation of financial liabilities and in the intermediation of savings,

— the effects of a potential impossibility of the payment system on the real economy and the society,

— the violation of the small depositors' interests,

— the possible loss of wealth for the state as an owner,

— the efficiency improving effects of regulatory measures.

Yet, an analysis of social costs is very often missing. This is because state intervention and economic regulation in the financial sector have produced a large number of unwanted side-effects and increased transaction costs. Several financial

[38] "Sunspot" is often called a "bubble" as well—indeed, bubbles and sunspots were long considered to be identical. We can see that, despite the similarity, the two phenomena occur for different reasons, and are different in nature (e.g. sunspot implies "incident", while bubbles can also be deterministic. (LeRoy and Gilles 1990, pp. 74–76)

innovations have actually been prompted by regulation or taxation.[39] The other typical problem is that individual factors will get enlarged in such a list even though their weight is much smaller than earlier. Today, the operation of the payment system is more independent of a particular bank's success or failure. The collapse of the giro system would require such a general banking crisis which would probably be caused by a large-scale external shock; this—as in other areas—would require state intervention.

The theory of banking regulation lists other factors as well to justify regulation. One category contains factors related to the special nature of banks, such as the high ratio of loans to equity, the link with the payments system, or the transformation function of the banks. The factors in the other group are related to regulation—for example, the need to ensure liquidity, or the deposit insurance. Still, we should conclude that most of the factors are not so special as we think, and the system works well in other industries without any state regulation. When a company finances a long-term investment with short- or medium-term bonds, it actually performs transformation similar to a bank. In most countries, insurance companies and brokerage firms are as active players in the giro system as the banks but even so, their regulation is different (Dewatripont and Tirole 1993).

Of the reasons for a special banking regulation listed above, the most significant is the need to offer risk-free savings opportunities to small depositors. In the same way as small investors in most financial businesses, depositors may suffer significant losses due to adverse selection and moral hazard. This is due to the fact that small depositors are not able to monitor the banks' activities, thus the management can assert their own interests at the depositors' expense. An important dilemma concerns the areas which require governments to regulate, and the place where participants can operate under rules determined by themselves.[40]

A credible policy not only can contribute to the continued stability of individual banks but also lead to financial panics, where sound financial institutions also fall victim to the crisis (Harmati, László and Zsámboki, 1996). It is also crucial to detect the border between micro and macro level risks as their mixing may lead to excessive intervention.

Fears concerning the expansion of the crisis to other segments of the financial system are also often exaggerated. In countries with a developed financial system, the unregulated nature of derivative transactions is seen as a much greater danger (Dewatripont and Tirole 1993; Szalai 1996). The market and the regulation of these financial procedures are rather chaotic, and a standardised and balanced regulation

[39] The capping of the interest rates of sight deposits resulted in a sea of non-banking intermediaries: for example, open-ended mutual funds; this practically offered a similar opportunity at better interest conditions.

[40] For a detailed analysis of the question, see *Várhegyi* (1997). For a case of deposit insurance, see Harmati, László and Zsámboki (1996).

does, in fact, seem necessary. However, we must point out that while abuses with these instruments may have led to serious bankruptcies, such crises were invariably contained within the given financial institutions, and they did not influence market prices, or only for a short time and to a small extent.

The individual members of the financial system are undoubtedly in contact with each other: banks trade with banks on the interbank market, banks give credits to brokerage firms, insurance companies deposit a part of their funds with banks, etc. However, before erecting high protection walls around the institutions, we must examine each element of this chain according to whether market mechanisms create natural risk management mechanisms, and whether state regulation is necessary.

It is obviously important that banks should provide a possibility for safe depositing, but there are other financial intermediaries which were established just because investors did not need the level of state intervention that banks normally offer. Regulating open-ended mutual funds—on the grounds of even larger risks, just like banks—would in fact abolish its very reason for existence since they are institutions where investors wish to get free from the shackles of the banking regulation.

The effects of globalisation

The globalising financial market institutions and actors, enjoying a rising degree of autonomy and crossing national borders, curb the economic power of the governments, and narrow the scope of "national" economic policies. The state's economic power is essentially built on four pillars which are, at the same time, legal guarantees. The first is the state's exclusive tax-raising power, the second is the government's currency issuing monopoly, to which is related the state's right to eliminate the budget deficit by borrowing, and finally the state's regulatory monopoly—specifically the monopoly of regulating the financial markets.

Free capital movement and the development of the financial markets present a great danger to these state monopolies. While, at the time of the isolation of national markets, both individual and institutional taxpayers and investors were prisoners of these state monopolies and could only protest if they were unsatisfied, today they have the option to exit: voting with their feet and wallets, they can choose from alternative financial institutions, taxation systems and different currencies. The increased decision-making freedom of citizens and companies can have not only an inherent danger but also a large disciplinary power: it forces government to pursue more sensible fiscal and monetary policies, and to show more care in safeguarding the value of the currency.

The competition for funds also restrains the potential indebtedness of national states since it opens up new alternatives for potential borrowers who used to

be squeezed between the barriers of a narrow, undeveloped financial institutional system and the national markets. This, of course, does not mean that governments cannot do certain things unpunished: the economic tools[41] often applied in times of missing or seriously restricted convertibility of the national currency, the regulation of capital transfer and the ban on international banking trigger opposite effects in the new economic environment, and undermine the government's domestic and foreign credibility.

Since governments and civil servants involved in the preparation and implementation of government decisions still feel a political responsibility for the macroeconomic indicators, they are reluctant to accept a narrower playground for economic policy. Moreover, decision-makers who advocate the continuity, or national targets for economic policy, and fear that the global commodity and foreign exchange markets curb the state's sovereignty often receive substantial political support from groups of producers and employees who—since they only possess products, skills and knowledge with a limited marketability—are interested in maintaining state regulation; this creates opportunities for rent by restricting competition.[42] The rent seeking—e.g. income and wealth transfers, monopolistic rights, government allowances and privileges—belongs to the category of non-price competition where social benefits are smaller than costs. Sizeable empirical and theoretical evidence proves that the advance of the rent-seeking groups and the distribution coalitions undermine the conditions for long-term economic growth since it reduces the ability to adopt the new technology, and deteriorates the conditions of any necessary change in redistribution of funds.[43]

Thus, any restriction of the government's tax-raising, money-creating, borrowing and regulating power—just like the disciplinary power of the creation and enforcement of fiscal and monetary constitutionalism—ties the hands of the political decision-makers but it will, with a high degree of probability, improve the efficiency of resource allocation.

We do not deny that the development of the financial markets creates numerous new sources of danger at the level of particular states or national regulatory authorities. Governments may react to these dangers—from the emergence

[41] Fixing the exchange rate of the domestic currency, unbridled government spending, inflationary money creation, using the state's regulatory monopoly for raising revenues, etc.

[42] Readers are recommended to consult Stigler (1989) and Mueller (1989) on the political economics of regulation.

[43] See Olson (1987; 1997). The validity of this conlusion, which originally comes from Olson, is fairly broad, so it is not by accident that several empirical counter-examples can be listed alongside the facts which support the theory. See Mueller 1989, p. 319. We think that in transition economies rent-seeking induced by indirect state economic regulation, and rent-seeking efforts related to the distribution of ownership are enormously important. Unfortunately, very few studies have been written on this topic in Hungary, and social scientists still have to present the analysis of the distribution of privileges concerning financial intermediaries, and the bank and debtor consolidation.

of speculative bubbles to the collapse of large banks—in two ways. They will either jointly create globally valid rules for economic actors—similar to minimum capital requirements imposed on banks—or, also by way of a joint effort, establish a global economic environment which encourages actors to behave in a prudent way and to regulate themselves. International action will, of course, have to face the well-known traps of collective action, coordination problems and the typical phenomenon of free riding.

Conclusion

Although the authors we have quoted repeatedly do not constitute a homogeneous group, or belong to one "school", the logic and the normative background of their argumentation seem very much alike. We have presented this "philosophy" alongside three statements which we consider fundamental: (a) the dominance proposition points out the dominance of the financial world over the real economy, (b) the second proposition expresses the excessive development of financial transactions and institutions, their detachment from natural boundaries, and (c) the third proposition argues for the need for new administrative restriction.

We were not motivated to write this study by a simple refusal of the issue. We believe that such critiques of the financial system have been triggered by phenomena which do indeed require an explanation. The significant influence of financial institutions or their managers on certain political or economic decisions is a hypothesis that can and should be examined. The dematerialisation of money, the emergence of new segments in the money markets, the recent fast expansion of the derivative markets and the appearance of certain, formerly unknown or insignificant risks are all facts of life. However, as opposed to the majority of critics quoted, we do not think that these phenomena are underpinned by some conspiracy of ambitious élite groups, and probably it is not these phenomena that direct mankind's development into a deadlock (if it is going there anyway).

The primary purpose of this study has been to explore the methodological and normative background of writings that uncover the "money-world's dominance", and to present some theoretical explanations and empirical research findings about the operation of the institutions in question which we find methodologically acceptable. The phenomena under attack are not obvious facts for us either, and although we have formulated the questions in a different way and included new aspects, we have essentially tried to move the debate on from the current impasse.

In addition to methodological foundations and empirical validity, we have identified another weakness in the strong and weak versions of the dominance proposition, notably that in the mist of "great ideas" analysts and politicians may overlook significant issues such as deadlocked institutions, rent-seeking, free riding

and the potential shortcomings of regulation. The study has presented the development of money and the financial markets as a usually efficient solution to the most basic human problems. We have focused on the determination of information and transaction costs, friction arising from economic transactions, and the description of actions, institutions aimed at alleviating this friction. We have tried to define the basic functions of these institutions and instruments as well as explain their operation, because this is necessary for the examination of their operating disorders and social costs.

The critics of the financial system often see the side-effects of this development as a more serious danger. Therefore—explicitly or implicitly—they call for the raising of barriers. They will stress the dangers of the rising trading volume and globalisation, even though it results in not only the realisation of increasing risks but also, as a by-product of competition and larger liquidity, lower interest rates and improved conditions. In the financial system, competition is not linked to a single product but a series of products which—figuratively speaking—plot a risk and yield function. However, although the development of money markets may bring about marked product differentiation and market segmentation, this would impact the quality, the risk and the price of other products and services as well. The high number of transactions will make it easier for investors and depositors to fine-tune prices and risks.

Regulation must, of course, be developed in certain cases, such as the futures market, but it must not jeopardise the development of the financial system. This is not only because it is unreasonable but also because the financial intermediation processes will invariably duck administrative barriers. We agree that the role of governments in stabilising crises originating from or reinforced by the financial system has diminished, but thereby their ability to destabilise is also contained. However, if we incorporate unjustified administrative barriers in the system again, the stability of the financial system and the economy will not increase noticeably, only the information and transaction costs. Consequently the system will operate less efficiently, and incur larger social costs.

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FOREIGN TRADE DEFICIT OF COUNTRIES OF EAST-CENTRAL EUROPE*

Causes and Consequences in the Light of Preparations for Accession to the European Union

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In the last years, most associated Central and Eastern European countries have been faced with rapidly growing trade deficit with the European Union. Due to quick economic modernization and further import liberalization, stipulated in the Association Agreements, still ahead, the widening of the already substantial trade deficit can be predicted. Since the Association Agreement did not create a linkage between rising trade deficit resulting from free trade in less developed countries and simultaneous financial transfers, the trade and current account deficit may become a constraint in the transformation and modernization process of Central and Eastern Europe. More importantly, it may jeopardize or even temporary bloc official negotiations to be started in the first half of 1998. The study identifies the main factors of rising trade deficit and looks at the different sources and economic policy instruments that may be able to finance it in the next and crucial years of preparing for full membership in the European Union.

In recent months, and especially after figures about the foreign trade balances of 1996 were made public, analysts both in Hungary and abroad noticed that the respective foreign trade balances of the transition countries of East-Central Europe, which are associated countries of the European Union, had undergone a dramatic deterioration. The process started as early as 1991–1992, yet in the initial years of transition the deficit was kept under control, and the massive amounts of capital invested (either in the form of foreign direct investment, portfolio investment or as compensation for services) comfortably compensated for the trade deficit. In 1996, however, fundamental changes upset what used to be sustainable imbalances (*Table 1*).

Between 1995 and 1996 the deficit in Poland increased from USD 6.2 billion to USD 11.9 billion, and from USD 3.8 billion to USD 5.9 billion in the Czech Republic. In 1995, there was a minor trade surplus in Slovakia, which had turned into a deficit of USD 2.1 billion by 1996. The deficit in Slovenia was as high as USD 1.2 billion already in 1995, and levelled off at US 1.1 billion a year later. Even in Hungary, which introduced a radical stabilisation programme, the deficit of USD 2.6 billion in 1995 climbed to USD 3.1 billion because, by the second half

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Table 1

Comparison of foreign trade flows of peripheral EU and CEFTA countries

Country	Destination (origin)	Year	Exports	Imports	Balance
			USD mn		
Ireland	world	1970–1972	3,869	5,533	−1,664
		1973–1975	7,935	10,371	−7,935
	EC	1970–1972	480	928	−448
		1973–1975	6,109	7,209	−1,100
Greece	world	1978–1980	12,365	24,930	−12,565
		1981–1983	12,958	28,294	−15,335
	EC	1978–1980	6,202	11,800	−5,598
		1981–1983	6,146	13,594	−7,748
Spain	world	1983–1985	67,262	87,550	−20,288
		1986–1988	101,696	144,357	−42,661
	EK	1983–1985	34,288	30,398	3,890
		1986–1988	64,633	78,866	−14,233
Portugal	world	1983–1985	11,353	23,882	−12,528
		1986–1988	27,513	41,304	−13,792
	EC	1983–1985	9,662	10,642	−979
		1986–1988	19,445	26,464	−7,019
Hungary	world	1989–1991	29,380	28,848	532
		1992–1994	30,313	38,163	−7,850
		1995	12,867	15,466	−2,599
		1996	13,145	16,209	−3,064
	EU	1989–1991	10,132	9,922	210
		1992–1994	14,923	16,358	−1,435
		1995	8,080	9,515	−1,435
		1996	8,250	9,684	−1,434
Poland	world	1989–1991	42,691	35,709	6,982
		1992–1994	44,570	56,316	−11,746
		1995	22,896	29,050	−6,155
		1996	24,750	36,640	−11,890
	EU	1989–1991	19,060	15,505	3,555
		1992–1994	27,393	31,632	−4,239
		1995	16,028	18,781	−2,753
		1996	16,203	23,647	−7,444
Czechoslovakia	world	1989–1991	37,200	37,397	−197
		1992	11,656	12,530	−874
	EU	1989–1991	10,138	8,585	1,553
		1992	6,180	6,285	−105
Czech Republic	world	1993–1994	27,499	27,587	−88
		1995	17,086	20,886	−3,800
		1996	21,918	27,824	−5,906
	EU	1993–1994	12,103	12,241	−138
		1995	9,426	11,774	−2,349
		1996	12,746	17,349	−4,603

Table 1 *(continued)*
Comparison of foreign trade flows of peripheral EU and CEFTA countries

Country	Destination (origin)	Year	Exports	Imports	Balance
			USD mn		
Slovakia	world	1993–1994	12,138	12,945	−807
		1995	8,545	8,485	60
		1996	8,828	10,934	−2,106
	EU	1993–1994	3,235	3,034	201
		1995	3,195	2,947	249
		1996	3,643	4,029	−386
Slovenia	world	1990–1991	7,992	8,858	−886
		1992–1994	19,570	19,889	−319
		1995	8,286	9,451	−1,165
		1996	8,306	9,397	−1,091
	EU	1990–1991	4,853	5,245	−392
		1992–1994	11,197	10,837	360
		1995	5,569	6,512	−943
		1996	5,362	6,352	−990

Source: OECD Foreign Trade by Commodities, Series C (for data on Greece, Ireland, Portugal and Spain); WIIW (figures on CEFTA, 1989–1995); Central Statistical Office (Hungary). External trade (figures for 1996); Embassy of the Republic of Poland (Polish data for 1996); Embassy of Hungary, Bratislava (Czech and Slovak data for 1996); Embassy of Slovenia (Slovene data for 1996)

of 1996, the stabilisation-oriented economic policy was unable to keep on reducing the foreign trade deficit.

Statistics about the early months of 1997 indicate that the above tendency has persisted and even occasionally strengthened. In Poland, where earlier the deficit was planned to reach USD 12 billion, observers cannot rule out that the figure may even reach USD 16 billion—which would amount to 11 percent of the GDP. Although in the Czech Republic the rate of the increase of the GDP slowed down in March 1997, the deficit in the first quarter of the year was more than 40 percent higher than the all-time high deficit of 1996. For the whole of 1997, it can be forecast that the deficit may even reach between USD 7 and 8 billion in the Czech Republic. In Slovakia, in the first months of 1997, a deficit of USD 200 million was generated; projected onto the whole year, this figure may come to a level of around USD 3 billion. In comparison, Hungary may be considered as a refreshing exception: even the most pessimistic estimates indicate that the deficit will not be higher than USD 3 billion. Knowledgeable predictions put the deficit lower—that is, it could be a figure similar to that of 1996.

There are three key issues that need to be considered in connection with the deficit:

a) are the deficits generated by an increase in economic growth—that is, whether it is a consequence of the so-called "modernisation deficit"—or by other factor(s)?

b) to what extent has the Association Agreement contributed to the increase in the deficits, given the fact that the European Union is by far the most important trading partner for the countries of this region and the Association Agreement provides for the creation of free trade in manufactured goods by 2001?

c) what types of instrument are available for reducing deficits?

On the causes of the increase in the deficit

Compared to the whole of the East-Central European region, the Polish, Czech and Slovak economies have recorded considerable growth in recent years. Hence it follows that some analysts suppose that there is a direct connection between the faster pace of growth and the increasing reliance on the imports of growing economies. Because it takes some time before the imports may be converted into an increase in exports—as it is stated by these analysts—the exports of these countries are bound to lag behind their imports. The conclusion drawn from this train of thought is that the increase in the trade deficit is chiefly due to the import of capital goods and is therefore of a transitional character. More importantly, it is not only possible to find funds for the financing of this deficit, it is also the duty of these countries to find sufficient funds for the purpose.

At first sight, this argument seems to be corroborated by the national statistics. In those countries, just as in Hungary in the early 1990s, the import of capital goods grew faster than average. Capital goods have dominated imports and these belong to product category 7 in the Standard International Trade Classification. It must be borne in mind that this rather heterogeneous group of products includes both machinery and installations. These exclusively serve investment purposes and products that at best can be described as serving double purposes. In other words, they include motor vehicles (including used ones), and personal computers and their components. It is difficult to tell whether the import of such products has served investment or consumption purposes. The case of Hungary, however, suggests that the latter option is more likely. This theory is apparently confirmed by the fact that in 1996, in the northern countries of the Central European Free Trade Association (CEFTA), there was a massive increase in the incomes of the population calculated in real prices. This increase—with the exception of Poland—was in excess of the rise in productivity.

There has been another development that justifies caution on the part of the analyst: the dynamic increase in exports that had been experienced in previous

years seemed to have lost steam by 1996. *While in the first half of the 1990s, the increase in imports (which was occasionally steeper than that of exports) coincided with the dynamic expansion of exports, in 1996, and especially in the early months of 1997, imports continued to grow, while exports stagnated.* (Developments in Hungary followed a different course.) The causes behind this tendency are related to competitiveness and the rate of exchange of the national currencies. In Poland, the devaluation of the zloty, which was announced in advance, proved to be insufficient to compensate for the difference between inflation in Poland and that in the rest of the world. Although in the Czech Republic and Slovakia, the rate of exchange—which was practically fixed—lent considerable impetus to exports (following a drastic devaluation of nearly 100 percent in 1991) over a period of several years, the difference in the rate of inflation in these two countries versus the rest of the world eroded the initial advantage in price competition within a few years. By 1996, the price competitiveness of the Czech and Slovak products were clearly proving to be insufficient.

The roots of the growing problems related to foreign trade balances are to be found in the economic policy pursued by these countries in previous years. Each of the transition countries of East-Central Europe made a major stride towards liberalising their trade when their traditional Comecon markets collapsed; the domestic markets shrank due to the fall in these countries' respective GDPs; and the secondary instruments of market protection were not applied. Compared to economic policies pursued by other countries in the past, this practice is unparalleled. After all, common sense would dictate, even for countries much more advanced than those of East-Central Europe, the immediate introduction of protectionist measures when even a minor share in domestic and foreign markets are lost. Such common sense was not heeded by the countries of East-Central Europe—in fact, an opposite tendency prevailed. The adverse consequences will be felt, albeit with some delay in the second half of the 1990s.

It goes without saying that the liberal champions of the fast dismantling of the barriers to trade (Poland and Czechoslovakia of the time, both of which followed a course different from Hungary's) have so far failed to include in their "success story" the fact that their radical liberalisation efforts coincided with an even more radical devaluation of their national currencies. In other words, what they achieved in the field of liberalisation by reducing customs tariffs, they compensated for by protectionist measures in the field of exchange rate policy. In their case, a drastic devaluation of the national currency proved to be the principal protectionist instrument. (No such measure had to be taken in Hungary. Besides, it would have been difficult to do so here because, already in the early 1990s, the difference between the respective official and market rates of exchange of the forint was negligible.)

In countries where the devaluation of the currency was radical, the position of the domestic companies improved in foreign markets overnight because—with some exaggeration—nearly all of their products became attractive in the interna-

tional price competition. At the same time, for these countries imports became much more expensive and, as a consequence the import of foreign goods remained limited. However, this development had its unfavourable effects as well. Due to the fact that the devaluation imparted a momentary advantage in price competition, the manufacturing companies had no incentive to upgrade their equipment and technology. Moreover, few companies had the funds to buy imported goods, given that the price of the latter had gone up. As the exports of these countries became more saleable than before, there was no real motivation to proceed with technological improvements. More importantly, the structural changes were delayed both by the privatisation policy pursued by these countries and the low level of foreign direct investment (which was related to that privatisation policy).

To sum up the situation in other words: *the transformation of the microstructure of the economy—which is essential to any sustainable export-oriented growth—did not take place.* This issue became a serious cause for concern when it was found out that the traditional export mix had become less and less competitive and imported goods had become more and more competitive as the national currencies of countries like Poland and Czechoslovakia were gradually revalued. It was at this juncture, sometime during 1995, that a partial modernisation of the microstructure (firm-level structure) began. Even so, obstacles that have since arisen in privatisation are still blocking the course of modernisation in several fields.

For the above reason it is justified to suppose that one of the causes of the present trade deficit is the transformation that has started in the microstructure. This transformation has had a considerable influence on modernisation; in fact, it generates "modernisation-related imports". In Hungary, however, such modernisation-related imports have been experienced ever since the middle of the 1970s. Along with some gross blunders committed in investment policy, such imports represent one of the causes of Hungary's heavy foreign indebtedness. However, this was not a phenomenon that was characteristic of Hungary alone. Such a conflict is encountered by all countries where modernisation takes place at a fast speed. Exceptions to this rule are countries that have revenues from gold, diamonds or oil to finance the surplus in imports. It is justified to suppose that in countries of East-Central Europe—which are suffering from massive trade deficits—the modernisation of the microstructure has just begun, even though with a considerable delay. The rapid economic growth, the import requirements of macro-level modernisation and consumption by the population, which in these countries is increasing faster than productivity, has been further exacerbating these countries' respective trade imbalances. Hence it follows that *the question of deficit is too complex just to be explained as a consequence of over-heated economic growth or the redistribution of incomes to the benefit of consumption.* As a matter of fact, it would be relatively easy to rectify the two latter "dysfunctions" (albeit not, of course, without public discontent or even open conflicts). The question remains: how to treat the import requirement of the micro-level transformation? It is especially difficult to answer

this question if we bear in mind that this process was initially hampered by a state socialist economic policy which had for a number of decades been based on central planning and regional isolation. Moreover, the privatisation which had started in 1989–1990 did not reckon with the forces of the market, an exchange rate policy that resorted to devaluation heavy-handedly, and the behaviour of foreign capital based on selected priorities.

The interplay between the Association Agreement with the EU and trade deficits in East-Central Europe

As the European Union (EU) is a major trading partner of each of the countries of East-Central Europe, and as Western European integration is a modernisation anchor for this transition region, the question arises: to what extent should the steeply increasing deficit be ascribed to trade with the EU?

The comprehensive, comparative statistics compiled by the EU and covering all the countries of the region show that since 1992 the EU has realised a growing surplus in its trade with countries of the region. In 1992, trade between the EU and five CEFTA countries showed an EU surplus of ECU 2.3 billion. In 1993 the figure was as high as ECU 6.3 billion, in 1994 ECU 6.4 billion, and in 1995 ECU 7.6 billion. Between 1993 and 1995, the aggregate trade surplus of the EU with the countries concerned was in excess of ECU 20 billion, which roughly equalled the EU's total trade surplus in its trade with the outside world. To put it more precisely, it is the countries of East-Central Europe which account for the EU's trade surplus, at exactly the same time as they are struggling with all the pains of transition. Throughout their existence they have always been undercapitalised and they still need massive external sources of capital to finance their modernisation. Yet these were also the countries which—at least on paper—in these very years were supposed to benefit from the asymmetrical advantages that it was supposed would derive from their Association Agreement with the EU. Let us mention yet another, even more convincing figure referring to 1995: the five CEFTA countries accounted for 6.7 percent of the EU's total imports, while these five countries accounted for 32.5 percent (ECU 7.6 billion) of the EU's surplus in its trade with the rest of the world.

It is common knowledge that free trade transacted between countries of different levels of development usually produces greater benefit to the more advanced and more competitive countries; this, among other areas, can be seen in the balance of bilateral trade. This study shows a comparison of trade between the above five countries of East-Central Europe and the EU with that between the EU and countries that acceded to the EU during the 1970s and 1980s and are less developed than the average EU Member States. As shown in *Table 2*, the basis of comparison

Table 2

Some indicators with regard to total and EU-trade of selected countries

Country	Year	Share of EU (in percent)			Import coverage	
		exports	imports	balance	total	EU
Ireland	1970–1972	12,4	16,8	−26,9	69,9	51,7
	1973–1975	77,0	69,5	−13,9	76,5	84,7
Greece	1978–1980	50,2	47,3	−44,6	49,6	52,6
	1981–1983	47,4	48,0	−50,5	45,8	45,2
Spain	1983–1985	51,0	34,7	*	76,8	112,8
	1986–1988	63,6	54,6	−33,4	70,4	82,0
Portugal	1983–1985	85,1	44,6	−7,8	47,5	90,8
	1986–1988	70,7	64,1	−50,9	66,6	73,5
Hungary	1989–1991	34,5	34,4	+39,5	101,8	102,1
	1992–1994	49,2	42,4	−18,3	78,5	91,2
	1995	62,8	61,5	−55,2	83,2	84,9
	1996	62,8	59,7	−46,8	81,1	85,2
Poland	1989–1991	44,6	43,4	+50,9	119,6	122,9
	1992–1994	61,5	56,2	−36,1	79,1	86,6
	1995	70,0	64,7	−44,7	78,8	85,3
	1996	65,5	64,5	−62,6	67,5	68,5
Czechoslovakia	1989–1991	27,3	23,0	*	99,5	118,1
	1992	53,0	50,2	−12,0	93,0	98,3
Czech Republic	1993–1994	44,0	44,4	−156,8	99,7	98,9
	1995	55,2	56,4	−61,8	81,8	80,1
	1996	58,2	62,4	−77,9	78,8	73,5
Slovakia	1993–1994	26,7	23,4	*	93,8	106,6
	1995	37,4	34,7	+415,0	100,7	108,4
	1996	41,3	36,8	−18,3	80,7	90,4
Slovenia	1990–1991	60,7	59,2	−44,2	90,2	92,5
	1992–1994	57,2	54,5	*	98,4	103,3
	1995	67,2	68,9	−86,4	87,7	85,5
	1996	64,6	67,6	−90,7	88,4	84,4

*The balance of total and EU trade shows opposite signs (in all cases, deficit in total trade contrasted with surplus in trade with the EU).

Source: own calculations based on *Table 1*.

was a period that preceded these countries' accession and the period that followed accession after two or three years. The following hypothesis is suggested: accession to the EU significantly weakens the new entrants' trade balance (which, of course, may be largely compensated for by access to various EU funds). The examples of Ireland, Greece, Spain and Portugal clearly show that following accession, these countries' respective trade deficits with the EU were higher than they had been before accession. This was especially so in the case of Spain and Portugal, where the deterioration in the balance amounted to ECU 17 billion and ECU 6 billion,

respectively, over a period of three years. (Broken down, in the case of Spain, a surplus of ECU 3.9 billion achieved three years before accession changed over to a deficit of ECU 14.2 billion within three years of accession.)

It cannot be ruled out, however, that in terms of trend and magnitude, a trade deficit with the EU is not necessarily different from a trade deficit with other areas of the world outside the EU. Indeed, Ireland's trade deficit with the world outside the EU increased to a much higher degree than that *vis à vis* the EU (in this case, it was chiefly due to the impact of the first oil price explosion, which coincided with Ireland's accession). Although, in the case of the other countries, the deterioration of the trade deficit with the EU largely exceeded that of trade with the rest of the world—with the exception of Greece—the EU's share in the resultant deficit remained smaller than on the export and import side of the bilateral trade of the countries concerned. It has to be added that, *with the exception of Ireland, the import coverage indices of trade with the EU deteriorated for all the countries concerned, and yet they were still more advantageous over the average of the three years following accession than corresponding indices of trade with non-EU countries.* (This may have been due to the fact that all the EU Member States of the Mediterranean region obtain a considerable part of their energy and raw materials imports from outside the EU, while most of their exports are directed towards the EU, and in markets outside the EU they are not competitive enough to be able to counterbalance major import purchases.)

The above criteria in our examination of the countries of East-Central Europe could only be applied by separating the period that preceded the entering into force of the Association Agreement and that coming after it. In the latter period, the figures covering 1995 were dealt with separately from those referring to 1996. Our findings show a fairly mixed picture. In 1996, the import coverage index of trade with the EU in the case of Hungary, Poland and Slovakia was more favourable than that of trade with the rest of the world. By contrast, the opposite was true in the respective cases of the Czech Republic and Slovenia. On the whole, however, the coverage indices of trade with the entire outside world and that with the EU did not show significant differences—they were between 1 and 5 percentage points, and this index only reached 10 percentage points in the case of Slovakia.

The trends experienced between 1989 and 1996 are more telling. *In the case of each of the associated countries under survey import coverage indices of trade with the EU deteriorated. In fact, trade balances registered deficits following initial surplus positions.* It has to be borne in mind that a similar process took place in trade with the entire world. (The EU now accounts for a growing share in that trade. Therefore, trade with the EU has played—and continues to play—a dominant role in the overall processes which follow the same line as that of trade with the EU.) Note that, *following 1992, the trade deficit with the EU grew much faster within the deficit of trade in general than the way the EU increased its share in the total exports and imports of the several associated countries.* In the case of Poland,

between 1992 and 1996, the share of trade with the EU increased by 6 percentage points while the share of the EU in Poland's foreign trade deficit increased by more than 26 percentage points. In the case of Hungary, the corresponding figures were 16 and 26 percentage points. In the cases of Slovenia and Slovakia, it was in this period that the surplus of trade with the EU turned into a considerable deficit. Special mention should be made of the change which occurred in 1995–1996, given that predictions indicate the continuation of that process for 1997. In the trade of the Czech Republic with the EU, the share increased by some 5 percentage points from 1995 to 1996, while the deficit registered an increase of 18 percentage points. In Slovakia's trade, the EU's share went up by about 3 percentage points, while the trade balance for 1996 ran into deficit as opposed to the considerable surplus of previous years. In the overall foreign trade of Poland and Slovenia, the EU's share declined by approximately 2 percentage points each, while the EU's share grew by 18 and 4 percentage points, respectively, in the two countries' trade deficit. The only country where the situation did not follow suit was Hungary: in the overall foreign trade of the country, the EU's share went down by 1 percentage point, while the EU's share declined by more than 8 percent in the deficit.

All in all, it is impossible to deduct a clear-cut tendency from the above figures, it cannot be stated that proof has been found that the increase in the trade deficit is the effect of trade with the EU or that conducted with other regions of the world. (To render the picture even more complex, there may be multifarious input-output interrelations between these two spheres of trade, which the primary statistical figures are unable to reflect.) It can be safely stated that—as a part of the overall process of increase in the trade deficit—in the given time frame the deficit in trade with the EU has shown a considerable increase. Occasionally that tendency may cause serious disequilibria, which in turn may bring about temporary or even persistent disruptions in the relations of the associated countries with the EU. Such disruptions may even be a drawback for the pre-accession process. In this context it is worth reminding the reader that, following a brief transitional period of asymmetrical trading conditions, the Association Agreement provides for symmetrical free trade in industrial goods between countries that are on different levels of development, competitiveness and economic capacity. Moreover, the Association Agreement *cannot handle the apparent disequilibria that follow from free trade. The situation was different for the three Mediterranean countries that acceded to the EU earlier. Their respective trade deficits with the EU Member States increased also in their case yet that could be considerably compensated for by immediate access to various EU funds.* Tools that would cushion such adverse consequences for the countries of East-Central Europe are missing both from the Association Agreement and the whole of the relationship with the EU.

There are two considerations that lend topicality to this issue. First: in view of certain commitments which have been assumed recently, *it can be safely predicted that import competition will further increase* in the East-Central European

countries. This in turn will push trade deficits further up. Three factors can be mentioned which are likely to expand imports: (1) the commitments made in the World Trade Organisation to reduce customs tariffs, (2) the elimination of temporary asymmetry in trade conditions between 1997 and 2001—such conditions being part of the Association Agreement, (3) and the elimination of the temporary import surcharge (and of other measures that render imports more expensive). Added to these factors will be the classic "modernisation deficit", which originates from the acceleration of economic development and the emphasis on exports. There are marked differences in selected countries in terms of microeconomic development—which in turn can also generate increases in imports in numerous countries. Foreign direct investment—which is currently flowing into countries of the region—is also likely to demand massive imports. (It will take several years before sufficient export capacities will be available to counterbalance those imports.) What is more, it has to be borne in mind that foreign direct investment, which was absorbed in an earlier period by the strategic industries, will in forthcoming years also require growing imports for its new projects. *The key question therefore is whether or not the countries concerned can tolerate such a huge pressure for imports, and if they can, what economic policy measures should be employed?*

The second consideration is the present level of preparation for EU accession on the part of the candidate countries, with special reference to the accession negotiations; the latter are to open in early 1998. It is beyond doubt that the negotiations will cover several conditions of full membership, and occasionally it will be possible to acquire important derogations. However, it will be an indispensable precondition of accession for the candidate countries to fulfil the requirements of the Association Agreement and, within that, to ensure the free trade of industrial goods already in the pre-accession period. (The transposition of the dominant majority of the *acquis communautaire* will be another precondition.) It would be very embarrassing if, in the course of the negotiations for accession (or shortly before their conclusion), any of the East-Central European candidate countries "threw in the towel" because it thought its trade deficit could only be handled by applying tough protectionist measures. Whichever country of this region does so, the chances are that it would have serious consequences also for the other countries in the negotiation process. After all, eastward enlargement is not solely based on the "merits" of the several countries involved. Inevitably, it takes into consideration certain geostrategic and geopolitical factors.

Economic policy dilemmas and options

Three basic instruments can be applied to reduce the foreign trade deficit in an effective way. They can be used separately or in various combinations. They are as follows:

(a) to reduce the deficit by increasing exports and substituting imports by domestically produced goods;

(b) to finance the deficit by using surplus that has been generated under other headings of the current account of payments;

(c) to apply drastic austerity measures.

The reason why option (c) will not be discussed here is not that we regard it as inconceivable but because it would deal a serious blow to the region's aspirations to accede to the EU. Such an option would both ruin preparatory efforts and postpone accession for an inestimable period of time. In contrast, it cannot be ruled out that certain restrictions will be applied—temporarily and as a response to certain circumstances that may emerge as a consequence of the Association Agreement. Let us emphasise that such a development would negatively affect the image of the country concerned (which may be in the process of accession negotiations at the given moment) and would further weaken its bargaining position.

Increasing the capacity to export

(a) This option is undoubtedly the most reassuring. It depends, however, on numerous internal and external conditions. There are basically three ways of increasing export capacity:

(aa) The importing countries, in this case, the Member States of the EU, could assure greater access to their markets;

(ab) The appeal of exports could be heightened by devaluation;

(ac) Exports are rendered more competitive in the long run by employing various export-oriented instruments.

(aa) The EU is planning to liberalise all its import quotas for manufactured goods by the beginning of 1998. The remaining restrictions have already been cancelled for the last group of sensitive goods (i.e. iron and steel and textile clothing). Only one group of products will be unaffected by free trade—i.e. agricultural produce and foodstuffs. As far as these categories of goods are concerned—according to the agreements currently in force—there will be no free trade even beyond 2001. Such a situation may have the following consequence: a negative asymmetry may emerge in the trade between the EU and the associated countries, to the detriment of the latter. The explanation for this is that, in the case of exports to the EU from the countries of East-Central Europe, the ratio of agricultural produce that

falls under restrictions is higher than that of their imports from the EU, and the ratio of goods affected by free trade will be lower for the countries of East-Central Europe than for the EU. (It is full membership, which is scheduled for 2002, which could help resolve this problem.) It is difficult to predict today what magnitude of export potential will be "frozen" by the EU restrictions on agricultural produce. At present, the EU keeps claiming that the associated countries are unable to fully utilise several EU quotas due either to quantitative or qualitative problems. In contrast, the East-Central European countries stress that there are certain goods that could be offered for export but their sale is prevented by barriers in the market. Agricultural exports could, in part, bypass the barriers that can be found in EU markets by selling these products in other markets. It should not be forgotten that the conditions under which these latter sales are realised are not necessarily better than those that could be reached in the EU market if the latter was open. It seems to be unjust to put the blame for all capacity-related problems on the internal situation of the countries that act as producers. After all, no country is prepared to expand its production unless it is convinced that its output can be safely sold. Therefore, if the EU were to open its agricultural markets, this would help to create considerable new production and export capacities. As long as the EU restrictions are in force, the above production capacities are kept in reserve and therefore cannot create additional exports. Consequently, they are unsuitable for reducing the widening trade deficit.

(ab) After the systemic change, the countries of East-Central Europe did not follow a uniform exchange rate policy. The individual exchange rate policies were and have remained due to the different conditions of the countries concerned before and after 1989. As the export structure of the associated countries of this region is dominated by products which lack sophistication, it is probable that the volume in which they can be sold abroad depends heavily on their price level. Price competitiveness can be improved with two techniques: through a shock therapy and in a step-by-step manner. The shock therapy approach opens with a one-off drastic devaluation and then fixes the exchange rate where it stood at the moment of devalution. The second approach realises a gradual nominal devalution, however, in that the difference between the real and the nominal devaluation is entirely compensated for by the increase in productivity between the exporting and importing countries (as well as an accompanying structural upgrading).

The one-off radical devalution has the effect of rendering every product competitive overnight. This is especially true if the country concerned possesses a relatively broad assortment of goods. (Classic examples include Czechoslovakia and, after 1993, especially the Czech Republic). Yet such a devaluation weakens the compulsion to carry out structural adjustments both on the export side (as every product becomes saleable), and on the import side (because the devaluation increases the costs of import competition, which in turn cannot make itself felt in the domestic market). As time goes by, the difference in the rate of inflation in the

principal export markets, as compared with the domestic market, is bound to eat away the temporary competitive edge that was created by the drastic devaluation. In fact, the fixed exchange rate becomes the most important obstacle in the way of progress. This is exactly the situation today in the Czech Republic and in Slovakia. When a country's foreign trade balance is running into the red, there is no doubt that devaluation is the cure. However, this may encourage speculative capital—which for the time being is available to cover the balance of trade deficit—to flee the country. More importantly, a confidence crisis would evolve in the long run between the foreign investors and a country which, until that time, had welcomed them. In previous years, Western investors found the Czech (and, to a lesser extent, the Slovak) economy attractive, especially because they expected a higher than average interest margin due to a fixed exchange rate. These same Western investors were, however, unable and reluctant to finance capital projects directly, partly in view of the privatisation techniques employed by the countries concerned, and partly because of the absence of certain "fine textures" in the micro-economic sphere. The presence of speculative capital assured a pleasant, almost "velvet" financial environment as long as the surplus of invisible revenues (drawn especially from tourism and, to a lesser extent, foreign direct investment) could compensate for the trade deficit. When, however, that coverage is missing, the market becomes nervous, the fear of devaluation strengthens, and the confidence of people involved with speculative capital starts to evaporate. At the same time, the government starts panicking as it tries to keep that capital within the country. It should be noticed that the government is aware that capital may vanish from one day to the other, while devaluation cannot itself do good for the trade deficit overnight. At the same time, devaluation cannot fill the "gap" that remains, despite the surplus in the invisible income.) Furthermore, inflation is bound to accelerate after the exchange rate is no longer fixed; and the likely changes in the structure of the economy are expected to widen unemployment and cause corporate bankruptcies, which in turn are bound to increase the budget deficit. In fact, in the initial phase, the structural changes that for a long time used to be absent (for example, they became victims of well-publicised savings campaigns), are likely to generate increased demand for imports. Thus it is a mistake to expect devaluation to reduce the deficit in the short run.

The consequences of any change in the exchange rate are, at best, incalculable. The longer the period of a fixed exchange rate, the more incalculable the aftermath is. It is, therefore, not surprising that expert opinions vary widely on how to use devaluation as a tool to handle a trade deficit. Sooner or later, the right response will be found by rule of thumb, but the later it is worked out, the more it will cost.

It goes without saying that even those countries of East-Central Europe that have opted for step-by-step devalution (which may occasionally be haphazard or announced well in advance) have certain problems with their balance of trade. As long as nominal devaluation is lower than the difference between the rate of inflation

in the exporting country and the principal importing countries—such a difference can be more than compensated for if productivity goes up faster in the exporting country than in the importing countries—the general competitiveness (which does not necessarily extend to each and every sector!) of exports can be improved. At first, it appears there are no problems with this but the effects of devaluation are gradually eroded by inflation, and in fact push inflation higher. Moreover, devaluation alone cannot generate massive new export capacities in a short time; however, in the wake of the collapse of Comecon, the associated countries of East-Central Europe badly need such export capacities. *The foundation of an effective export capacity is not price competitiveness but the presence or absence of the required* volume *of export capacity.* Nevertheless, in most cases, the redirection of production towards export orientation is inconceivable without the simultaneous upgrading of the domestic market. If domestic demand is restricted or is in a state of decline, export-oriented projects are bound to remain no more than plans on the drawing board. Furthermore, certain devaluation practices may provoke complaints also from the EU Member States because they may seem to them to be instances of "social dumping".

(ac) No sustainable increase in export capacity is conceivable without the deliberate use of an export-oriented system of incentives. Instruments that are available for the exchange rate policy can redeploy revenues for the export sector in the short run. In contrast, an export-oriented strategy can lay the ground for the long-term rechannelling of such revenues. Tools available for an exchange rate policy can be used to direct certain revenues to the exporters at the level of direct corporate earnings. In contrast to this, an appropriately evolved strategy can make its effects felt at the level of capital projects and an improved structure of the economy. While in the previous case nothing can guarantee that the increased revenues, that are realised as a result of the devaluation of the national currency, will be used for capital projects and for improving the structure of the economy. For example, they may be diverted to upgrade consumption. In the latter case, involving capital projects, an export-oriented strategy would surely be dedicated to the creation of competitive ventures.

Undoubtedly, export-oriented development means a redistribution of GDP to the benefit of those capital projects on which the consumers' well-being depends. The question remains open: what is the tolerable level of redistribution towards investment projects that the interest associations of consumers would find acceptable (and whether such redistribution would be approved by them at all)? Foreign aid targeted to investment projects could ease this "squeeze". (In principle, that is the very purpose of the transfer of funds within the EU; however, for the time being, such funds are not available for the associated countries.) Another way of "rectifying" the situation could be to "ease" budgetary restrictions. This option would not be acceptable to the international monetary institutions, nor to the monetary authorities of the countries concerned because this would push up inflation

and could ultimately endanger economic stability. *When, however, the need for an export-oriented economic policy is also justified by a dramatic deficit of the trade balance, it is worth trying to estimate which is more dangerous: a trade deficit, which seems to be untenable; a social and political conflict that originates from the redistribution of budgetary resources; or the pressure of the international financial organisations and the domestic monetary lobbies. It is impossible to satisfy all the requirements at the same time.* Politicians have to bear in mind all three of the above considerations, yet it requires day-to-day decision-making in order to define the emphases. When, for instance, the trade deficit reaches critical levels (which, among other things, may be a consequence of a missing export-oriented policy), those emphases need to be shifted.

Often governmental recommendations which are aimed at improving competitiveness lay undue emphasis on exports. Such proposals tend to forget that it is often advisable to substitute the import requirements of producers of exports with competitive domestic products. This is primarily due to the fact that, in the short run, this seems to be the best method of reducing the trade deficit given that the "lead time" of the export-oriented capital projects spans over longer periods. Furthermore, this is a good way of strengthening the system of sub-contractors for the exporters (which can also be seen as a form of indirect exportation). Finally, such an approach can encourage domestic production, the generation of jobs, regional development, the further incorporation of the national economy in the international division of labour and, also very important, it can promote the "indigenous" development of the domestic stratum of entrepreneurs (or, to be more exact, those entrepreneurs who are domiciled in the East-Central European countries concerned). Devaluation can itself help the substitution of imports by domestic goods. However, its beneficial effects may be weakened or even totally neutralised by certain factors of inertia, such as a relatively slow response to cost-related advantages, close input-output relationships within certain conglomerates, or differences in terms of financial and organisational potentials.

Financing the balance of trade deficit from other revenues

Some of the above dilemmas can be effectively eased if in the long run sources other than the export of goods can cover a runaway trade deficit. Such sources can be as follows:

(a) Revenues from various services can become an important factor to compensate for the trade deficit of the countries of East-Central Europe. Certain sources can be considered which, in recent years, have been more than enough to cover a trade deficit: for the Czech Republic such a source has been tourism (concentrated chiefly in Prague and along the respective borders with Germany and Aus-

tria); for Slovakia there have been the transit revenues; Poland has benefited from the non-registered trade along the Polish-German, Polish-Belorussian/Ukrainian/Lithuanian/Russian border. However, in the future reliance on these respective situations seems to be untenable for at least two reasons. First, because of the limits to the supply and demand for such services, the related revenues cannot grow as fast as the runaway trade deficit. Second, certain revenues from services have considerably decreased because the price differences between the countries concerned are becoming smaller and smaller; and the direct trade in goods is making the intermediaries redundant. (The fall in such revenues is the most spectacular in the case of Poland, where in recent years non-registered trade is believed to have realised an annual profit of between USD 6 and 8 billion.)

(b) There is another way of financing the trade deficit, and it is perhaps the most widely used method in numerous dynamically developing countries: it involves the rapid expansion of foreign direct investments. In recent years, foreign direct investment has been the most important source covering Hungary's trade deficit, and occasionally it has even produced a surplus in the balance of payments. In most of the countries of East-Central Europe, however, foreign direct investment has, until now, played a limited role only (especially in Slovakia and Slovenia). In the years ahead, its weight may steeply grow, especially in Poland which has a large domestic market and where the growth rate is high. However, the growth of foreign direct investment is inconceivable without an adequate macro-economic environment, and it takes time to create this. To make the question more complex, in the initial phase, the creation of an appropriate macro-economic environment (which foreign capital may promote) incurs *both an additional import of capital and the bankruptcy of numerous companies that cannot withstand competition.* The two processes exert simultaneous and opposing effects on the trade deficit. Furthermore, when the capital projects are financed from foreign capital, this generates growing imports due to the fact that a considerable part of the investment requirements cannot be met from the domestic market. Finally, the foreign capital that is entering the economy of Poland (which is a large country) is interested chiefly in satisfying Polish domestic demand rather than pursuing export-oriented objectives. Consequently, it is impossible to predict whether commercial activity is likely to improve or cause a further deterioration in the trade balance.

Foreign direct investment is likely to help reduce the deficit of the trade balance. It is impossible, however, to foretell with certainty whether or not foreign direct investment and declining revenues from services will be sufficient to compensate for the trade deficit in the final years of this decade.

(c) It is in this situation that attention is shifted towards a traditional form of financing deficit: raising credit in the international financial markets. The countries of East-Central Europe—with the exception, in a sense, of Poland—currently have access to such credits without significant difficulties. Provided such external sources are used to improve the trade balance within a short time—given that they are

used to finance the production of exportable goods—the international financial community should continue to have firm confidence in this region. If, however, the raising of such credit brings about massive additional indebtedness—for which the economic output of the country concerned is unable to offer cover—then confidence may weaken, and *in fact another debt crisis may emerge. Needless to say, regardless of which country created such a situation, it would negatively influence the image of the whole region in the eyes of international financial circles.* Hence it follows that this method, which may increase indebtedness, must be used with caution.

(d) It is impossible to rule out a situation in which the countries that are currently suffering from a trade deficit decide to *finance their export strategy*—among other sources—*from their reserves of foreign currencies (the level of which is presently reassuring—in fact, higher than the required minimum).* For the time being, neither the principles, nor the macro- and micro-economic conditions of such a strategy have been elaborated. In principle, it may be possible and, viewed from an economic policy point of view, even useful to mobilize the "superfluous" reserves of foreign currencies in order to develop exports. It must be borne in mind, however, that this technique is not without risks either. Even a minor deterioration in the economic stature of a country can create a situation in which a considerable part of those reserves leave the country. Provided coverage is embodied in capital projects in which capital is not interested (in other words, it is not inclined to convert its portfolio investment into direct investment), then the required coverage has to be generated by the country concerned. If the remaining reserves are insufficient to do so, or if such action were to fully deplete the coffers of the central bank, then there is the danger that the international financial community would respond nervously. Such a development would exacerbate rather than reduce the problems. Consequently, this method may also backfire and therefore it requires utmost caution.

(e) The last option could be non-repayable transfers. However—partly with the exception of the PHARE programme—such transfers are for the time being not available. Although the worsening trade balance situation requires such an instrument—*among other sources*—to be available (in the same manner as in the case of other countries of a medium level of development), presently the East-Central European countries that aspire to accede to the EU do not have access to it.

Concluding comments

The size of the trade deficit and the instruments to be used in the future to handle it will exert a very important influence on the short- and medium-level development of those countries of East-Central Europe, which are about to enter (or

have entered) the modernisation phase of their transition. This is a question of cardinal importance both in connection with full EU membership—which, it is hoped, will take place within a few years—and the success of the entire modernisation process.

Undoubtedly, *the countries of the region need to attempt to catch up with the most advanced countries of the world under conditions that have no parallels anywhere else.* They have to bring about modernisation (which, viewed from a historical point of view, is belated) simultaneously with the transformation of their political and economic systems; at the same time they have to adjust to the European Union, whose integration system is today more complex, and whose requirements are more demanding than ever before. *These are the assignments which the countries concerned have to realise in a situation where they can only benefit from an extremely low level of support from abroad.*

In the years ahead, the size of the trade deficit and the techniques employed to handle it will be a litmus test of these countries' ability to adjust and to catch up. For these countries of medium-level development, it is a momentous challenge, without a precedent, to realise free trade in industrial goods within a period of ten years without getting any support from outside—with the exception of a temporary and limited asymmetry in certain conditions of trade. The question arises whether or not the East-Central European decision-makers, and the peoples of this region in general, were aware of the magnitude of this challenge when the measures related to the liberalisation of trade were approved and when the Association Agreement was signed. There is also the issue of whether or not the European Union, which was the other signatory to these Association Agreements in their present form, was aware of the consequences (which have only appeared recently but could be foreseen from the outset). If the EU was not aware of these consequences, then its thoughts and actions were motivated by short-term considerations and by its short-sighted interests. If, however, the EU anticipated such problems (which were likely to happen both because of the difficulties of transition and the difference in the level of development between Eastern and Western Europe), then why did it fail to assert in the Association Agreements (or in some other framework agreements) some key components of "development-promoting integration" which the luckier late-comer EU Member States had access to?

As long as no appropriate external financial support is made available, the worsening of the respective trade balances of the countries holds out the danger that the "timetable of peaceful pre-accession preparations" of the East-Central European region will collapse. Such a turn of events may have grave consequences both for the countries that are aspiring to EU membership and the EU itself. What seems to be a short-term and short-sighted approach on behalf of Western Europe during the early 1990s may bring about destructive consequences at the very moment when strategic decisions have to be made. It would be advisable to prevent such a turn of events to the benefit of every European state and citizen. It has to be hoped

that there is still time to join forces and think about the possible consequences: to draw the lessons as soon as possible, and implement an all-European development strategy without delay.

It need to be reiterated: *today* this is not a question that is acute in Hungary, even though it may well become a problem for Hungary as well. Yet even if it is not a specifically Hungarian concern, it is one that can be regarded as being of essential and urgent importance. At stake is the future of the whole of the region—i.e. of the whole of Europe—of which Hungary is a part.

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FORTY YEARS OF TRADE BETWEEN EAST ASIA AND EUROPE

A. NAGY

The study analyses the development of trade between three East Asian regions (Socialist Asia, Japan and other Eastern Asian countries) and three European regions (Western Europe, USSR/CIS and Eastern Europe) for the period 1955–1995. It investigates the growth and structural changes of the trade flows, the trade balances and their commodity breakdown between the regions and their development during this long period.

Special attention is paid to the effects of trade policy changes, liberalisation policies of the European economies on the one hand, and increased export promotion efforts of the Asian countries on the other. For this purpose trade intensity measures are analysed which reveal the impact of trade policy changes on the commodity flows of the regions. It was found e.g. that the trade between Western Europe and the East Asian regions does in most cases not even reach half of what would follow from their opportunities. The same could be told about Central and East European countries where a rapid expansion of trade with East Asia may be expected.

Introduction

In this study the trade relations of East Asia with Europe will be analysed using a trade flow model covering forty years—i.e. the period 1955—1995.[1] The overall research project—of which this study is a by-product—deals with the analysis of emerging new tendencies in international trade and follows research which has been carried out over several years on structural changes in international trade. (*Nagy* 1972, 1979, 1983, 1985, 1995)

Analysis of international trade flows is an approach by which, instead of dealing with the foreign-trade relations of a single country, or surveying bilateral trade between pairs of countries, world commodity trade as a complex system is examined in an attempt to demonstrate its structural changes in a consistent framework.

The trade flow model used in our analysis is based on the data published regularly in the *Monthly Bulletin of Statistics* (MBS) of the UN[2] and aggregated into 11 regions and 6 commodity groups.[3] Summing up the trade flows by regions,

[1] An earlier version of this study was presented to the International Research Seminar on East Asian Economies: "Economic Relations between Europe and East Asia", at the Université Paul Valéry, Nimes, France, 19–20 June 1997. The research project was supported by the Hungarian National Scientific Research Foundation (OTKA), No. T 018311.

[2] Published on two occasions annually in February and May. See tables D.

[3] For a list of regions and commodity groups see *Appendix 1*.

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or by commodity groups, they add up to total world trade (TW). When trade flows are mentioned, it has to be taken into account that this term differs from the usual export and import values, where exports are, respectively, usually measured in FOB and imports in CIF parity. In international trade flow models the value of exports of country A to country B has to be equal to the value of imports of country B from country A, even if the expenditures of country B are higher than the income of country A (because of transportation, insurance and other costs). The trade flow data published in the MBS use exports statistics (whenever possible) measured in FOB parity, which means that in most cases they exclude transportation and other costs; as a consequence of this the import values are less than they are in reality, and in the trade balances surpluses are higher and deficits lower than in financial statistics. The trade flow data published in the MBS are given in current US dollars and, which means that the price and exchange rate changes have a strong influence on the tendencies which can be observed.

In this study the intention is to analyse the development of trade relations between three East Asian and three European regions. Following our regional breakdown these regions are: Japan (JP), Socialist Asia (SA), East Asia (AS), Soviet Union/European CIS countries (SU), Eastern Europe (EE) and Western Europe (WE). As the intention here is to examine the long-term development of structural change in international trade relations, an attempt has been made to reduce changes in the regional breakdown of our model. However, the changes of national borders following the political changes after 1989 obviously had to be taken into account.

Thus, after 1992, the region marked by SU means the European part of the Commonwealth of Independent States (CIS), and this refers to the European countries of the former Soviet Union, except the Baltic states.[4] The trade data of the Central and East European countries (EE) include—from 1992—the data of the Baltic States, Yugoslavia, Croatia and Slovenia.[5] Up until 1991 the Socialist Asia/China (SA) region included Vietnam, Mongolia and North Korea, but their intra-regional trade was not reported. The export data of this region between 1991 and 1995 contain only the exports of the People's Republic of China—the import data are missing. From 1992 the imports of China, the reported trade of the other three SA countries, and those of the previously Asian Soviet Republics are all included in the East Asian (AS) trade.

First, a demonstration and comparison will be made of the growth of trade between the different East Asian and European regions; then the changes in their commodity structure will be shown. In sections 3 and 4 an examination is made of

[4] The intra-trade among these countries has not yet been reported. Starting in 1991, the trade data of the former Soviet states are reported in commercial exchange rates and are not exactly comparable to the previous trade values.

[5] Yugoslav trade data were previously included in Western Europe (WE).

the way in which trade policy factors have influenced the trade relations between these regions by computing the tendencies in the trade intensities. Finally, some conclusions will be drawn on the probable future tendencies of East Asian-European trade developments.

The growth of East Asian-European trade

It is well known that East Asian exports have grown at an extremely fast rate in recent decades: total Japanese exports increased nearly seven times between 1970 and 1980 and 3.4 times between 1980 and 1995 (see *Tables 1* and *2* in *Appendix 2.*). The increase of total exports of the SA and AS regions respectively was even faster: 766 percent and 864 percent in the first period, and 645 percent and 447 percent in the second. However, this spectacular increase was very unequally distributed in the different regions of the world and especially in Europe, as can be seen in *Figures 1, 2 and 3.*

While Japanese exports to Western Europe grew nearly 3.4 times between 1980 and 1995—i.e. as fast as total Japanese exports—they were 56 percent lower in 1995 than in 1980 in the direction of the SU, and on about the same level as in 1980 towards the EE region. SA (mainly Chinese) exports to the European regions show a moderately different development: WE imports from SA increased much faster than from Japan (553 percent between 1980 and 1995), SU imports grew by 242 percent, while EE imports decreased by 15 percent in the same period. The East Asian region's exports (dominated mainly by the "small tigers") behaved very differently: they were growing fast on the respective markets of all three European regions: by 372 percent in WE, 418 percent in EE and by 144 percent in SU between 1980 and 1995.

However, we have to take into account not only the differences in the speed of export growth rates, but the sizes of exports oriented towards the three European regions and their changing share in the total exports of the Asian regions. The value of Japanese exports to WE was US $ 74 milliards in 1995 for example, while only US $ 794 million and US $ 1215 million to EE and SU respectively. This means that the share of WE in total Japanese exports was 18 percent, and those of EE and SU only 0.2 percent and 0.3 percent respectively in the same year. The distribution of exports for the other two Asian regions was quite similar; the exports of SA and AS to the two East European regions were respectively only 6.1 percent and 3.3 percent of the value of their exports to the West European markets in 1995. In the light of these enormous differences of size, the variations in the growth rates are even more conspicuous; the much higher export volumes directed to the WE markets grew much faster than the much smaller ones oriented to EE and to SU.

The export flows in the opposite direction—i.e. from the European to the East Asian regions—and their growth can be seen in *Tables 3* and *4* in *Appendix 2*. It was quite unexpected that, while the total exports of both East European regions declined strongly in the 1990–1995 period, their exports both to Japan and to the other Asian regions[6] would increase significantly. This contrasts with the decreasing Japanese exports to SU. The export growth of Eastern Europe to Asia was much slower in the period of 1980 to 1995 than in the previous decade: while it increased more than four times in the seventies, its growth was to be only 52 percent over the next fifteen years.

West European exports to East Asia were not only incomparably greater than the East European exports, but their growth was also much smoother and faster. It increased 5–6 times in the seventies and rose, nearly equally, to above 560 percent between 1980 and 1995 to Japan and the other Asian regions.

The development of the trade balances between the three European and the two East Asian regions can be seen in *Table 5*. Since the mid-seventies a strongly negative trade balance has been evolving between the European regions and Japan. In the case of Western Europe this reached US $ 32 milliard by 1993 and then decreased to 27 milliard by 1995. With the decline in Japanese exports to Eastern Europe the deficit did not increase, but fell and the European CIS states have shown a trade surplus since 1990.

The West European trade balance with the two other Asian regions has frequently been negative since the eighties, even if the deficit is not very high. The trade balance of the SU remained positive after a few negative years in the early nineties, while the East European countries which regularly had a surplus with this region, developed a deficit in 1994–95.

Changes in the commodity structure

To show the strong changes in the commodity structure of East Asian-European trade we used three commodity categories, aggregating agricultural products, raw materials and fuels into primary goods, and showing separately machinery and all other manufactured goods. The SITC numbers for these categories are the following:

— Primary goods (SITC 0+1+2+3)
— Other manufactures (SITC 5+6+8)
— Machinery (SITC 7+9).

Figure 4 shows both the changing values of exports and the commodity shares of Japanese exports to the EE between 1970 and 1995. These started to grow in

[6] As Chinese imports are reported in AS from 1991, we had to combine the two regions, SA + AS, in this part of the analysis.

the early seventies, but the share of machinery remained at around 50 percent until the mid-eighties. Since then the respective shares of primary goods and of other manufactures have diminished and machinery reached about 70 percent of Japanese exports to EE. East Asian exports to EE only started to show substantial growth in the late eighties (*Figure 5*). Since then the share of primary goods has diminished strongly and manufactures now cover about 80 percent of exports and machinery more than 30 percent of them.

Figures 6 and 7 illustrate Japanese and AS exports to Western Europe. The value of exports is 8 to 3 times higher than that which was oriented to Eastern Europe. The increase from the mid-eighties is spectacular and is completely due to manufactures. Primary goods practically disappeared from Japanese exports and remained very low in the case of East Asian exports to Western Europe. The share of light industry products is very small in Japanese exports, but it is great in the exports of AS. Machinery exports—which were practically non-existent in East Asian exports to WE prior to the eighties—increased rapidly and their share had reached more than 40 percent after 1993.

The trade policy factor—measuring trade intensities

Looking at the very significant changes which have occurred in recent decades in East Asian-European trade relations, there are obviously questions to be asked about the major factors which caused these changes. It seems obvious that both the supply side and the demand side developed rapidly, especially due to the fast economic development of Japan and the newly industrialising Asian countries, and also because of the policies of liberalisation in both Western and Eastern Europe. As Asian economic growth was export oriented, their "push" effect was certainly strong. Growing income and trade liberalisation in Europe also increased the "pull" effect of their imports. The growing trade deficit of the European countries shows that the "push" and "pull" effects in the other direction (i.e. from Europe to Asia) were not equally strong, even considering that the European countries tried to promote their exports, and the Asian countries liberalised their imports in legal terms.

Analysing the results, and looking at the dynamics of trade flows, one question which presents itself is: *even if trade has developed rapidly among these regions, is it enough? Is it too much, or too little and, if so, compared to what? What can we expect: will it grow further, or faster or slower, than it has done so far?*

To answer these questions, we have to look into the factors influencing this development and try to separate them in order to measure their influence on the development of inter-regional trade. It is well known that international trade is an intricate system of visible and hidden attractions and resistances which regulate

intra- and inter-regional commodity flows. International trade is influenced—in addition to being affected by economic potential, resource endowment and the competitiveness among partners—by a number of political, traditional and non-economic factors.

In the analysis below these factors are classified in two categories:

— *volume factors*: these regulate the total export supply and import demand of the respective regions, and they reflect their trade potentials;

— *trade intensity factors*:[7] these include the influence of trade-policy and economic-distance; they display the characteristics of the partners' bilateral relations, and they regulate the commodity flows and the allocation of total exports and imports among markets.

The idea of the trade intensity coefficients is based on the assumption that trade flows depend on the "push" of the exporting country, on the "pull" of the importing country, and on particular factors regulating bilateral relations. This means that the respective sizes of total exports and total imports are determined mainly by internal economic conditions. However, each trade flow is strongly shaped by factors which regulate bilateral exchanges, (such as transport costs) and—in most cases to an even greater extent—by various trade-policy measures.

It is due to this distinction of two categories of factors that there has originated a separate analysis of the *volume effects* performed by the economic potentials, (i.e. the "push" and "pull" effects of the domestic economies), and the *intensity effects* which separately influence each individual trade flow. The distinction of "volume" and "intensity" effects takes place in such a way that a fictive, so-called "*normal*" flow is computed by taking into account the *volume effects*; then, by comparing this with the corresponding factual trade flow data, the *intensity effects* are obtained as a residuum.

The trade intensity indicator is defined as:

$$\delta_{ijk} = \frac{z_{ijk}}{z_{i.k} z_{.jk}}$$

where

$$z_{ijk} = \frac{x_{ijk}}{x_{..k}}, \qquad z_{i.k} = \frac{x_{i.k}}{x_{..k}}, \qquad z_{.jk} = \frac{x_{.jk}}{x_{..k}} \qquad \text{and}$$

[7] The origins of the "trade intensity" indicator (or as it was previously called, the "delta" coefficient) can be found in the papers of *Froment and Zighera* (1964) and *Theil* (1967), but the idea goes back to the multi-regional input-output analysis of *Leontief and Strout* (1963). Since then a great many publications have dealt with this type of international trade analysis. See for example: *ECE* (1973, 1985), Nagy (1985) and *Panic and Vacic* (1995).

x: means the value of the trade flow,
i: the exporting region,
j: the importing region and
k: the commodity group.

The delta coefficient indicates the intensity of trade of commodity k from region i to region j in such a way that it compares the share of the actual flow in total trade of commodity k with the same share of "*normal*" flow. In this sense, a flow is "normal" when its share in the total trade of a given commodity group is equal to the product of the corresponding shares of the exporting and importing countries, i.e. $(z_{i.k}z_{.jk})$.[8]

The trade intensity indicator shows the effects of all factors influencing the trade flows between a given pair of regions or countries over a given period of time, apart from the volume effects of total exports and imports. If the effects of trade-policy measures, discrimination, integration, traditional and other historical links, distance, etc. do not influence strongly the bilateral trade between two countries, the value of the trade intensity indicator will be unity, or near to it. If, however, these factors considerably reduce or increase the trade flows in question, this indicator will be less or greater than unity, respectively. A trade flow of "normal" intensity is but a starting-point of measurement, and no normative value judgement can be attached to it. A trade flow being "normal" means merely that it is not influenced by trade-policy, distance and similar effects.

The trade intensity indicators are not always comparable between regions of very different sizes, but—even in this case—they are useful tools for analysing their time series in order to see the consequences of trade policy changes between regions. In this sense, the term "trade policies" is not meant to imply simply the barriers to trade and their eventual increase or decrease. Trade policies include trade promotion efforts and any other policy intervention which can have an influence on the direction of trade. Many of these are, of course, politically motivated.

In previous time series analyses of trade intensities three main types of change were observed:

a) *continuation* of the formerly-observed course—i.e. continued stability of the coefficient in question, or continuation of its former time-trend;

b) "*flattening-out*" of the former trend, whereby the rate of change diminishes and the coefficient approaches a certain level in time;

c) *change* in the former level or trend of the coefficient, due to significant changes in trade-policy factors (given that economic distance usually does not change, or at least, not abruptly).

[8] In this study the trade intensities by commodity groups are not dealt with in detail. In the next section we shall deal with the intensity indicators of total trade between regions only.

Behind these typical movements of trade intensities, two essential trends were observed:

(i) *intensity indicators approach unity*—i.e. trade flows verge to "normal" flows as a consequence of trade liberalisation and globalization of the world economy;

(ii) *integration* of certain groups of countries, tends to increase the indicators of intra-regional trade *above unity*, and to decrease those of extra-regional trade to figure *below unity*.

It was also observed that the more the intensity indicators diverge from a certain centre of attraction—unity in the case of (i), and above or below unity in case (ii)—the greater are the changes; this explains "the flattening-out" of the trends mentioned above.

Changing intensities in East Asian–European trade

Table 6 shows the export intensities of the East Asian regions between 1955–1995. Looking at the development of Japanese export intensities, there is a remarkable difference between the very low intensities oriented to Eastern Europe and the mediocre intensities of exports to Western Europe and to the SU region. The intensity indicator of EE imports from Japan remained below 0.2 over the whole period, and since the mid-eighties in most years this figure has been less than 0.1. This means that Japanese exports to Eastern Europe are less than ten percent of what could be expected from the "normal" flows (i.e. by their respective shares in world exports and imports).

The intensity of Western Europe's imports from Japan showed a slowly but steadily growing tendency: from below the 0.3 of the sixties, approaching 0.5 until the early nineties, and fell back afterwards to 0.4 by the mid-nineties. The mediocre intensities could be explained by referring to the great distance between the two regions. However, looking at the indicators of Japanese export intensities to other regions, it is to be suspected that trade policies are also hindering Japanese exports to WE in a significant extent. For the sake of comparison Japanese export intensity indicators to North America are shown below:

1955	1960	1965	1970	1975	1980	1985	1990	1995
1.48	1.90	2.08	2.05	1.53	1.79	1.98	1.89	1.57

Japanese export intensities to America have been very high, being near 2.0 from the sixties to the late eighties, showing only a slight decrease since then.

Similarly, the intensity indicator was high in the direction of the other developed countries—for instance, in the direction of Latin America, and even in relation to Africa it was higher than that for Western Europe.

Japanese export intensities to the Soviet Union developed very differently from the pattern which was observed in the direction of Eastern Europe. It increased strongly from 0.35 to 0.89 between 1960 and 1976 and started to decline from the late eighties reaching 0.19 in 1995. For a long period of time it was significantly higher than the intensities of WE imports and this was a result which was not expected. Of course, the distance factor played a significant part in this development, given that Russia is regarded as an Asian country; however, one can suspect that—even if diplomatic relations were cooler—trade policy barriers could have been lower than in the other two European regions.

East Asian export intensities to Western Europe have remained fairly constant over a long period, staying at around 0.4 since the seventies. This is rather similar to the Japanese export intensities to Western Europe, and it seems to be rather low only in comparison with the export intensities to North America, which have been between 1.4–1.8 since the early seventies. East Asian export intensities to Eastern Europe were low (like those of the Japanese exports) until the late eighties, but they have become significantly stronger in the nineties.

Soviet import intensities form East Asia were relatively high (0.7–0.9) in the sixties and early seventies, but later declined to a level similar to that of Western Europe; nevertheless, between 1989–1992 it has increased again to 0.7–0.8, falling back to 0.4–0.5 in 1994–95. In this case distance once again plays an obvious role; however, as distance does not change one can assume that trade policy factors could have been more advantageous in certain periods than in the other European regions.

The Socialist Asian countries had very intensive exports to the two European socialist regions: in the case of exports to the SU it was between 5 and 16 (!) in the fifties and sixties, but remained near, or significantly above 2.0 from the seventies. It is remarkable that after a short decline between 1989–1991, in the following years Chinese export intensities reached again a level higher than 2.5. A serious drop came in 1994–95, showing the end of politically motivated high trade intensities, or—in our terms—the effect of "normalisation" in Russo-Chinese trade relations. SA exports to Eastern Europe were also very intensive, even if the indicators were always somewhat lower than those of the SU. From a level of 1.7–1.9 in the seventies, export intensities declined to 1.0–1.2 in the eighties; then they dropped to 0.2–0.3 in the early nineties. All these movements show how strongly politics influence trade relations, especially in the case of the Socialist economies at a time when political hostilities with western countries were predominant.

The import intensities of Western Europe from SA were low and they declined slowly from 0.4 to 0.2 till 1992, when it started to increase above 0.3. It is much below of the intensities of Japanese and East Asian imports. There can hardly be

any doubt that—in comparison with SU and EE imports—in this case politics have again played an important role in shaping trade relations. What is surprising is that the import intensities of WE are significantly below those of North America from SA. While they were below 0.2 in the seventies, they started to increase, reaching approximately 0.5 in the eighties and a level of 1.0 by 1995. The barriers of Chinese exports to the US are apparently much weaker than those to the EU.

Table 7 shows the export intensities of the European regions to East Asia.[9] The intensity of East European exports to Japan were just as low as those of the opposite trade flows, even if one can observe a slight increase beginning in the late eighties. Their export intensities to the East Asian region follow something approximating to a U-shape curve: from a level of 0.35 in 1965 they diminished to 0.1 in the mid-seventies, and remained low until the late eighties; then they started to increase, reaching a level of 0.4 in the early nineties, declining to 0.2 again in 1995. This may be due to the shift of the Chinese import data to AS. EE export intensities to SA were above 2.0 in most years until the late seventies, in the eighties they gradually decreased to around 0.8 in 1988, increasing again to 1.6 in 1990.

West European export intensities to Japan were much lower than those in the opposite direction in the seventies and early eighties, when they started to increase from a level of 0.2 to 0.4, reaching about the same level as those of Japanese export intensities to WE. This shows that the barriers entering the Japanese market were even stronger than the barriers facing Japanese goods entering West European markets for a long period, this difference, however, disappeared lately. The export intensities to the East Asian region were very similar to WE import intensities from there, with both figures staying steadily near 0.4.

Soviet export intensities to Japan declined after 1973, from a level of 0.7 going down to 0.2 in the early eighties, and then starting to increase in the nineties, reaching 0.7 again in 1993. This is remarkable given that the European CIS countries are smaller than the previous USSR and their export intensities have become two-three times higher than the intensities of Japanese exports to SU. Soviet export intensities to AS were between 0.3–0.4 for a long period, but they declined to about half this figure in 1988–1989 and jumped to near one in the nineties (apparently due to the fact that it also included Chinese imports). SA import intensities from the SU were always very high, being between 3–6 since the sixties.

Comparing the intensity indicators of bilateral flows to the trade balances (*Table 5*), one can see the reasons why the balances evolved as they did and how they have been influenced by trade policy differences. For example, the fact that the West European export intensities to Japan were about 0.1 lower than those of the opposite flows explains the negative balance of trade for WE. Similar differences in intensities can be found in WE-AS trade, even if they are smaller.

[9] The data are missing for SU in 1991. As it was mentioned Chinese imports have been reported in AS since 1991.

The surprising SU export surplus to Japan in the nineties can be regarded as a consequence of the much stronger SU export intensities to Japan than those of the opposite flows. The trade surplus of the East European countries with AS + SA till 1993 is explained by the fact that the export intensities of Eastern Europe were significantly higher than those of the two East Asian regions. When the former intensities dropped in 1994–95, the trade balance became negative for EE.

Some conclusions

After looking at the intensity indicators of East Asian and European trade, *what can we say about the future?* In the case of EE the direction of development seems to show a clear tendency: the liberalisation of trade and the consolidation of market economies in the Central-East European countries will increase their extremely low trade intensities with the Asian regions. This means not only that the low intensities we have observed will increase, but quite probably also that the lower they were the faster the rise will be. This is true for both directions of the trade flows. It is very likely, for example, that the very low intensity indicator of Japanese exports to EE—only 0.08 in 1995—will move in the direction of the level of West European import intensities (0.43 in the same year) and a similar development can be expected in East Asian exports to EE.

In the case of Asian trade intensities with Western Europe, the future is not so certain. We have seen the great differences, for example, between Japanese export intensities to North America and to Western Europe: the former is more than three times higher than the latter. One could expect that this difference will diminish—i.e. West European import intensities will increase, both with Japan and with the other Asian regions. Further steps towards globalization and liberalisation will quite probably decrease trade barriers, but it does not seem evident that this will happen soon. Taking into account the great stability of the intensity indicators over a long period of time, and also their uneven development, there is a question with regard to the factors which can induce a faster increase of trade intensities between the two regions.

One of the possible conclusions of our study is the enormous—and for many people: hidden—potential in trade creation due to the process of globalization and liberalisation: in our terms they represent a "normalisation" of international trade. Let us take two examples; what would have happened if:

— the Japanese export intensity to WE increased from its 1995 level of 0.41 to 0.75 and West European export intensities to Japan increased from 0.40 also to 0.75?

— the Japanese export intensity to EE increased from its 1995 level of 0.08 to 0.3 and East European export intensities to Japan from 0.08 also to 0.3?

Looking at *Tables 6* and *7* such changes do not seem to be exaggerations: in the first case the WE import intensities would be less than half of those of North American imports from Japan, and in the second the intensities would be lower than those between Western Europe and Japan. We are using the trade data of 1995 and this begs the question: what would have happened if, in that year, the distribution of trade corresponded to the estimated intensity indicators? If we are looking into the future the consequences of such trade policy changes would be even greater, given the fact that international trade is growing—i.e. our estimates underrate likely future increases.

Using the equation on page 8 and the trade data of 1995 we get the following results:

— Japanese exports to WE would have increased by US $ 61 billion and WE exports to Japan by US $ 40 billion.

— Japanese exports to EE would have increased by US $ 2.4 billion and EE exports to Japan by US $ 1.1 billion.

As can be seen, the changes are enormous: bilateral trade between the regions would have increased by 82 percent and 85 percent respectively in the first case, and by 300 percent and 270 percent respectively in the second.

Of course, the aim here is not to make projections: what has been attempted is to show what potential there is for trade extension in the cases where past trade policies have reduced the intensities to levels much below what they might "normally" be. There are also many other factors which have to be taken into account if we really intend to look into future development possibilities—e.g. domestic economic growth, the trade balance, capital flows, trade in services etc. However, *there can be little doubt that advances in the direction of the reduction of trade barriers and export promotion policies on a more global scale can and will substantially change not only the size but also the structure of international trade.*

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Appendix 1

The regions and commodity groups of the trade flow model

Regions[a]	
1) Soviet Union/CIS states	SU
2) Central and Eastern Europe	EE
3) Socialist Asia/China	SA
4) Western Europe	WE
5) North America	NA
6) Japan	JP
7) Other developed countries	OD
8) Latin America	LA
9) Africa	AF
10) Western Asia	WA
11) East Asia	AS
12) Total world trade	TW

[a]The list of countries belonging to the regions can be found in UN Standard Country Codes, Statistical Papers, Series M No. 49.

Commodity groups[b]	Abbreviations	SITC numbers
1) Food and Agricultural materials	AGRPROD	0+1+4+2−27−28
2) Minerals and metals	MINMET	27+28+67+68
3) Fuels	FUELS	3
4) Chemicals	CHEM	5
5) Other manufactured goods	OTMAN	6+8−67−68
6) Machinery[c]	MACH	7+9
7) Total world trade	TW	0+...+9

[b]Details of the commodity classification in UN Standard International Trade Classification, Revision 2 and 3. Statistical Papers, Series M No. 34.

[c]After investigation it was assumed that the trade in non-specified products (SITC 9) consists mostly of armaments and for this reason it was included in the machinery commondity group.

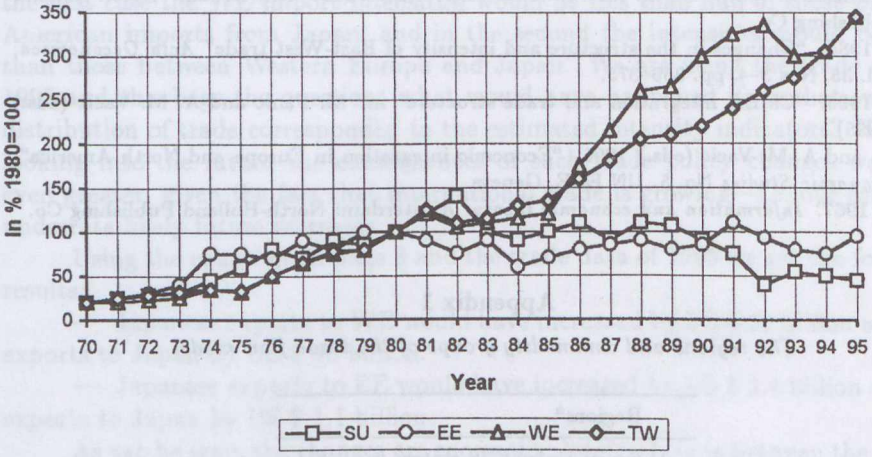

Fig. 1 Export growth of Japan

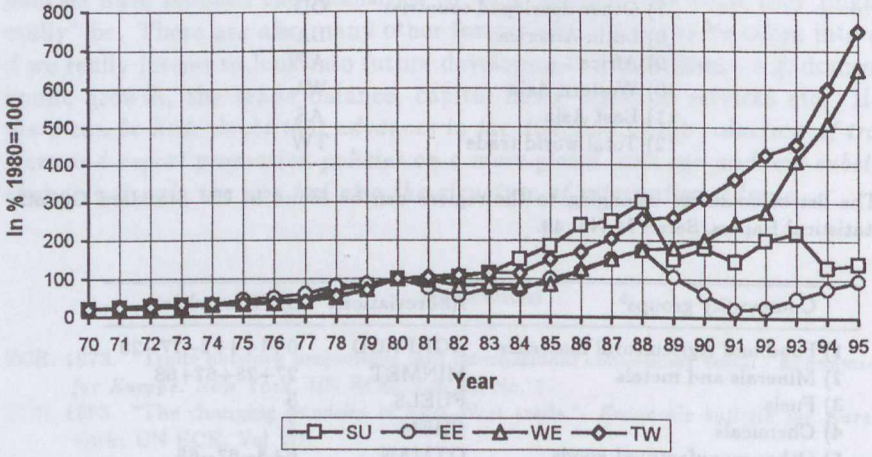

Fig. 2 Export growth of SA

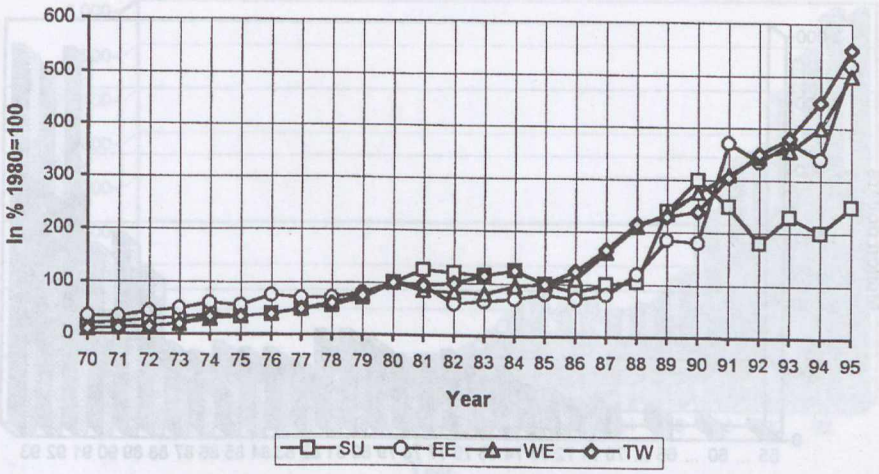

Fig. 3 Export growth of AS

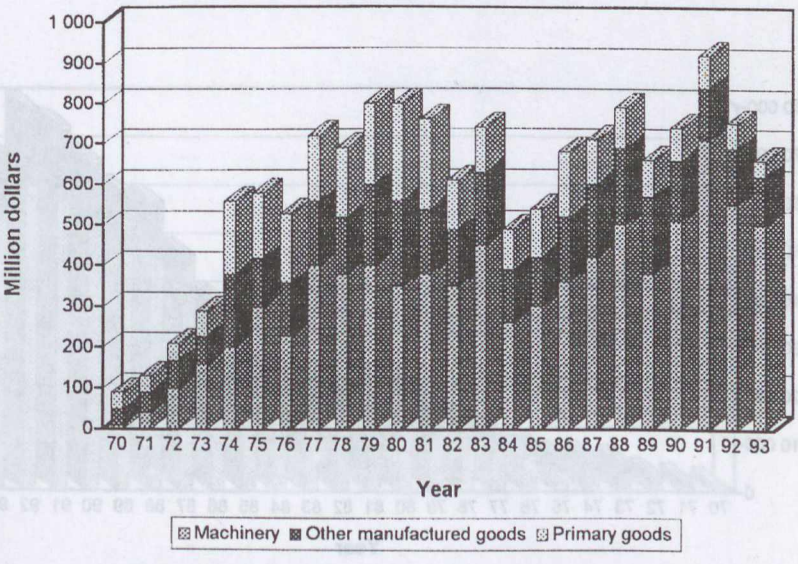

Fig. 4 Japanese export to EE by commodities

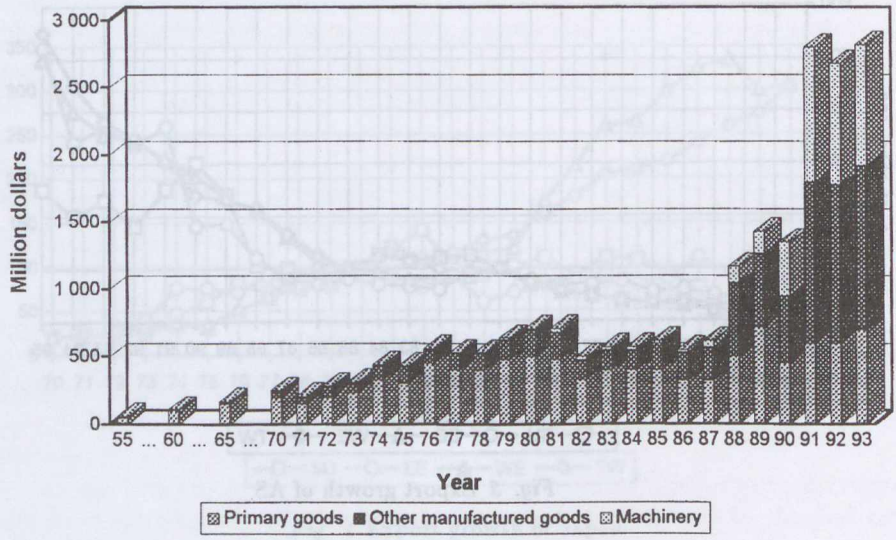

Fig. 5 AS export to EE by commodities

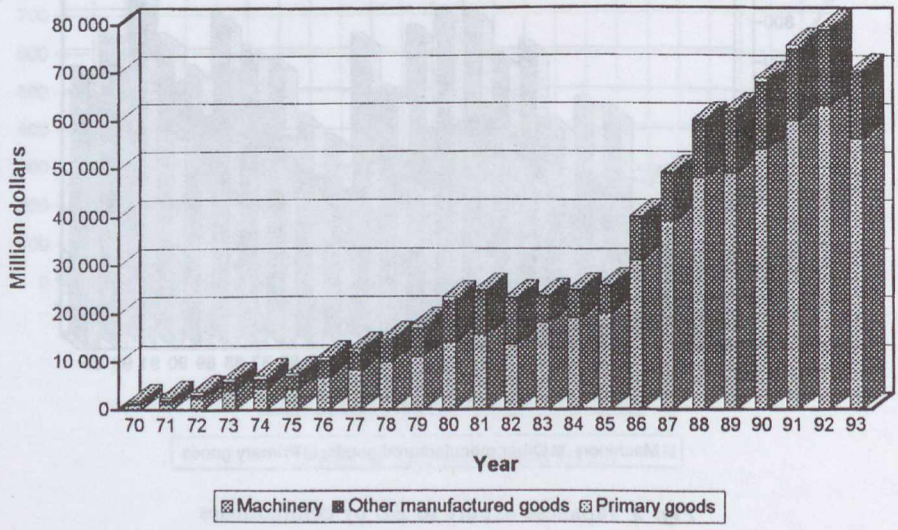

Fig. 6 Japanese export to WE by commodities

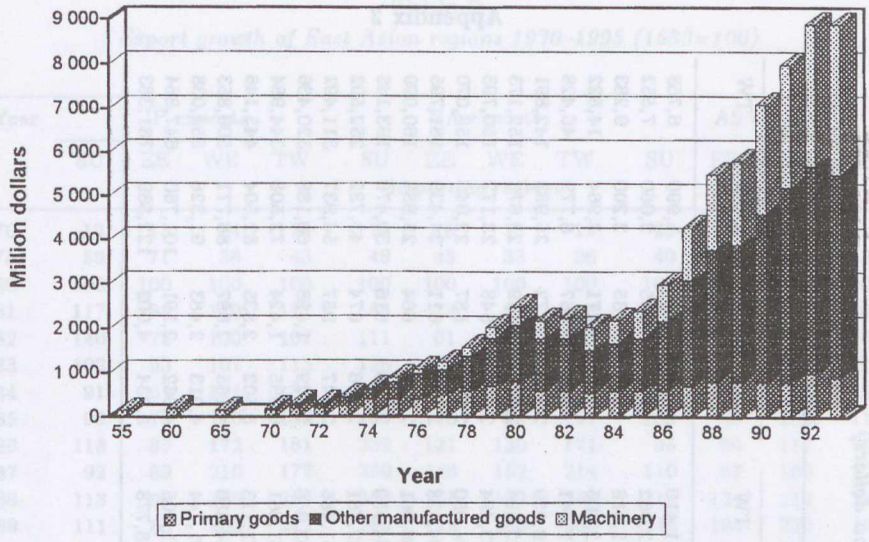

Fig. 7 AS export to WE by commodities

Appendix 2

Table 1

East Asian exports to Europe (million dollars)

Year	JP exports				SA exports				AS exports			
	SU	EE	WE	TW	SU	EE	WE	TW	SU	EE	WE	TW
	importing regions											
55	2	9	195	1,990	740	220	120	1,410	31	61	1,990	6,768
60	60	4	475	4,057	1,000	360	235	2,062	190	125	2,060	7,552
65	170	40	1,100	8,462	410	190	305	2,018	385	185	2,200	9,283
70	341	107	2,910	19,315	235	250	394	2,305	494	271	2,964	14,822
75	1,625	574	8,081	55,750	599	637	1,009	7,241	868	467	8,779	46,428
80	2,778	807	21,463	129,541	1,230	1,415	3,031	19,959	2,145	772	25,953	142,891
81	3,259	758	23,687	151,769	1,044	1,035	2,899	22,594	2,726	759	23,673	152,173
82	3,899	584	21,454	138,380	1,362	858	2,500	23,494	2,608	548	23,172	150,793
83	2,821	747	23,048	146,660	1,549	1,054	2,801	24,050	2,507	587	22,046	158,070
84	2,518	492	23,808	169,940	1,838	1,049	2,600	24,438	2,790	611	24,439	181,795
85	2,751	564	24,934	175,659	2,328	1,462	2,676	30,061	2,206	664	25,888	160,099
86	3,150	682	36,927	208,801	2,935	1,716	3,952	34,050	2,028	616	30,476	193,148
87	2,563	717	45,155	228,787	3,078	2,091	4,620	42,781	2,366	674	43,732	252,502
88	3,130	776	55,736	264,373	3,718	2,478	5,525	51,485	2,447	957	54,937	311,492
89	3,082	673	56,283	274,742	1,849	1,557	5,555	53,048	5,329	1,498	60,188	320,436
90	2,563	745	62,412	286,272	2,239	909	6,147	61,661	6,595	1,424	72,508	344,984
91	2,115	922	68,325	314,525	1,823	255	7,340	71,113	5,502	2,835	82,504	445,146
92	1,128	762	71,584	339,651	2,448	313	8,331	84,850	4,165	2,097	88,771	500,853
93	1,581	660	64,117	360,911	2,821	675	12,677	91,744	4,913	2,483	91,326	554,038
94	1,298	598	65,134	395,599	1,694	951	15,950	121,005	4,062	2,591	101,760	647,864
95	1,215	794	73,874	442,937	1,760	1,209	19,789	148,778	5,234	4,002	122,589	781,383

Table 2

Export growth of East Asian regions 1970–1995 (1980=100)

Year	JP exports				SA exports				AS exports			
	SU	EE	WE	TW	SU	EE	WE	TW	SU	EE	WE	TW
	importing regions											
70	12	13	14	15	19	18	13	12	23	35	11	10
75	58	71	38	43	49	45	33	36	40	60	34	32
80	100	100	100	100	100	100	100	100	100	100	100	100
81	117	94	110	117	85	73	96	113	127	98	91	106
82	140	72	100	107	111	61	82	118	122	71	89	106
83	102	93	107	113	126	74	92	120	117	76	85	111
84	91	61	111	131	149	74	86	122	130	79	94	127
85	99	70	116	136	189	103	88	151	103	86	100	112
86	113	85	172	161	239	121	130	171	95	80	117	135
87	92	89	210	177	250	148	152	214	110	87	169	177
88	113	96	260	204	302	175	182	258	114	124	212	218
89	111	83	262	212	150	110	183	266	248	194	232	224
90	92	92	291	221	182	64	203	309	307	184	279	241
91	76	114	318	243	148	18	242	356	257	367	318	312
92	41	94	334	262	199	22	275	425	194	272	342	351
93	57	82	299	279	229	48	418	460	229	322	352	388
94	47	74	303	305	305	67	526	606	189	336	392	453
95	44	98	344	342	342	85	653	745	244	518	472	547

Table 3

Export flows of European regions to East Asian regions (million dollars)

Year	SU exports			EE exports			WE exports		
	JP	SA+AS	TW	JP	SA+AS	TW	JP	SA+AS	TW
	importing regions								
55	2	932	3,366	3	330	4,458	160	2,195	35,050
60	76	1,065	5,508	7	550	7,305	360	2,910	51,220
65	185	855	7,902	30	495	11,458	620	3,330	78,660
70	379	875	12,004	88	638	17,677	1,679	4,293	136,244
75	927	1,902	31,551	187	1,499	43,469	3,546	11,314	360,141
80	1,464	4,574	71,046	289	2,718	77,707	8,215	25,954	804,382
81	1,130	5,003	74,085	301	2,428	76,953	8,067	26,240	737,907
82	1,042	5,462	80,630	281	2,370	77,181	7,896	26,584	710,876
83	1,115	5,982	84,317	403	2,431	82,896	8,474	26,607	698,059
84	1,035	6,515	84,735	410	2,310	81,995	9,358	28,055	716,496
85	928	6,179	68,176	349	2,965	83,837	9,972	32,085	747,337
86	1,396	8,481	86,795	383	3,063	88,848	13,777	39,004	907,438
87	1,540	9,709	96,430	467	3,249	99,792	19,068	47,841	1,093,943
88	1,951	10,855	99,050	644	3,024	102,577	24,058	54,536	1,200,711
89	2,134	8,799	95,144	739	3,483	82,831	27,733	60,518	1,287,525
90	3,351	8,654	89,473	319	3,104	91,179	34,454	71,168	1,537,982
91	0	0	0	1,872	6,344	99,128	32,720	74,271	1,566,655
92	1,784	6,536	50,060	364	3,137	56,881	31,630	84,566	1,664,487
93	2,090	6,696	51,349	362	3,607	61,509	31,523	99,172	1,519,254
94	3,203	15,369	86,954	339	3,198	71,262	37,707	117,808	1,727,590
95	3,986	19,130	108,182	422	4,156	93,320	46,541	147,673	2,081,312

Table 4

Export growth of European regions 1970–1995 (1980=100)

Year	SU exports			EE exports			WE exports		
	JP	SA+AS	TW	JP	SA+AS	TW	JP	SA+AS	TW
	importing regions								
70	26	19	17	30	23	23	20	17	17
75	63	42	44	65	55	56	43	44	45
80	100	100	100	100	100	100	100	100	100
81	77	109	104	104	89	99	98	101	92
82	71	119	113	97	87	99	96	102	88
83	76	131	119	139	89	107	103	103	87
84	71	142	119	142	85	106	114	108	89
85	63	135	96	121	109	108	121	124	93
86	95	185	122	133	113	114	168	150	113
87	105	212	136	162	120	128	232	184	136
88	133	237	139	223	111	132	293	210	149
89	146	192	134	256	128	107	338	233	160
90	229	189	126	110	114	117	419	274	191
91	0	0	0	648	233	128	398	286	195
92	122	143	70	126	115	73	385	326	207
93	143	146	72	125	133	79	384	382	189
94	219	336	122	117	118	92	459	454	215
95	272	418	152	146	153	120	567	569	259

Table 5

Trade balances of European regions (million dollars)

Year	SU	EE	WE	SU	EE	WE
	balances with Japan			balances with SA+AS		
55	0	−6	−35	161	49	85
60	16	3	−115	−125	65	615
65	15	−10	−480	60	120	825
70	38	−19	−1,231	146	117	935
75	−698	−387	−4,535	435	395	1,526
80	−1,314	−518	−13,248	1,199	531	−3,030
85	−1,823	−215	−14,962	1,645	839	3,521
90	788	−426	−27,958	−180	771	−7,487
93	509	−298	−32,594	−1,037	448	−4,831
94	1,905	−259	−27,427	9,613	−344	98
95	2,771	−372	−27,333	12,136	−1,055	5,295

Table 6

Export intensities of East-Asian regions

Year	JP exports			SA exports			AS exports		
	SU	EE	WE	SU	EE	WE	SU	EE	WE
	importing regions								
55	0.03	0.10	0.23	16.15	3.37	0.20	0.14	0.19	0.70
60	0.35	0.02	0.27	11.48	2.93	0.27	0.60	0.28	0.64
65	0.48	0.08	0.28	4.81	1.56	0.33	0.98	0.33	0.52
70	0.48	0.10	0.33	2.75	1.95	0.37	0.90	0.33	0.43
75	0.71	0.19	0.34	2.02	1.61	0.32	0.46	0.18	0.44
80	0.68	0.15	0.37	1.96	1.70	0.34	0.48	0.13	0.40
81	0.63	0.12	0.38	1.36	1.13	0.32	0.53	0.12	0.38
82	0.74	0.10	0.38	1.53	0.86	0.26	0.46	0.09	0.37
83	0.49	0.11	0.39	1.65	0.97	0.29	0.41	0.08	0.34
84	0.40	0.07	0.36	2.05	1.00	0.27	0.42	0.08	0.34
85	0.42	0.08	0.36	2.06	1.21	0.22	0.37	0.10	0.41
86	0.44	0.07	0.42	2.54	1.08	0.27	0.31	0.07	0.37
87	0.37	0.07	0.45	2.36	1.15	0.24	0.31	0.06	0.39
88	0.40	0.08	0.48	2.42	1.23	0.25	0.26	0.08	0.40
89	0.45	0.07	0.46	1.40	0.88	0.23	0.67	0.14	0.42
90	0.46	0.07	0.46	1.86	0.40	0.21	0.78	0.16	0.40
91	0.43	0.14	0.47	1.64	0.17	0.22	0.80	0.31	0.40
92	0.28	0.12	0.47	2.44	0.19	0.22	0.70	0.22	0.39
93	0.36	0.09	0.44	2.56	0.36	0.34	0.74	0.22	0.40
94	0.23	0.07	0.41	0.98	0.37	0.33	0.44	0.19	0.39
95	0.19	0.08	0.41	0.80	0.34	0.33	0.46	0.21	0.38

Table 7

Export intensities of European regions

Year	SU exports			EE exports			WE exports		
	JP	SA	AS	JP	SA	AS	JP	SA	AS
				importing regions					
55	0.03	16.90	0.08	0.03	3.93	0.14	0.20	0.17	0.77
60	0.45	10.59	0.25	0.03	3.49	0.24	0.23	0.45	0.65
65	0.63	5.35	0.67	0.07	1.64	0.35	0.21	0.41	0.54
70	0.63	4.50	0.32	0.10	1.84	0.23	0.25	0.39	0.44
75	0.50	3.40	0.39	0.07	1.94	0.22	0.17	0.58	0.39
80	0.33	2.97	0.39	0.06	1.93	0.16	0.16	0.37	0.36
81	0.24	3.09	0.38	0.06	1.57	0.16	0.17	0.34	0.37
82	0.20	3.26	0.35	0.06	1.62	0.14	0.17	0.34	0.38
83	0.21	3.04	0.35	0.08	1.40	0.13	0.19	0.36	0.37
84	0.20	2.66	0.39	0.08	1.15	0.11	0.21	0.33	0.37
85	0.23	2.59	0.41	0.07	1.21	0.11	0.23	0.42	0.39
86	0.31	3.26	0.35	0.08	1.16	0.12	0.29	0.40	0.40
87	0.30	3.49	0.36	0.09	1.10	0.12	0.33	0.36	0.40
88	0.34	3.53	0.32	0.11	0.86	0.10	0.34	0.31	0.37
89	0.36	4.90	0.14	0.14	1.64	0.15	0.34	0.39	0.40
90	0.61	6.37	0.16	0.06	1.64	0.13	0.37	0.40	0.41
91				0.31		0.44	0.35		0.33
92	0.65		0.84	0.12		0.36	0.34		0.33
93	0.71		0.75	0.10		0.34	0.36		0.37
94	0.68		0.96	0.09		0.24	0.40		0.37
95	0.66		0.92	0.08		0.23	0.40		0.37

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FLEXIBILITIES AND TRUST: PRODUCTION MARKETS AND ROLE PRODUCTION IN THE HUNGARIAN ECONOMIC TRANSFORMATION

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In this study, we problematize the notion of flexible economic strategies. We develop two ideal types. In "flexibility based on studied trust", actors can afford to be flexible because the institutions supporting their flexibility—i.e. constitutional orders—minimize the likelihood that anyone will take advantage of their various forms of behaviour. In "flexibility based on distrust", actors are flexible because they assume that others will take advantage of anything that they might do. We examine the ways in which studied trust and distrust contribute to actors' decisions to behave flexibly in the two types of environments, and we consider the way information flows in the two contexts and the contents of relations developed among actors in the two realms. We claim that most flexible strategies pursued by actors are combinations of the two ideal types. The aim of the research proposal presented at the end of the study is to understand the different flexible strategies which arise from the combinations of flexibility based on studied trust and distrust. The setting for the research proposal is a particular type of production market in the Hungarian economic transformation.

Uncertainty and flexibility

The current period of economic transformation is characterized by heightened uncertainty in Hungary. A significant part of this uncertainty has bureaucratic origins. Laws and regulations concerning all aspects of economic life, from taxation to social security dues and privatization are subject to frequent and often unforeseeable change (*Stark* 1996; *Voszka* 1994, 1995, 1996; *Lányi* 1991). This unpredictability is partly the result of the lack of consultative institutions between civil society and the state (a deficit is particularly evident in Hungary among the East Central European countries) (*Stark and Bruszt* forthcoming). The scarcity of such institutional ties has exacerbated the traditional distrust between economic actors (especially the owners of small and medium-sized enterprises) and government officials (*Gábor* 1991; *Ékes* 1992; *Csanádi* 1995; *Kemény* 1996).[1] This distrust has also increased the likelihood that at least some changes in regulations are intended to carry an element of surprise for economic actors.[2]

[1] For an abstract formulation of this link, see e.g. *Sabel* 1992, 1993, 1994. For a similar phenomenon in Italy, see *Regini* 1995.

[2] Please note, that we do not refer only to changes in economic factors which are purposefully unexpected (like interest-rate hikes, or currency devaluation), but to sweeping institutional changes in the economic environment as well.

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The transformation has also increased the rapidity of change of market signals. The liberalization of private enterprise, the fragmentation of large state-owned firms and the lowering of barriers to foreign trade and investment have raised the number of competitors in every market (*Major* 1995; *Ehrlich and Révész* 1996). As a result, markets have fragmented and product life-cycles have shortened. The economic uncertainty experienced by market actors is further increased by the fact that several companies are empty shells, often used for opportunistic strategies (*Czakó et al.* 1994).

In order to survive in uncertain environments, economic actors rely on flexible strategies.[3] They rarely implement plans that would lock them into unique alternatives. In order to be able to change quickly, they pursue tactics of hedging, keeping several courses of action open to themselves (*Leifer* 1988, 1991; *Piore and Sabel* 1984; *Sabel* 1995c; *Sabel and Zeitlin* forthcoming).

Analysts have often pointed to the positive as well as to the negative consequences of the flexible strategies adopted by Hungary's economic actors. Writing about the second economy, István R. Gábor emphasized not only entrepreneurs' ability for organizational innovation, but also their focus on short-term profitability, leading to widespread opportunism. He repeatedly underscored the importance of the small proportion of full-time entrepreneurs in the Hungarian economy, and pointed to its negative consequences in terms of technical development and international competitiveness (Gábor 1985, 1991, 1992, 1996). David Stark, investigating the hedging strategies of companies characterized by recombinant property forms, has stressed the possibility of a trade-off between adaptability and accountability (Stark 1996).

Starting from the above statements regarding the possibly Janus-faced consequences of flexibility, our aim here is to problematize the notion of flexible (economic) strategies. We contend that flexible strategies have different forms and that the type of flexible strategies implemented by Hungarian economic actors will greatly influence the course of the country's economic development. Some types, like those evidenced in industrial districts (*Pyke et al.* 1990, *Pyke and Sengenberger* 1992; *Cossentino et al.* 1996; Sabel 1995a) and "lean" manufacturing systems (*Womack, Jones and Roos* 1990; *Nishiguchi* 1994; *Herrigel* 1996; *Cusumano and Selby* 1995; Sabel 1991; *Bowman and Kogut* 1995b) are associated with economic development. In this literature, the more flexible the strategies are that economic actors develop, the better they can adapt to their constantly changing economic environment, and the more successful they can be—individually and collectively.

[3] Flexible strategies (in which the ability to change quickly is an important goal) are contrasted here with strategies of stability and slow change. While strategies of stability are adequate when there is little variation in the environment, strategies of slow change are appropriate when the intended transformation is profound: for example, in the case of changing the culture of an organization (e.g. *Harvard Business School* 1989).

Expressing a common feature of these forms of flexible strategies, we shall call them "flexibility based on studied trust".[4] However, flexibility has another face. A separate branch of literature on the topic, concentrating on—what we contend to be—*another type* of flexible strategy links flexibility to less beneficial social phenomena. Studies on the Sicilian and Russian mafias (Gambetta 1988c, 1993, 1994a, 1994b, 1994c; *Varese* 1994) and Italian corruption networks (*Pizzorno* 1992; *della Porta* 1992; *Vannucci* 1992; *della Porta and Vannucci* 1994) also emphasize the importance that flexibility has for the survival and *individual* success of actors in these milieus. Underscoring a common feature of these flexible forms of behaviour, we shall denote them as "flexibility based on distrust".[5]

In what follows, we shall examine the ways in which studied trust and distrust contribute to actors' decisions to behave flexibly in the two types of environments; how information flows in the two contexts and the contents of relations developed among actors in the two realms. At this moment, our typology consists of two ideal types. As in the case of every typology based on ideal types, emphasis should be placed on intermediate categories (*Weber* 1978; *Wittgenstein* 1992). Our hypothetical empirical generalization is that most flexible strategies pursued by (economic) actors possess some features of each ideal type. Unfortunately, at the present stage of our research, we cannot provide a systematic analysis of the area in between the two pure types. The aim of the research programme presented at the end of this study is, on the theoretical level, to attempt to fill in the existing gap. Related to this, on the empirical level, we shall contend that the flexible strategies pursued by Hungarian small entrepreneurs possess a mixture of features of the two ideal types. The aim of the research programme presented at the end of the study is, on the empirical level, to deepen our understanding of these strategies, as well as of those evidenced in other sectors of the Hungarian economy.

Flexibility based on studied trust

Studied trust and constitutional orders

In the following paragraphs, we shall argue for the importance of what Charles Sabel calls "studied trust" and of the institutions through which it is created and

[4] In what follows, we shall rely on the following definition of trust: "trust (or, symmetrically, distrust) is a particular level of the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action, both *before* he can monitor such action (or independently of his capacity ever to be able to monitor it) *and* in a context in which it affects *his own* action." (*Gambetta* 1988b, p. 217)

[5] As it will be evident in our argument later, the expression "based on" denotes a different logical relationship between trust and flexibility in our two ideal types. This should not affect our argument.

maintained (Sabel 1992, 1993) in enabling actors to follow the flexible strategies that we classify in this ideal type. Sabel's starting assumption is that "trust is a precondition of social life" (Sabel 1992, p. 218). He postulates that "individuality and sociability—here, unthinking attachment to a body of collectively defined routines and precepts—are indissolubly linked. Just as an artist defines his or her style by varying some—but only some—of the elements defining the commonly acknowledged genres, so the individual becomes an individual by applying the repertoire of socially acknowledged behaviors in a distinctive way." (Sabel 1993, p. 87.)[6] A cardinal concept in this formulation is that of the reflexive self: "a self taken as a hierarchy of identities or a cacophony of voices that somehow decides which of its many possible selves the self will be." (Sabel 1993, p. 87) Combining his argument about individuality with his notion of reflexivity, he states that reflexive selves, while enacting their individual strategies rely, and therefore make themselves vulnerable to, the actions of other individuals (Sabel 1993, p. 88).

Relying on the concept of reflexivity, Sabel argues that trust is not an all-or-nothing concept. "(I)n a world of reflexive agents, everyone knows what it means to trust, and everyone can imagine trusting persons one does not currently trust, and ceasing to trust persons one currently does." (Sabel 1993, p. 90) "We do not simply trust or believe or not. Rather we come to trust; we renew our beliefs; we disbelieve; we fear duplicity, and so on." (Sabel, 1993, p. 92)[7] Trust between reflexive selves is studied: granting it does not exclude questioning its basis, while raising doubts about it does not entail all-out suspicion. In conditions of studied trust, emphasis is based on negotiations in which qualms regarding the ground-rules of behaviour are made explicit, but with the specific purpose of ironing out differences. Based on these assumptions, the proper question is not "How might trust be possible?" but "Given that some trust is unavoidable in human relations, how do we come to trust some persons, groups, or institutions, rather than others?" (Sabel 1993, p. 87.)

Studied trust is created and maintained in what Sabel calls "constitutional orders" (Sabel 1993, pp. 73–75). Constitutional orders incorporate constituent units and a superintendent. In our examples, constituent units might be the employees of a company (or of several companies), or firms in a market. Superintendents might be people resembling, but in fact performing very different roles from, the traditional supervisors of these employees; most often they are composites of the constituent entities, such as trade associations, or groups of employees responsible for the production of a gadget at a company.

[6] For related formulations see, for example, *Bourdieu* 1984; *Bourdieu and Wacquant* 1992; *Boltanksi* 1996b; *Boltanski and Thevenot* 1987. *Wagner* (1994) provides a survey of related arguments.

[7] In the formulation of an economist, "a person's reputation is the 'public's' imputation of a probability distribution over the various types of person that the person in question can be in principle. Reputation is rarely of the all-or-nothing variety." (*Dasgupta* 1988, p. 62)

A salient feature of constituent units is their high degree of interdependence; they would not be able to accomplish their tasks on their own, only jointly, with other constituent units. This, however, does not mean that the task can be completed *solely in a given* group; it only means that *a* constituent unit would not be able to do it, or the contribution of a constituent unit, strapped from those of other constituent units, would be meaningless. Also, constituent units usually perform several tasks and, as a consequence, they are the members of several groups at the same time.

The most important constraint of rule-making in constitutional orders, for our purposes, is that "all rules (about which questions arise—S.K.) must be set in consultation with constituents" (Sabel 1993, p. 74). This arrangement is based on the assumption that constituents usually know more about the object of discussion than the superintendent. Normally, the superintendent facilitates communication among the constituents; the superintendent is not the constituent's boss. "Consultative rule-making...makes the ranking of constituents and superintendent indeterminate" (Sabel, 1993, p. 75).

The basis of studied trust in constitutional orders is the joint reduction of information asymmetry over sensitive issues and the assurance that disputes will be resolved by the participation of all parties concerned. Typical ground rules of constitutional orders "specify *only* the forms of information exchange (which the parties will follow) and...create no separate machinery for dispute resolution" (Sabel 1995b, p. 35). Since all parties agree to reveal whatever information is necessary for their joint involvement, and their close integration (the parties exist, to a great degree, as members of constitutional order(s)) makes certain that hiding information is both costly and unlikely, suspicions are minimized. At the same time, the explicit and reliable nature of all relevant information induces the questioning of the present arrangement. Openness about information and the frequent questioning of practices lead to the fact that trust among the parties will not be blind. While the unravelling of the arrangement is possible, tight interdependence prompts the parties to seek joint solutions to their problems.[8]

Such an arrangement helps the players to adapt flexibly to changes in their environment because actors, contexts, rules and methods can be jointly redefined in order to enable new, mutually advantageous courses of action. As long as a new way of acting provides benefits to the parties the requisite redefinition of their identities and their relationship is perceived as possible because the underlying constitutional order decreases the likelihood that any parties will take advantage of the consequent but unforeseen vulnerabilities of others. The participants—constituent

[8] In Sabel's words: "The central effect of these institutions...is to blur the boundary between policing behavior and articulating consensus. (...) They do this by allowing the parties to monitor each other's behavior while encouraging them to jointly reevaluate their situation in the light of these observations and adjust their reciprocal expectations accordingly." (Sabel 1993, p. 93)

units and superintendents alike—can perform virtually any roles as long as their mutual advantages are explored in consultations. Moreover, when new forms of behaviour are contemplated the mutual interdependence of the parties renders such consultations necessary since no unilateral role change is likely to lead to success. As a result, flexible strategies are always joint endeavours in this context. My flexibility is made possible by your flexibility alone.

In the subsequent paragraphs, we shall "bring life to" the above, rather abstract argument, and illustrate how economic actors enhance their flexibility by participating in constitutional orders. The story will be that of emerging networks of specialists operating in very uncertain contexts. In their quickly evolving markets, what to produce is very difficult to define, considering the amorphous character of consumer tastes about non-existing products, rivals' guesses about the same moving target appearing in quick succession, and the relative lack of knowledge about what is possible to produce until it has actually been tried. Continued presence in such markets is possible only on the basis of the continuous exploration of possibilities: organizational learning and flexibility are of paramount importance. Besides, in their quickly evolving environments, where one can be certain to collect, on one's own, only a decreasing proportion of the knowledge necessary to perform one's tasks properly, actors' jobs become profoundly interdependent and hierarchies fade. Uncertainty prompts the continuous questioning of rules, methods and identities; interdependence and the fading of hierarchies induces actors to engage in their *joint* redefinition. As a result, actors' flexibility is based on their studied trust.[9] In order to place these activities in context, we shall outline the developments that have led to their recent diffusion in industrialized countries.[10]

[9]The need to devise flexible organizations has resulted in several innovations, not all of which conform to the ideal typical argument presented here. For example, an analysis of workplace practices, focusing on the telecommunications and automobile industries in seven industrialized countries found four recurring patterns, while also emphasizing variation within the patterns (*Darbishire and Katz* 1996). These patterns reflect different configurations of many of the organizational developments outlined below, as well as of some arrangements which are more similar to our second ideal type. (We argue that an isomorphic diversity of organizational forms can be observed in the phenomena conceptualized by the other ideal type.) This wide variation in the social organization of flexibility is one of the most important reasons why we contend that the arguments presented in this and the subsequent section of the paper describe ideal types. We shall present our argument about the necessity to transcend this ideal typical framework in the third part of the study.

[10]Besides the areas of modern economies treated below, flexibility based on studied trust is also important in the economic development policies of industrial districts (Cossentino *et al.* 1996, Pyke 1994, Sabel 1994).

Market fragmentation and its organizational consequences

The growing instability and saturation of traditional mass markets in industrialized countries from the beginning of the 1960s has probably been the most important economic process that contributed to this diffusion[11] (Piore and Sabel 1984, pp. 165–193; Herrigel 1996, pp. 178–180). Specializing one's products in order to distinguish them from those of one's competitors became a successful strategy in this environment.[12] As a result, mass markets became fragmented, and product life-cycles shortened.

These developments resulted in the flexible integration of several specialists, engaging in the continuous reflexive redefinition of their world and constitutional orders.[13] In the fragmented mass-markets, large, hierarchical organizations, characterized by an extreme and rigidly defined division of labour producing long runs of standardized products were not profitable any more. Two processes emerged: the first was (collaborative) subcontracting which created specialist organizations with complex identities;[14] the second was the blurring of boundaries between functionally or hierarchically separate parts of organizations, as well as of those between organizations—this process reintegrated the "complexified specialists", let they be people or organizations (Piore and Sabel 1984, pp. 205–220; *Bowman and Kogut* 1995b; *Fisher et al.* 1995; Herrigel 1996, pp. 235–253; Locke 1995, pp. 105–121; Nishiguchi 1994; *Storper* 1989; Womack, Jones and Roos 1990). The first process started because it no longer made economic sense to place all aspects of the production in-house (Herrigel 1996, pp. 182–186). Specialized departments, focusing on the production of a small component of the final product could no longer be sustained if based on smaller production runs. Also, combining the risks resulting from fluctuations in—what became—several markets within the walls of a single organization was too hazardous. Besides, in order to have access to the know-how necessary to produce specialized items, it was more advantageous to rely on components manufacturers who became specialists in that particular part of the

[11] The strategies mentioned here existed earlier but probably on a smaller scale. See, for example, Herrigel 1996, pp. 33–71; Sabel and Zeitlin, forthcoming.

[12] But not the only one. Another possibility has been to pool together so far separate markets around a single standardized product, thereby shielding one's organization from the new uncertainties. Probably the most famous example of this was the "world car" strategy of American car companies. This strategy, however, proved to be less successful than the ones mentioned below. See, for example, Piore and Sabel 1984, pp. 197–202.

[13] Paradoxically, the emergence of technologically intensive mass markets from the early 1980s has had a similar effect (*Garud and Kumaraswamy* 1993; Cusumano and Selby 1995).

[14] This form of subcontracting, described further in greater detail, is different from dualist subcontracting. Dualist arrangements, in which the subcontractor is a buffer against fluctuations in demand, are rife with distrust. Such relations fall under our second ideal type. On the two forms of subcontracting see, for example, Nishiguchi 1994, pp. 90–139; Womack, Jones and Roos 1990, pp. 138–168.

production process by supplying several customers requesting the same type of items, as opposed to relying on a unit which served just one, in-house "customer". As a result, subcontracting became widespread.

The second process entailed the blurring, or, occasionally, the elimination of barriers between different hierarchical layers and departments of the same organization, as well as between those of different organizations (Sabel 1991; Bowman and Kogut 1995a; *Drucker* 1990; *Manz and Sims* 1987; *Nishiguchi and Anderson* 1995). The changes occurred because of two groups of interrelated reasons—their common ground being the need to increase the adaptability of organizations. On the one hand, as competition intensified, lowering production costs and shortening development-cycles became imperative. On the other hand, specialized machinery was replaced by generalized (flexible) machines. The latter change came about because, among other reasons, small niches could absorb significantly shorter runs of the same product. As a result, enormous investments in dedicated machinery, which could be recouped only by producing masses of the same, standardized product, were no longer feasible. It was more profitable to invest in generalized (flexible) machinery which could be adapted to the quickly varying set of gadgets produced by the same organization. This, in turn, augmented the value of skills on the shop-floor.

Both the introduction of flexible machinery and the need to reduce costs and shorten development cycles increased the importance of organizational learning and, consequently, heightened the interdependence of previously compartmentalized areas of knowledge within organizations. Conception and execution were no longer separate activities. Designs became profitable only if they could be inexpensively manufactured, and correct decisions regarding economical investments in flexible machinery became viable only on the basis of an understanding of design adequate enough to allow considerations of the appropriate range of flexibility (Sabel 1991, p. 27.). Also, in quickly changing markets, where firms often moved into uncharted territory, manufacturing of the prototype started before the specifications were complete, thereby providing design engineers with feedback about the feasibility of various options (*IEES Spectrum* 1991).[15] Moreover, the engineering possibilities of flexible machines could be exploited only by relying on the first-hand experiences of the people working on them. All of this prompted the integration of the design and manufacturing operations. Consequently, decision-making about producing a gadget was increasingly done in units comprising different functional areas of the

[15] Contrast this with an account of traditional manufacturing operations: "Traditionally, ...manufacturing would wait until a product was completely designed with all drawings final. Then the drawings would go to industrial engineering, who would work out the process, and then on to the shop. They handled the interdependencies by taking plenty of time to work issues out. Not surprisingly, each department also blamed the other for taking too much time." (*Dougherty and Cohen* 1995, pp. 88–89.)

organization where no representative of any specialty could perform an unequivocal leading role.[16]

The emerging networks of several specialists were not rigid, in the sense that roles and positions became malleable—a design engineer had to consider manufacturing problems, just as the worker on the production-line became involved in quality-control issues. The new groups were characterized by studied trust, as emphasis was placed on joint problem-solving based on an efficient information-flow between the parties, as well as on continuous improvement by questioning established practice, while (partly as a result of questioning routines, partly as a result of increasing interdependence) hierarchical relations became blurred (Manz and Sims 1987). Studied trust has led to increasing flexibility, as diminished suspicion increased the parties' willingness to question established ways of doing business (and to question status), as well as to explore new avenues of practice.

Similar changes took place between different organizations. It became difficult to define where one organization started and another ended, and the traditionally well-defined roles between client firms and subcontractors became fluid. The need to reduce costs and development-cycles induced firms to seek other companies that would take greater responsibility in designing parts of their product (Sabel 1991, p. 28; Nishiguchi 1994, pp. 125–133; Herrigel 1996, pp. 239–244 and 251–3.). Since companies often lacked the particular expertise needed in the particular production area in which they wished to subcontract, they often resorted to "black-box" design. In this arrangement, the client provides only vague specifications of the product to the subcontractor, which are concretized through iterative communication. Again, what is to be produced and how is decided in a group of interdependent parties, none of whom has direct command over the other. Their mutual interdependence requires and prompts the actors to be very open about the way they manage their business. Hiding what, in a dualist subcontracting arrangement, would be proprietary information, would hurt the competitiveness of all members of the network by leaving opportunities for improvement unexplored. The result is the development of studied trust—and increased flexibility—through heightened interdependence and the continuous questioning of past practice.

Flexibility based on distrust

We shift our attention now, moving from the turbulent worlds of modern industry into the tempestuous realms of the Sicilian and Russian mafias and Italian corruption-networks. They will be the stages for the demonstration of our arguments in this section since they are the central fields where games imbued with

[16] Cooperation between various organizational layers has been further reinforced by the introduction of "Just-In-Time" manufacturing systems (*Klein* 1987).

distrust unfold.[17] These environments are not only characterized by a high level of distrust among individuals; they are also the fora where *substitutes*[18] to a pervasive lack of trust are elaborated.[19] The mafia is a specific "industry" providing private protection to mutually distrusting agents (Gambetta 1988c, 1993; Varese 1994). One of the factors behind the development of widespread corruption is citizens' distrust in the efficiency and impartiality of the state (della Porta and Vannucci 1994).[20]

Distrust and robust action

Agents pursue flexible strategies in these environs, but these strategies are remarkably different from the ones examined in the previous section. While in conditions of studied trust actors can "afford to be" flexible because they assume that (almost) nobody will take advantage of their various forms of behaviour, in fields of pervasive distrust actors are flexible because they assume that others will take advantage of everything that they might do. Approaching another party with distrust, skilful actors (Leifer 1991) are careful not to reveal their willingness to acquire a specific role. "A coveted role is acquired when it is both taken and given." (Leifer 1988, p. 867). Exposing one's intentions makes one vulnerable: "(t)he vulnerability of trying to step directly into a role with unilateral role behavior stems from the power it confers on the role complement to define the role setting...(that is to say, it) stems from (1) A's *dependence* on B for a response that reinforces A's role claim; and (2) the *alternative* responses open to B." (Leifer 1988, p. 866) Once A has signalled her intentions to acquire a specific role, B can—if he has some freedom of movement—very well refuse her access to it, thereby making A the loser of the game. Moreover, this result partly marks what A is by rendering evident what she is not, and thereby it reduces her flexibility to capture other positions in the network.

While the mutual definition of roles is a characteristic of all interpersonal encounters (e.g. Bourdieu 1990, pp. 80–1), we probably devote particular attention to it in conditions of distrust, *when we specifically assume that the other party*

[17] For patron-client networks, the third environment of pervasive distrust and private protection, see especially *Padgett and Ansell* 1993.

[18] We emphasize that these institutions provide only substitutes—and very imperfect ones, as we shall see—to trust. See, for example, Gambetta 1993, pp. 24–28; 1994c.

[19] Markets of private protection have certain characteristics which, acting as intervening variables, reinforce actors' incentives to perform some of the strategies outlined below.

[20] In spite of this similarity, some of its consequences, and the fact that the two different versions of private protection might coexist (Gambetta 1993, pp. 214–220; della Porta and Vannucci 1994, pp. 246–248) the above two phenomena are, in various ways, very different from one another. See, for example, Gambetta 1994c, p. 293; della Porta and Vannucci 1994, p. 250, n. 16.

will take advantage of our consequent vulnerability. In such circumstances, the best strategy is not to evade typifications altogether, but to ensure that one is typified in many ways at the same time—hence the importance of flexibility—while, with the same action, locking others into identifiable roles, thereby limiting their possibility of doing the same to *ego*.[21] If A's actions are left ambiguous, their interpretation is up to B,C,D... who, by committing themselves to a specific understanding of A's actions, make themselves vulnerable to A. The key is not simply to hinder unequivocal interpretations of one's actions, but to make sure that everybody translates, misunderstands one's actions according to *their* revealed goals, preferably each interpretation differing from the next. By revealing little, the robust actor induces others to interpret her actions as *they* see it. As a result, each interpretation can not only be denied when necessary, but also played against the others, thus further increasing the robust actor's flexibility.[22] The likelihood of *ego* locking into specific roles can also be avoided by reducing accountability through appearing reactive, acting only on *alter's* initiative.

As opposed to environments of studied trust, the aim here is not mutual flexibility, but of achieving one's flexibility at the expense of that of others. Ideally, in this context, *ego's* flexibility is an increasing function of *alter's* rigidity.

The flexible strategies of agents operating in conditions of pervasive distrust are based on these principles. Mafiosi are well-known for their reticent way of expressing themselves (e.g. Gambetta 1988c, p. 165.). Besides their laconic expressions, mafiosi are likely to use "cryptic signs, allusions and metaphors", which can give rise to a number of different interpretations (Gambetta 1993, p. 121).

Likewise, corrupt politicians avoid making explicit political commitments. They rarely give political speeches or statements of their program that would lock them into a concrete ideological position and limit their freedom of movement in the political arena. "Maybe there were notices hanging in the squares to announce (Alberto Teardo's)[23] speech, but someone substituting him usually arrived, holding in his hand a telegram from comrade Teardo, who excused himself for not being able to participate in the event." (della Porta 1992, p. 46) Corrupt politicians rarely link themselves to a particular current within their party for a long time (della Porta 1992, p. 47). In order to reduce responsibility for one's own actions, and thereby

[21] Leifer (1988) denotes it local action, Padgett and Ansell (1993) call it robust action.

[22] Padgett and Ansell (1993, p. 1264) nicely formulate the essence of this strategy: "(c)rucial for maintaining discretion is *not* to pursue any specific goals. For in nasty strategic games,...positional play is the maneuvering of opponents into the forced clarification of their (but not your) tactical lines of action. Locked-in commitment to lines of action, and thence to goals, is the product not of individual choice but at least as much of others' successful "ecological control" over you...Victory in (such games) means locking in others, but not yourself, to goal-oriented sequences of strategic play that become predictable thereby."

[23] A politician of the Italian Socialist Party, the leader of a group of corrupt politicians and civil servants active in the 1960s and '70s in Savona, known as the *clan Teardo*.

to diminish the likelihood of being locked into specific roles, corrupt politicians act reactively, "A nurse wanted to get her son into the Sacco? Very good, let's get on with it. The comrade needed a place to live because he has been evicted? Very good, let's try to find him an apartment...The doctor at the hospital wished for a transfer from one department to another? Very good, let's put pressure on the administration" (della Porta and Vannucci 1994, p. 219).[24]

Inscrutable markets and gossip

There is another group of reasons why people are likely to guard information and release it selectively in those realms of widespread distrust where private protection is supplied. Protection is a good which is valuable only if it is the best one available. Having second best protection in a particular setting is like having no protection at all since it can always be eliminated by the best protection available. (Gambetta 1994b, p. 357; della Porta and Vannucci 1994, pp. 331–2) Consequently, both protectors and protectees look for signals that would reveal a protector to be the best possible. Another reason why signals of being the best protector and the reputation to which they give rise are important is that holding the reputation of being the best protector greatly saves on the production costs of protection. If one is successful in convincing prospective challengers that they "do not have a chance" they are unlikely to test the protector.[25]

The problem is that signals of being *the best* protector are extremely difficult to find. Past performance is not always a guarantee of future success. Markets of private protection are often *inscrutable*: neither buyers nor sellers have a good idea of the quality of the good involved (Gambetta 1994b). Both parties find out the quality of protection only after it has been put to the test.[26] Consequently, the production of honest signals, those which would be correlated with quality, proves to be very difficult. Protectors, instead, try to rely on symbols (Gambetta 1994b): signs which are arbitrarily related to quality. These are, ideally, easier to rank than the qualitatively elusive protection and difficult to pirate.

The arbitrary relationship of symbols to the good itself causes further confusion. It is always uncertain which among the many behavioural characteristics displayed by protectors is a *true* arbitrary signal. Since signals are not always

[24] The authors cite *Andreoli* 1993, pp. 42–3.

[25] This relationship is stronger in the mafia where assessment costs are extremely high—the costs of being proven wrong in the test of being the best protector is usually death—as are those of protection—often murder. (Gambetta 1994b, pp. 355–57) However, the relationship can be observed in corruption markets as well (della Porta and Vannucci 1994, p. 335).

[26] It is true if there is competition among protectors. This happens most often among mafiosi but it can be perceived in a corruption market as well. See, for example, della Porta and Vannucci (1994, pp. 337–9).

signalled, almost anything might be a sign about the relative standing of competing protectors. This, on the one hand, prompts protectors to be even more cautious with revealing any information about themselves. On the other hand, both competing protectors and protectees alike ceaselessly scrutinize every aspect of protectors' behaviour. Information exchange, in these environments, is, to a great extent, *gossip* (Gambetta 1994a). Gossip, however, often creates more confusion than it eliminates.[27] Gossip does not require truth (Gambetta 1994a, pp. 211–2); moreover, gossipers are often concerned with "deducing wholes from minutiae" (Gambetta 1994a, p. 213). This last factor can partly defeat the purpose of getting information because it often leads to inaccurate conclusions.

Distrust and blind trust

As we have pointed out earlier, in environments of pervasive distrust, being successfully flexible means locking others into rigid ties and well-defined roles.[28] Strategies which aim to strengthen the consequent relations of dependence rely on the coexistence of distrust and blind trust. Blind trust is likely to be frequent in conditions of widespread distrust since, in such conditions, there is a contradiction between the highly desirable act of trusting someone and actors' underlying pessimistic expectations. When making an exception from the rule by trusting somebody, agents have to perform a reduction of cognitive dissonance (Gambetta 1988b, p. 223; 1993, p. 46.). The result of the reduction of cognitive dissonance is blind trust, where one does not so much trust an actor because one expects, rather it is because one *wishes* him to be trustworthy.[29] The propensity for establishing such overly trusting relations is further augmented by the confusion about the reliability of information. Trust is an expectation—which we form on the basis of our knowledge of the other party's dispositions, interests, commitments (Dasgupta 1988, p. 51). In inscrutable markets, there are too few truly reliable signals on which to form dependable expectations, while, at the same time, there is an overabundance of possible signs of future behaviour. Whereas such overabundance can cause confusion about learning the correct strategies of actors, it can be an excellent source of rationalizations of desired behaviour—that is, of granting trust.

[27] Largely as a result of the unreliability of gossip, "(t)he mafia is fraught with uncertainty, distrust, suspicion, paranoid anxiety, misunderstanding: who is the stronger? Who will be the successor? Is Don Peppe really a mafioso? Is he about to attack another Don Peppe? Is Mr X really protected by Don Peppe or just pretending? Is Don Peppe still strong enough to protect Mr X?" (Gambetta 1994a, p. 220)

[28] It is important to emphasize here that relations of dependence are the results of success. We shall return to this point.

[29] "Distrust may be an unaffordable luxury for those with no alternative course of action." (Gambetta 1993, p. 26)

We can see the work of blind trust in the way in which protectees view their protectors. Mafiosi were often reified by their customers as early as the nineteenth century. "(There is a) tendency to turn the mafioso into a legendary type, a feeling natural enough indeed in a professor of literature, but much harder to explain in wealthy landowners."[30] Corrupt politicians are also overly adored by their followers. "Among the entrepreneurs, there was a real and proper rivalry to present oneself as the friend of this or that politician, to be solidary to him in everything and for everything. 'Your successes are my successes, your ideas are my ideas', in a whirlpool of complicity." (della Porta and Vannucci 1994, p. 334).[31]

Flexibility and rigidity

In the above paragraph, we implied that the providers of private protection usually have the upper hand over their protectees—the fundamental reason being that they offer an inscrutable substitute for a good that is in short supply.[32] The resultant asymmetric relationships help the providers of private protection to reduce their dependencies that would arise from trusting people in environments of pervasive distrust. They often further decrease their demand for trust by exploiting, moreover frequently reinforcing their protectees' tendencies to blindly follow them. By establishing relationships in which their partners are dependent on them, their expectations of others' behaviour will be more grounded on their knowledge of others' interests and constraints than *vice versa*. In realms of widespread distrust, such relations of dependence are used to gain control as well as to get action (White 1992). When people are reluctant to make commitments to any course of action there is special emphasis on decreasing the prospects of *alter* strategizing against *ego* as well as on increasing the probability of alter following *ego's* requests (or, more aptly, orders). Widespread distrust, by increasing actors' motivations to minimize their vulnerabilities, prompts them to satisfy these aims by establishing relations of dependence.

[30] Franchetti, Leopoldo. (1876) 1974. "Condizioni politiche ed amministrative della Sicilia." Vol. I. in *Inchiesta in Sicilia*, edited by L. Franchetti and S. Sonnino. Firenze: Vallechi, p. 34. Quoted in Gambetta 1993, p. 46.

[31] Quoted from Andreoli 1993, p. 114. Displays of such attitudes to protectors can be used instrumentally as well. We shall return to this point later.

[32] While the direction of this relationship is generally true, it is rarer to observe it in corruption networks where several scarce goods can be exchanged in more than one direction (e.g. protection for votes, protection for protection, etc.) and, especially if corruption is widespread, the organization of providing private protection can be very complicated. See, for example, della Porta and Vannucci 1994, p. 250, n.16; pp. 357–365.

The mafiosi's willingness to resort to violence in order to achieve the compliance of their protectees is probably the strongest indicator of this strategy.[33] Even when corrupt politicians are protected by the mafia, the two parties do not have the same options. While the mafioso might refuse to comply with a request, in the politician's case it is usually unthinkable. As Antonino Calderone, a mafioso turned state's witness explained: "When I was in Sicily, many politicians were involved with the mafia. (They)...asked for serious, engaging help from the men of honor. Normally, the mafiosi did these favors, but they could also say no...But when the mafiosi asked for a favor from the politicians, there was no choice: they had to do what was asked from them." (della Porta and Vannucci 1994, p. 387)[34]

Corrupt politicians often relate to their followers with extreme arrogance—that is to say, by emphasizing their capacity to be flexible at the expense of their protectees—in order to underscore and thereby augment the asymmetric character of their relationship. (della Porta 1992, p. 49). The intended result is to increase the protectees' sense of dependence on the corrupt politician, and consequently, to enhance their blind devotion to him. Underscoring relations of dependence is used not only for gaining control but also for getting action. Pizzorno speaks of the "vicious circle of arrogance" (Pizzorno 1992, pp. 10–11), in which arrogant behaviour, by augmenting one's reputation of being powerful, leads to a concentration of requests on the corrupt politician. This enlarges the group of his supporters, which increases his political power, thereby leading to an even greater ability to make arbitrary decisions—over more salient matters.

So far, we have portrayed asymmetric relations as the result of robust (flexible) actors acquiring control in worlds of widespread distrust. Success, however, is not guaranteed; flexibility does not necessarily lead to victory. In environments where players rarely trust each other, robust actors often face other robust actors.[35] In such situations, if both partners are skilful, they "organize for involvement" (Leifer 1990, 1991, 1995). Their aim will be to maintain equilibrium, to deny the other party the accurate reading of their strategies, and thereby to avoid their partner gaining control over them. In such circumstances, even the appearance of control can hide a different reality. An agent might take on the role of the submissive follower not only to acknowledge his dependence, but also to ease his protector's suspicion and gain a greater room to manoeuvre. Several entrepreneurs have tried to implement this strategy in corrupt environments. "For example, the Merlos' firm was commonly known to be 'in the socialist area', but the en-

[33] There are several other reasons why the world of the mafia is so violent. See Gambetta 1993, pp. 40–43.

[34] The authors quote Arlacchi, P. 1992. *Gli uomini del disonore*. Milano: Mondadori, p. 210.

[35] This situation presupposes at least a relative equality of the parties in terms of the quantity of resources with which they are endowed—not forgetting that resources are often socially constructed (*Latour* 1988). In light of what we have said so far about the different worlds of private protection, this is most likely to arise in a corruption framework.

trepreneurs have reached the conclusion...that the best strategy was 'to rely on the (Christian Democratic Party) for national matters, and on the (Socialist Party) for local ones.'" (della Porta and Vannucci 1994, p. 337)[36]

Hedging between studied trust and distrust

Flexibilities

We have to move beyond the above two ideal types in order to understand the flexible strategies of most actors under conditions of uncertainty. One's flexibility is rarely based *solely* on studied trust or distrust. Firstly, people rarely grant trust to a person without qualifying what the action in question is. Trust is "a three-part relation: A trusts B to do X" (*Hardin* 1993, pp. 506–7). There probably are actions in which we are unwilling to make ourselves vulnerable to another party even if we trust her in many other respects. This is likely to be an issue in uncertain environments where interests related to commitments in future actions are likely to undergo substantial change. In such circumstances, actors are both probably unwilling to test the commitments of others to the maximum and hesitant to make others very dependent on them—even if renegotiations are possible among the parties. In connection with this, in today's industry, constitutional orders are rarely complete institutions of work or business. A fundamental question for most constitutional orders is to which matters the jurisdiction of constitutional orders should be extended, and which matters should be organized outside them. Conversely, even if we live in a world paralyzed by pervasive distrust, there are likely to be matters in which we negotiate our flexibility as members of a group—and we can find related examples even in the mafia, as we shall see below.

Secondly, these considerations acquire importance because operating in two (or more) separate worlds grants an actor such possibilities for flexibility which few players, operating in uncertain conditions, would be ready to sacrifice. To put it another way, accepting the assumption that actors hedge in uncertain environments (Sabel 1995c; Sabel and Zeitlin, forthcoming), we also have to entertain the thought that the dimension of granting trust will be governed by this principle as well. It is likely that actors' flexible strategies will be based on recombinations of granting (and creating) studied trust and exploring solutions that reduce their demand for it.[37] Agents, in most uncertain environments, sustain their flexibilit(ies) probably

[36] Partly quoted from *L'Espresso* September 20, 1993, p. 38.

[37] Central to this idea is the thought that trust can be not only a by-product of otherwise differently directed behaviour, but it can also be fairly purposively created among actors. See, for example, Gambetta 1988b, pp. 232–235; Sabel 1992.

through mixed strategies of, on the one hand, establishing mutually redefinable identities, and, on the other, attempting to gain control over their partners.

To the extent that actors operate in realms where several organizing principles are at work at the same time (which is valid for the Hungarian economic transformation (Stark 1996; Voszka 1995)), it becomes difficult to find any overarching utility function on the basis of which one could calculate the right mix of the different (flexible) strategies. Consequently, rational choice-based theories of cooperation (*Axelrod* 1984; *Taylor* 1987) cannot be fully adequate guides in these realms. In such circumstances, most agents are likely to exploit, rather than resolve, the dilemma of *the combination or separation of* adaptability and accountability.

We can see these principles at work in several different settings. One of the biggest conflicts in the decentralized sectors of today's German industry is between the country's traditional craft system and attempts at introducing team-based manufacturing (Herrigel 1996, pp. 193–204; 1994; Sabel 1995a). The two ways of organizing production operate according to antithetical principles. In a craft system, the flexibility of the craftsman is based on his professional autonomy, pertaining to him in recognition of his special skills. He is flexible because nobody has to *nor should* tell him what to do; he, however, precisely since he knows what he is doing, can and should direct a group of apprentices. In team-based manufacturing, as we have seen above, team-members' flexibility results from their close interdependence; they participate as equals in elaborating design and manufacturing solutions. The problem for German companies is that the second system clearly outperforms the first; however, the craftsmen's staunch defence of *their particular type of flexibility* can only lead to recombinations. In the emerging solutions, craftsmen usually retain some power of control over certain parts of the production process, while teams gain governance over others. Flexibilit*ies*, in these schemes, are seen to be guaranteed by a combination of one's independence from others and one's engagement in joint exploration—and action—with the same units.

On the other side of the spectrum, even mafiosi manage to cooperate sometimes. An important forum in the Sicilian mafia is the *commissione* which is a cartel of mafia families within a Sicilian province. The commissione regulates the use of violence and makes decisions in problematic cases of succession (Gambetta 1993, pp. 112–8). Its operation, however, is far from infallible, and mafia families play a careful game of combining independence and collaboration in order to gain the greatest possible room to manoeuvre.

We have found similar hedging strategies among Hungarian entrepreneurs. In a study of a construction market of a Hungarian city of 110,000 inhabitants, we have observed entrepreneurs performing a cautious balancing act among the strategies of competition, cooperation and corruption (Kemény 1996). In their uncertain environment, maintaining their flexibility(ies) is of paramount importance. A crucial question is the right mix of means through which the advantages of flexibility can be maximized. While a tightly knit social fabric resulting from their

previous work-relations[38] could generate enough trust to prompt them to engage in market-sharing cooperative arrangements, the fact that they regularly compete in several settings at the same time (either in terms of price and quality, or in terms of corrupt ties) for orders which are of varying importance to them makes their collaborative networks difficult to organize.

The result is a mixture of arrangements the structure of which changes with time. A salient question in these "networks"[39] is the extent to which their constituents are willing to collaborate with each other. While most entrepreneurs help one another in small matters (like lending raw materials, or even workers), only a few reach the point where they coordinate their offers in some (but never all) markets. A frequent intermediate formation is one in which a number of companies boost each other's flexibility by continuously redefining their identities and their relations to one another through participation in various, and often complicated subcontracting arrangements. In other realms, the same entrepreneurs continue to compete with each other in terms of price and quality; and again in others they keep using their corrupt ties to snatch a contract while relegating their friends to the sidelines. Not all entrepreneurs combine the different strategies of flexibility in the same way; while some predominantly rely on corruption, others combine collaborative subcontracting with competition, and another group attempts to balance the three strategies.

In my research, I wish to investigate the hedging strategies that owners and managers of small- and medium-size enterprises perform among the different ways of gaining flexibility in the Hungarian economic transformation. Both the remarks of Stark and Gábor, quoted earlier, and my empirical study suggest that most flexible strategies pursued by this group of actors fall in between the two ideal types. My research will be exploratory. The primary aim is to gain an understanding of the different flexible strategies followed by actors between the two ideal types. Agents get action on the basis of different principles whether they act in the framework of flexibility based on studied trust or distrust. They entertain dissimilar typifications and expectations about each other, treat information differently, and generate distinct types of social action *vis à vis* one another. When actors combine the two principles of flexibility (there are probably several ways of doing this) a considerable amount of work (Boltanski 1996b) must be involved in bridging the gap. Our principal focus will be to comprehend this bridging activity and the synthesized flexible strategies to which it gives rise.

[38] The majority of the entrepreneurs were colleagues within the former, now defunct, socialist dinosaur.

[39] Since action takes place among a constantly varying set of actors the boundaries of the network are often difficult to define. I am grateful to David *Dornisch* for this point.

Production markets with uncertain roles

The concrete setting in which I intend to examine actors' hedging strategies among the different forms of flexibility is a particular type of production market. In the writings of Harrison White (White 1981, 1988; *Leifer and White* 1987), production markets are stable role structures. Products are distinguished in terms of quality; these distinctions are manifest in different volume-revenue combinations. The existing quality-volume-revenue combinations form the menu of possible roles in the market, linked to a specific set of companies. Producers select roles (market niches) in order to gain the greatest amount of profit (within a limited set of opportunities) by watching the behaviour of other producers in the previous period. Provided that producers' costs do not change from one period to the next, producers, when reconsidering the possible quality-volume-revenue combinations against their variable costs at the beginning of each period, reselect their previous role for future activity. "*(E)ach enterprise assesses its situation in each cycle and reaffirms that its niche in a structure of niches is where it is best suited.*" (Leifer and White 1987, pp. 89–90, italics in the original)

This is a picture of market stability. White concentrates on the *re*production of particular markets as role structures. However, not all markets are stable. To the extent that relatively homogeneous producers (in terms of technical ability and variable costs) compete for ever varying sets of unique projects, market roles are subject to gaming among producers. In such conditions, (re)producing certain market roles becomes problematic. Construction markets in Hungary's larger cities,[40] like the one that I have examined (Kemény 1996), provide an example.

Construction markets in Hungary's larger cities usually satisfy the following set of criteria:

1. There are several producers in the market with a similar range of abilities, technical as well as costwise. General contractors are usually capable of performing almost all activities involved in constructing buildings of various shapes and sizes, from simple one-family homes to fancy office-buildings. The range of skills they command can also be employed separately, in subcontracting work as well as in smaller projects, like roof-repair or painting and decorating.[41] Consequently, companies can compete in several different market segments, sequentially, or at the same time.

[40] Probably over 100,000 inhabitants.

[41] This is usually the case even if a contractor is relatively small. Besides contractors, typically other participants of the construction market also command multiple skills. For example, larger companies of painters and decorators are likely to employ insulation specialists, bricklayers, floor-cover specialists, etc. While such companies can undertake all the covering and decorating activities in a building, their various specialists can also be employed separately, on diverse projects.

2. The projects for which contractors bid are evaluated along many different and, among projects, varying sets of criteria, of which price is only one. Although projects are not entirely unique in terms of the requirements that successful bidders have to satisfy, there is great variation among them, rendering specialization difficult. Each time a contractor bids for a project it is likely that he has to establish his "equivalences" (Boltanski 1996a) *vis à vis* other contractors in different terms. One of the main reasons behind this is the fact that (at least in Hungary during the transformation) most buildings are individually commissioned. When the customer defines the product the likelihood that standardized items can appear on the market is relatively low.[42]

3. Different projects are performed in dissimilar social organizations among producers. There is rarely a one-to-one correspondence among projects and producers—probably its simplest reason being that projects' requirements of resources either exceed or are less than what individual contractors can offer. Usually several contractors work on the same project, and a contractor is involved in more than one project at the same time.

In these conditions, roles are unstable in the market in the sense that they are difficult to reproduce from one period to the next. Even if companies' market roles do not change in time—which, we would argue, is quite unlikely in the aforementioned conditions—*there is significant work (Boltanski 1996b) involved in their reproduction*. Companies do not occupy for long market niches on the basis of a particular activity because a new set of projects redefines how specific market roles can be achieved. The distribution of roles is subject to significant gaming. The information revealed ex-post by producers' behaviour is an inadequate indicator of the way roles should be pursued in the next one. Taking the activity associated with the role that one occupied in an earlier period as something to be copied in the next is a likely recipe for failure. The dimensions along which an actor won a project in one phase is an imperfect indicator of relevant dimensions to be emphasized in the next one.[43] In such settings, flexibility is associated with success; stability of activities is usually viewed as rigidity, and as such, a basis of failure. In these markets, the best way to occupy one's resources, as well as to insure the capacity

[42] Although some contractors try to diminish their risks by initiating property development projects—where contractor(s) "define" what the product is—at this moment such initiatives are rare and very few contractors deal with property development to the exclusion of all other activities.

[43] Companies are more often busy building reputations rather than *a* reputation. On the one hand, companies intend to associate such vague terms with themselves which can appeal to almost all segments of the market (excellence in quality; prompt service, etc.) and can be suitably interpreted (Latour 1988) to almost any particular context; on the other hand, they market their abilities in several different activities. While establishing an unequivocal reputation related to a particular activity can be advantageous (as it may be used to create a protected market niche), such a strategy is risky for *most* actors in markets where producers' abilities are relatively homogeneous and products vary greatly in time.

for future involvement, is to covet several roles at the same time, to have stakes in the high, as well as in the lower ends of the market; to build office buildings for "blue chip" companies, to participate in school-renovations, to construct family-houses in the suburbs and to use one's spare painting crew in a small project in the same period—while contemplating hospital-building and factory-construction in the next one, thereby intending to invade niches occupied by other actors in an earlier period.[44]

Such markets have two interconnected features which are relevant for the purposes of our research. Firstly, since projects differ from one another, actors need to establish equivalences *vis à vis* their competitors in different terms when they are bidding for each undertaking. Bidding is rarely only in terms of price; technical expertise, aesthetic qualities, timing, brand of protection, etc. all come into play, and their specific configuration varies in each project. Secondly, different combinations of equivalences usually correspond to dissimilar social organizations of production. This arises, on the one hand, because actors can satisfy different evaluative criteria by organizing production in diverse ways; on the other hand, since different projects are viewed by distinct producers in different frames (*Goffman* 1974) dissimilar configurations of producers are willing to participate in them. The prerogative of meeting diverse evaluative principles—within projects and among different ones—requires considerable flexibility. The need to organize production in dissimilar ways in different projects—and often in different phases of the same project as well—probably implies that flexibilities are achieved on the basis of a combination of flexibility based on studied trust and distrust. Actors are likely to combine dissimilar strategies of flexibility when they are bidding for, as well as when they are working on, different projects.

In order to understand how different forms of flexible strategies are combined, I intend to investigate construction companies' attempts to (re)produce roles in their market(s). I wish to examine the bidding activities of building contractors, as well as the strategies they employ *vis à vis* their business partners while completing their projects. How do they combine their different social resources in order to satisfy dissimilar sets of distinct evaluative criteria at any time? What are the arrangements through which companies corrupt certain officials while creating an understanding with some "competitors" that the partially protected niche is not fair game? How can they compete with the same people in another setting, while collaborating with them in yet another one? What is the content of the emerging ties in such settings—how do actors view each other, and what kind of actions are acceptable? What is the work involved in balancing flexibility based on studied trust and distrust? While projects are under way, how do contractors blend dualist subcontracting arrangements with collaborative subcontracting? How are

[44] In the language of organizational ecologists, these organizations are *polymorph generalists*. (See, for example, *Hannan and Freeman* 1989, pp. 110–114; pp. 310–311.)

subcontracting relations modified when a new criterion suddenly appears during a project?

Undertaking the research in Hungary will have at least two advantages. On the one hand, the uncertain conditions of the transformation (beyond the above, general characteristics of the markets in which they operate) probably further induce actors to maintain their flexibilities, and to do it on the basis of hedging strategies. As a result, this setting is likely to be particularly rich in practices aimed at gaining flexibility, especially in those which combine the principles of our two ideal types. On the other hand, studying these strategies in the Hungarian setting will also allow us to learn more about the consequences of the institutional uncertainties of the transformation. The institutional uncertainty of the Hungarian economy has been cited as the cause of several negative consequences, from actors' unwillingness to invest in capital-intensive technology and markets, to widespread opportunism, and the "too many and too small" character of individual small business undertakings (Gábor 1991, 1992, 1996). I contend that one of the main reasons behind these phenomena is the special attention that actors devote to maintaining their flexibility in the Hungarian setting. Unfortunately, so far, no systematic analysis has been conducted on actors' strategies that would give an account of the direct link between (institutional) uncertainty and the associated, usually negative consequences. Since my focus will be on understanding the flexible strategies performed by a certain part of Hungary's small and medium-size enterprises, I hope to contribute to a greater comprehension of these mechanisms.

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THE IMPORTANCE OF THE HIDDEN ECONOMY IN HUNGARY, 1995-96

An Estimation on the Basis of the Empirical Analysis of Household Expenses[1]

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In Hungary in the middle of the nineties the extent of the hidden economy as compared to the officially reported GDP is not negligible. During the first part of the economic transition, in the midst of the recession—when the living standards of a significant part of the households decreased or were at risk—an important characteristic of the behaviour of a significant part of the households was that they obtained some of the necessary goods in unregistered forms. This fact, however, does not mean that all households take advantage of this possibility in an equal proportion. On the contrary, from the results of this paper it could be seen that this type of behaviour is only characteristic of a small proportion which decreases parallel to the increasing ratio of unregistered expenses. This means that the proportion of households which depend significantly on the advantages provided by the hidden economy is very limited. The paper shows that the income and financial condition of a household or the perception of these, as well as the size and infrastructure of the settlement where the household lives can only partly explain the affinity of the household towards unregistered expenses.

Introduction[2]

The *hidden economy*[3] is a phenomenon that can be found in all market economies. Governmental measures must take into consideration the importance

[1]The present work is a shortened and revised version of a study carried out by the author within the framework of the National Strategical Research Programme of the Hungarian Academy of Sciences, published under the same title.

[2]The research and the empirical survey conducted by the Kopint-Datorg Rt. and Tárki, which included 1000 households, were carried out with the support, and at the request of the Prime Minister's Office. The research was also supported by the Orex Trading Rt. and the Hungarian Tobacco Trade Union. We would like to express our thanks to János *Köllő*, András *Köves*, Mária *Lackó*, Mihály *Laki*, György *Lengyel*, Endre *Sík*, Zsolt *Spéder* and Róbert *Tardos* for their remarks on the various versions of the study; to Erika *Révész* and József *Tarjányi* from the Tárki staff for their valuable advice and help during the preparation of the survey; and also to my research assistant, Réka *Tóth*, for her work in the research. The calculations found in this study were carried out by the author—he is responsible for any errors or weaknesses in the text.

[3]When describing the concept of hidden economy in our study we take the EUROSTAT classification into account (*Árvay and Vértes* 1994; *Willard* 1989). The KSH (Central Statistical Office) working group (*Bedekovics et al* 1995) uses a similar classification for "human activities" described in the Hungarian National Accounts. According to this, in the concept of hidden economy we do not take into consideration work done at home, do-it-yourself activities, voluntary work (community services), exchange of products between households, criminal activities, activ-

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of the hidden economy within the national economy, especially when its ratio is considerable or increasing. In transition economies this problem needs even more attention since, besides the radical transformation of the legal economy, the economic sector which was earlier referred to as the "second economy" (Sík, 1992) also goes through a change of similar proportion. Moreover, the in the years prior to and following the transition the extent of the hidden economy compared to the official GDP was estimated to be considerable and it showed an increasing tendency (Lackó 1992 and Árvay and Vértes 1994).[4]

This research is the second in a sequence, the goal of which is to estimate the extent and amount of unregistered expenses within the total expenses of households.[5] In this sense, it can be considered as a repetition of our earlier (1995) investigation[6] but, owing to the fact that it is a repetition, it undertakes more than previously: namely, it tries to estimate whether there has been a change in the extent of the observed phenomenon, and if so, in what way. In other words, it looks at how the amount of unregistered expenses have changed over one year, within all expenses of a household.

There is another way in which we wish to contribute to the better understanding of the phenomenon of the hidden economy: similarly to our previous empirical analyses (Tóth 1996a; 1996b), we will try to test the assumptions that might explain the presence of the hidden economy in the expenses of various households.

As a result of the effectiveness of norms related to tax disciplines, great significance is attributed to that part of the hidden economy which might affect a wide range of the population. It is possible that the part of the hidden economy which is related to public expenses is only a small portion of the overall hidden economy, but its importance is greater than its ratio. From the point of view of

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ities which are productive but not legal (e.g. production and trade of drugs). This distinction is significant in order to avoid the error in the direct comparison between the concept and the results of the analysis, which are based on the definition of the hidden economy from another point of view (*Lackó* 1995; 1997).

[4] Lackó's cash-earning model shed light upon the continuously increasing tendency of the illegal economy between 1970–1989 (Lackó 1992). According to her estimation the illegal economy increased from 6 percent to 20 percent as a percentage of GDP between 1971–1989. On the other hand, a comprehensive investigation carried out at the beginning of the 90s put the amount of the hidden economy at 12 percent of the official GDP, and at 27 percent in 1992 (Árvay and Vértes 1994).

[5] In accordance with our earlier analysis (*Tóth* 1996b) those expenses can be considered as non-registered purchases when the buyer does not get a receipt or a letter of guarantee in the case of more valuable goods. In these cases we can suppose that these transactions will not appear in any kind of statistics or in any forms submitted to the tax authorities. More generally, these can be described as expenses which do not appear in official statistics. This includes the wages of illegal employees paid by the enterpreneurs. We will not deal with the latter, as this research only covers household expenses.

[6] The previous investigation—similarly to this one—was supported by the Prime Minister's Office. The results can be seen in Tóth 1996a; *Bóc and Klauber* 1996 and Tóth 1996b.

public opinion on hidden economy—i.e. collective consciousness and norms related to the hidden economy—it is very important to know how often it occurs in a household that, as a buyer, a person participates in a transaction which is considered as part of the hidden economy. Its extent and the probability of its occurrance is important because they show to what extent illegal economic activity is accepted by the members of society and to what extent they accept the norms that approve of these. When judging illegal economic activities, it is not the same when these occur occasionally and to a small extent, or when it is the everyday practice of a wide range of the population.

In the following, we will first describe data sources that were used and the basic theories of estimation, and then the estimations of the amount of unregistered expenses among the examined expenses which were obtained during the 1996 survey. After this, we will also do the same in the case of the aggregated groups of expenses. Furthermore, we will try to estimate the volume of unregistered expenses in the case of expenses which the survey did not include: this will enable us to give an estimate of the range of unregistered expenses compared to all expenses of Hungarian households in 1996. Finally, we will examine the relationship between unregistered expenses, social status, income and financial status of households, as well as the relationship between the characteristics of their residences.

Data sources

This study is based on two surveys—each of which included 1000 households—enquiring about the shopping habits of the households. The first took place in November–December 1995 (VASAR95); the second was carried in the following year, 1996 (VASAR96). Both surveys were conducted by Tárki (Social Research Information Center–SRIC). When examining the affinity toward unregistered expenses, besides the above, another database compiled from the above two surveys (VASAR56) was also used.

In Section 3 we used a settlement-based database (VASUT) set up by János Köllő which, besides the characteristics of the settlements, provides information on their public transportation network, the accessibility of larger settlements in the neighbourhood, and the expenses of daily commuting. These data are used only in the case of households outside Budapest. Besides these, we also use some data from the 1994 version (T-STAR94) of the Central Statistical Office (CSO) database, which includes data on 3200 settlements in Hungary, as well as the data of the 1996 survey of the Hungarian Household Panel (MHP96).[7]

[7]For the MHP 1996 survey see the report summarizing the first results of the research (*Sík and Tóth* 1997).

In the case of VASAR95 and VASAR96 the *household* was the unit of observation, while in the case of the other two sources of data it was the *settlement*. Due to the fact that, while conducting VASAR95 and VASAR96, the codes of the settlements which are usually used by CSO were also recorded, and the survey included about 70 settlements, we had a chance to compile the VASAR data and the two settlement-based databases.[8] This seemed to be a sensible venture as the settlement-based information was meant to play an important supplementary role in explaining the amount of the unregistered expenses within household expenses.

Methods and limits of estimation

Within the expense structures of the households, some parts of the expenses were assessed during both the 1995 and the 1996 surveys. Our goal was to collect information for the widest possible range of household expenses and to separate the registered and unregistered expenses within the assessed expenses. This method serves as basis for the estimation of the amount of registered expenses besides the expenses included in the survey and all household expenses. During the survey an "expense" was determined as being "registered" or "unregistered" on the basis of the place of purchase and whether a bill was made out or not. Besides stores operating with over 5 employees (1) we distinguished between the so-called "small shops", in which the number of employees does not exceed 5 (2) and market and street purchases (3).[9] All things bought in the first belong to the category of registered expenses; in the second case we only considered them registered if the salesperson made out an invoice with the cash register, otherwise they were listed as unregistered. Things bought in markets and on streets were all considered as unregistered expenses.

If the place of purchase did not supply any useful information (e.g. in the case of consumer durables or services), the value of goods obtained was considered unregistered if the receipt or the letter of guarantee was missing.[10]

We have four ways of estimating unregistered expenses, gradually generalizing the results of estimations obtained from the surveyed expense items. The steps used were the following:

[8] We are grateful to János Köllő and Gábor *Kézdi* for making this solution possible.

[9] In Hungary this latter is the so-called "COMECON (or flea) market" (Sík 1997). The logic behind the method we used was the same as the concepts of the research carried out by McCrohan and Smith, who investigated the extent of the hidden economy in the sale of goods and services. The results of their analyses make a good comparison with our results (*McCrohan and Smith* 1986).

[10] Thus, if the travelling agent gave a receipt or a letter of guarantee, this transaction was considered as registered.

1. First, we calculated the amount and the ratios of the registered, the unregistered and the total expenses with respect to the surveyed expenses.

2. The same was done in the case of the surveyed expenses, while the separate expense items were compiled into aggregated groups of expenses and within this we determined the average estimated ratios of the unregistered expenses.

3. Taking into consideration the data of the CSO household statistics (*CSO* 1997) we also calculated the ratio of unregistered expenses within the total expenses of households.

4. Finally, on the basis of the ratios obtained for the surveyed expenses, we tried to determine the possible ratio of unregistered expenses with respect to the whole economy.

Thus, the first step involved estimation of the observed turnover, then the total expenses of the households, and finally we can made some careful statements with respect to the total turnover of retail trade.

When estimating the surveyed expenses we started out from elementary data related to each expense item (often the goods themselves) and, summarizing these, we reached an estimated sum of the total expenses in the samples of registered and unregistered expenses. For the summarizing we used the annual total in the case of each expense item.

After this we formed four aggregates ($j = 1, ..., 4$), which also show the yearly expenses and their structures: food and consumer goods (1), clothing (2), other goods (3), services (4). Accordingly, we used the following equation:

$$CS_j = \sum cs_{i=1,n,j} \quad \text{and} \quad CNR_j = \sum cnri_{i=1,n,j}$$

where $cs_{i,j}$ is the estimated total sum used for each elementary expense item and $cnr_{i,j}$ is the total of unregistered expenses, i the number of elementary expense items surveyed ($i = 1, 2, ..., n$), and n is the number of all surveyed elementary expenses in the j-th expense aggregate. Due to the above:

$$CR_j = CS_j - CNR_j \tag{1}$$

Then, taking into consideration all the expenses:

$$CSS = \sum CS_{j=1,4},$$

$$CNRS = \sum CNR_{j=1,4} \quad \text{and}$$

$$CRS = CSS - CNRS \tag{2}$$

where CSS marks all the expenses, $CNRS$ all unregistered and CRS all registered expenses included in the survey.[11]

Besides this, we calculated the average expenses of a household with regard to, respectively, each expense item, each aggregate and all expenses—that is, the above sums were divided by the number of surveyed households.

If we want to estimate the total of unregistered expenses within each expense item and the total expenses, we have to bear in mind that not all of the expenses regarded as unregistered can really be considered as such.[12]

Besides these, we also have to take into consideration that the survey did not cover all the expenses of a household—e.g. the questionnaire did not include the purchase of cars or petrol, nor home building or catering as services. This is important because, in the area not covered by the survey, the proportion of unregistered expenses *is not the same* as in the surveyed area. In this case the unregistered amount within all expenses (NRH_{SC}) depends on the amount registered for the surveyed and non-surveyed expenses (NRH_{OC} and NRH_{NOC}), as well as on the amount of surveyed expenses within all expenses (C_O/C_S):

$$NRH_{SC} = NRH_{OC} \times C_O/C_S + NRH_{NOC} \times (1 - C_O/C_S), \qquad (3)$$

where $0 < C_O/C_S < 1$.

If, from among the expense groups (CS_j) which form CSS, we take those $c_{i,j}$ expense items in the case of which it can be *a priori* acknowledged that the unregistered amount is zero ($NRH_{c0} = 0$), then the unregistered amount can be obtained as follows:

$$NRH_{CS,j} = (\sum c0_{i=1,n,j} \times 0 + (CS_j - \sum c0_{i=1,n,j}) \times NRH_{OC,j})/CS_j \qquad (4)$$

After this, using the same method as in the analysis of the 1995 survey (Tóth 1996b), we calculated two quotients for each aggregated expense item: the amount of unregistered turnover within all expenses, and as a comparison with all registered expenses ($NRSH$ and $NRRH$). We used the following equations to calculate the minimum and maximum values for both quotients:

[11] When summarizing the non-registered and registered expenses, as well as the total expenses, we disregarded the fact that total registered expenses and the non-registered expenses, respectively, do not or only partly include VAT or duties related to the purchase value of the goods. Neither the buyer nor the seller can be charged for the full amount of duties not paid by the buyer in relation to a non-registered purchase. This is because that is the sum they divide between themselves during the transaction. We have no information with regard to the distribution itself, but it can be reasonably supposed that under the taxation conditions which were valid in 1996 this sum was divided half-and-half between the buyer and the seller (Tóth 1997).

[12] For distortion factors to be taken into consideration see Tóth 1996a.

$$NRSH_{min,j} = CNR_{min,j}/(CNR_{min,j} + CR_{max,j}) \quad (5)$$

$$NRSH_{max,j} = CNR_{max,j}/(CNR_{max,j} + CR_{min,j}), \quad (6)$$

where CNR_j and CR_j are the average total of unregistered and registered expenses, respectively, in the j-th aggregated expense group in the sample of surveyed households. Lower indices *min* and *max* show the minimum and maximum values of these averages, calculated with the standard error. We assume that in the case of, for example, $NRSH_{min}$ the average of the actual unregistered expenses in all Hungarian households falls onto the lower borderline of the reliability range,[13] while in the case of the average registered expenses we use the maximum value for our calculations. Thus, using the sums and proportions of the average registered and unregistered expenses of the 1000 households, we can deduce the extent of unregistered expenses within the expenses of all Hungarian households.

Equation (4) could be used if we wanted to make estimations with respect to the total turnover of retail trade. However, here we come across the problem that we do not know the extent of household expenses related to retail trade. First, we would need to know the total turnover of retail trade (not only the part covered by the *CSO* survey), and then we would have to divide this among the households, the government, the enterprises, the non-profit sector, and the expenditure of foreigners.[14] Given the lack of a reliable empirical background, we cannot calculate this; thus we can only assume that with regard to retail trade the amount of unregistered expenses is lower than the minimum unregistered expenses estimated for the surveyed household expenses.

The estimated amount of unregistered expenses in 1995 and 1996

Estimations regarding the surveyed expenses

Similarly to our experiences during the analysis of the 1995 survey, services form the widest range in which unregistered expenses can be estimated. If we examine each expense group—i.e. all surveyed expenses shown in *Table 1*—then the value of NRSH can be estimated in the ±1,5 percent zone and NRRH in the ±2,5 percent zone for both years.

[13] The averages were calculated at a standard reliability level of 95 percent.

[14] It is obvious, that the expenses we defined as non-registered are an insignificant part of the retail purchases of enterprises. The situation is not so unambiguous in the case of foreigners' expenses.

Table 1

The estimated amount of unregistered expenses within the surveyed expenses of Hungarian households in 1995 and 1996 (percent)

Household expenses	The estimated amount of unregistered expenses within the surveyed expenses NRSH		The estimated amount of unregistered expenses compared to the registered expenses NRRH	
	1995 (1)	1996 (2)	1995 (3)	1996 (3)
Food and consumer goods	11–14	13–16	14–16	15–20
and within this, food	12–14	13–17	13–17	15–20
consumer goods	11–15	12–16	12–18	13–20
Clothing	25–33	25–32	33–49	34–46
Other goods	6–10	9–13	7–11	10–15
Services	35–50	41–51	55–100	69–103
All surveyed expenses	17–20	19–22	20–25	24–29

From *Table 1* it can be seen that *the interval in which the average amount of the unregistered expenses of households can change has increased in the case of each expense group, both within all the expenses and in comparison with the registered expenses.*

In accordance with this, in the case of all surveyed expenses and all Hungarian households, the volume of unregistered expenses can be estimated as 19–22 percent in 1996, as compared to 17–20 percent in 1995.

The increase which can be observed, as compared to 1995, could be the result of two things: on the one hand, it could be due to the increase of unregistered expenses in the case of some expense items and, on the other hand, it could be due to the increase in the weight of expense items with higher unregistered ratios. The extent of the increase, however, cannot be considered statistically significant; thus, we cannot declare that the extent of unregistered expenses has increased within the expenses of all Hungarian households. Nevertheless, it can be stated that between 1995 and 1996 there was no decrease because, according to our estimations, this amount could not have decreased significantly.

Estimations regarding all household expenses

The above calculations—even though they enable us to follow through the changes in the amount of unregistered expenses—have a significant deficiency. As has been mentioned previously, they do not enable us to determine the amount of

unregistered expenses within all household expenses. To be more precise, this is due to two things: on the one hand, the ratios between the weights of the surveyed aggregated expenses do not correspond to the ratios between the aggregates of the actual household expenses; on the other hand, out of the household expenses we have to select those expenses which we cannot possibly classify as unregistered (e.g. household energy consumption).

Thus, first each expense item has to be considered with respect to their actual weight in order to enable us to give an estimation for each surveyed aggregated expense item for all households. This only solves the smaller problem—the examination of each elementary expense item of households still remains to be done; the calculations for the estimation of all household expenses can only be carried out after this. For this reason we followed the above described procedure and examined each expense item included in the household statistics in order to exclude all expenses where the possibility of them being unregistered expenses is insignificant or equal to zero.

As several of the steps were essentially different from those which we used in a study published previously (Bóc and Klauber 1996)—i.e. using the data of the 1995 survey—and as a result of this the obtained estimation results are also significantly different from the ones published there, it seemed necessary to recalculate the data of the 1995 survey and, for the sake of comparison, publish the data for both years in this study.[15]

Table 2

The amount of unregistered expenses within all household expenses (percent)

Household expenses	The estimated amount of unregistered expenses within all expenses (NRSH)	
	1995	1996
Food	9–10	9–12
Consumer goods	10–14	12–15
Clothing	25–33	25–32
Other	3–4	4–5
Services, home building, purchase of property	15–22	18–22
Total expenses	10–13	11–14

[15]The difference is probably due to the mistake which occurs when we "project" the non-registered amounts obtained for the surveyed household expenses onto the whole trade turnover. Even the direct generalization as to the expenses of a household—as we shall see later—can cause serious mistakes. We have already mentioned the difficulties of making any estimations with respect to total trading.

Table 2 includes the final results of the calculations. If we look at the numbers in this table it is conspicuous that, considering all household expenses in 1995, the amount of unregistered expenses was 10–13 percent, while in 1996 it was 11–14 percent. If we compare the unregistered expenses with the registered ones, then in 1995 the amount is 11–15 percent, while in 1996 it is 12–16 percent.[16]

The possible extent of the hidden economy within the whole of the economy

Given the amount of unregistered expenses among households, it becomes possible to measure the extent of the hidden economy and its proportion in the GDP. Before we start describing the results, it would be useful to look at the relationship between the hidden economy and the GDP. When calculating the GDP in Hungary the CSO (Central Statistical Office) includes a significant proportion of the hidden economy in the GDP; thus the GDP produced by the economy—or the exteded GDP (GDPs)—can be divided into parts which are declared as belonging to the hidden economy:[17]

$$GDP_S = GDP_D + GDP_{HE} + GDP_{HNE} \quad \text{and}$$

$$GDP_O = GDP_D + GDP_{HE},$$

$$GDP_H = GDP_{HE} + GDP_{HNE} \quad \text{where}$$

[16] We know, however, that household statistics do not include all household expenses which are part of our national economy (and which show an amount that is about 28 percent lower—CSO 1996). According to this, in 1995 the average per capita expense was HUF 94,764/0,72=270,506 in Hungarian households. According to the CSO the difference is due partly to the items they denied, did not want to mention or simply forgot, and partly due to the fact that people with higher incomes were better represented in the survey. The question now is: into what category should we put the HUF 75,742 average per capita expense which does not appear in the household statistics? If we include all of the latter expense with the non-registered expenses, then its amount would jump to 33–35 percent in 1995 and to 34–36 percent in 1996. Although it can be assumed that the expenses which were denied, not mentioned (or simply forgotten) are probably non-registered expenses, it does not seem well-founded to consider all missing expenses as non-registered. Another argument against handling all missing expenses as non-registered is that in our sample there were fewer people with high incomes. In case of these households it can be assumed that, within their expenses, the amount of registered expenses is not higher than in our report. After this all we need to estimate is that, within the omitted expenses, what is the extent of the expenses of households with higher incomes who were left out. A well-founded estimation of the distribution of the concealed expenses can be carried out by using the data of the Hungarian Household Panel and the microsimulating database of Tárki.

[17] See also Árvai and Vértes 1994

GDP_D = declared (i.e. explicitly exposed) GDP which appears in tax return forms and official statistics,

GDP_{HE} = GDP produced by concealed activities; its amount is estimated in the official statistics using different methods and is thus part of the official GDP,

GDP_O = the official GDP

GDP_{HNE} = a part of the GDP produced by concealed activities but which is not included in official statistics,

GDP_H = all GDP produced in the hidden economy

If we wish to express the sum of unregistered expenses as a percentage of the officialy calculated GDP then, using the GDP ratios characteristic for 1994 for our calculations, we can state that the extent of the hidden economy related to household consumption in 1995 could be considered 5–8 percent of the official GDP. This ratio is twice the amount measured by the same methods in Great Britain at the end of the 1970s (2.3 percent) and three times as much as was estimated on the basis of a survey conducted in 1981 in the USA.[18] Even so, it is still a lot lower than some assumptions and empirical research results estimating the extent of the hidden economy which put the ratio of the hidden economy to be one third of the official GDP in Hungary at the beginning of the 90s. In our opinion this deviation is not only a result of the different definitions of the hidden economy or the different estimating processes, but it means a real difference. We can either assume that, compared to a peak around the beginning of the 90s, by the second half of the 90s the ratio of the hidden economy really did decrease in Hungary—or, at least, that there had been no change compared to earlier years; only earlier research projects overestimated the extent of the hidden economy of those times.

If we assume that, in the case of transactions we did not include in our survey (e.g. community consumption, accumulation of fixed assets, export and import), the weight of the hidden economy is twice the extent of our estimation (which is an obvious exaggeration) then, as the whole, its amount would be about 16-20 percent of the official GDP. *In other words, the extent of the hidden economy would still be lower than the value estimated at the beginning of the 90s.*

It might be assumed that the extent of the hidden economy can be neglected in the respective areas of public consumption, accumulation of fixed assets and foreign trade; at the same time, during the statistical observation of households, the difference between the declared and the actual expenses—that is, the concealed or forgotten expenses—might be listed as unregistered expenses. *If these two above-mentioned standpoints are held, then the ratio of hidden economy can be considered to have been 17–18 percent of the official GDP in 1995.*

Even if we accepted these ratios it would not mean that the official GDP should be increased by this much in order to reach the "total or extended GDP". Using various methods of estimation, the CSO builds a significant part of the

[18] Data source: Willard 1989

hidden economy into the official GDP. In 1992, for example, the ratio of the hidden economy was estimated in such a way that it was over 10 percent of the official GDP (Árvay and Vértes 1994). Given that there is no way of knowing what percentage of the official GDP the actually declared GDP is at present,[19] we cannot tell how much the official GDP should be increased by in order to reach the actual GDP using our definition of the hidden economy. It is probable that, considering the possible development of the statistical estimating methods, the ratio of the hidden economy which is included in the official GDP is nowadays higher. In other words, in 1996 the official GDP did not have to be increased by 17–18 percent to reach the total GDP (as was the case with estimations made in 1992—Árvay and Vértes 1994).[20]

Possible explanations for affinity toward unregistered purchases

Assumptions

Having given an outline of the average amount of unregistered household expenses, an examination can be made of how the investigated households are divided with regard to the ratio of unregistered expenses within their respective expenses. Furthermore, an analysis can be made concerning characteristics of the households and their places of residence with respect to the affinity of households for unregistered purchases.[21] Can we establish the range and characteristics of the groups of households which are usually characterized by a high level of unregistered expenses—that is, by more intensive participation in transactions that are part of the hidden economy?

During our investigation we compiled the 1995 and 1996 data and used both as bases for calculation. If there was no relevant data which could be used for the examination of household characteristics for 1995 (e.g. subjective judgement of the financial situation of the household), we only used data collected in 1996. This transformation made sense because—as could be seen earlier—there was no significant difference between the amount of unregistered expenses in the two years with regard to the aggregated expense items or to all recorded expenses. Thus, we assumed that the effects of the factors responsible for the ratios of unregistered expenses were not different in either of the two years.

[19] The CSO does not carry out calculations in relation to these.

[20] If we consider that the declared GDP is 90 percent of the official GDP then, on the basis of the data we obtained, the amount of hidden economy is about 18–20 percent of the declared GDP. This also means that the official GDP should be increased by 7–8 percent to reach the extended GDP.

[21] The definitions and distribution of the investigated variables can be seen in *Appendix 1*.

The compilation was made possible by the fact that the questionnaires used in the two surveys were almost the same and so they could be easily transformed into a new database.

Several assumptions could be made during the examination concerning the affinity of the households towards unregistered expenses. These are the following:

Income standards. First of all, it seems evident that the affinity of a household towards unregistered expenses is in a very strong negative relationship with the per capita income (EHJOV) of the household: the amount of unregistered expenses is higher in households with lower income standards, than in the expenses of the well-to-do.[22] It is obvious that in poorer households people are probably more often forced to adapt to this kind of consumption. A form of this is the purchase of goods at a lower price; this would certainly mean an increase in unregistered expenses within the expenses of the household.[23]

Property. The effect of the financial condition (HVAGYON) can be assumed to be similar to that of incomes: i.e. the richer households have less unregistered expenses than the poorer.

The perception and the dynamics of financial circumstances. With relation to the influence of incomes it can be assumed that it is not the actual income condition but its subjective perception that plays an important role in the volume of unregistered expenses.[24] On the other hand, it is not the actual standard of income but the dynamics of the income that is more closely related to the involuntary adaption of the consumers—that is, to the ratio of unregistered expenses within recorded expenses.

Accordingly, the ratio of unregistered expenses depends, on the one hand, on the subjective perception of the standards of income and, on the other hand, on the changing of the standards of income. We expect that those who perceive their financial circumstances to be bad, instead of considering their actual standard of income, will have more unregistered expenses. Also, the ratio of unregistered expenses is higher within the expenses of households which report that their standard of income has been falling.

We used two variables to measure the subjective perception of the standard of income: the first was the ordinal variable describing the financial circumstances

[22] Analyses carried out on the basis of the 1995 survey did not verify the assumptions related to the negative effect of the income. Measuring the income standard of a household in relation to per capita income in the household, we found no significant relationship between the surveyed expenses and the non-registered expenses at any level of acceptance. We could not disclose any kind of relationship even when we examined the non-registered ratios related to each expense group (e.g. food and consumer goods, clothing, other goods, or services) one-by-one (Tóth 1996a).

[23] It should be added, that empirical analyses examining the supply and prices of the flea markets warn us that in many cases the "low prices" of the flea markets are only an illusion for the buyers (Czakó 1997).

[24] The subjective perception of the income standard can also be a relevant accounting factor, independent of the actual income standard (*Lengyel and Tóth* 1996).

of the family (SZAHELY), and the other was a continuous variable sensitive to the deviation between the actual and the expected standard of income (DEPRIVH). This yields the ratio of the difference between the expected and actual incomes compared to the actual incomes.

To approximate the dynamics of the perceived incomes we used the ordinal variable describing the changes in the financial circumstances of the families during the previous year (CSAHELY).

Social status. The choice between the registered and unregistered expenses can also be comprehended as the choice between the non-material advantages (guarantee) and the tangible, material advantages (lower price). The attitudes of consumers preferring one or the other are quite different. When buying the same products some consumers prefer registered purchases in order to obtain an "enforceable" guarantee, while others prefer to pay less and in doing this they are willing to waive the sense of safety which is provided by the guarantee. This difference in preferences is related to the social status of the consumers—that is, the social status of the members of the household can have an influence on the shopping habits of the household. We assume that households where the members are better educated and of higher social status spend less on goods and services purchased in unregistered form than the ones with lower social positions. We measured the social position by the qualification of the head of the household (HFOISK).

Enterpreneur in the family. In Hungary it can be observed that the budgets of those who are self-employed in the form of enterprises and of micro-enterprises based on family participation are considerably intertwined with the household budgets. The results of empirical analyses (*Tóth and Ábrahám* 1996) also indicate that, in order to minimize tax obligations, some enterprises include the day-to-day expenses of the household in the expenses of the enterprise as "production consumption". As a result of this we expect that the presence of an enterpreneur in a household (VALLALK) decreases the affinity towards unregistered purchases because goods purchased in this form, in the absence of invoices, cannot be accounted for as expenses of the enterprise.

The size of the settlement. In Hungary the areas that serve as bases for most of the flea markets are concentrated mainly in the larger towns and in Budapest. It can be assumed that the range of goods these markets offer increases with the size of the settlement.[25] As a result of this, we expect that there is a close connection between the type of settlement in which the household is located (TELEP) and the affinity towards unregistered expenses: the ratios are probably higher among those who live in larger settlements—*ceteris paribus*—than among those who live in smaller settlements.

[25]The results of empirical investigations related to the supply and size of the flea markets indicate the same (Czakó 1997).

Availability and transaction costs. The other way in which the size of the settlement also has an influence is that the expenses related to the actors of the unregistered transactions vary—that is, the *transaction costs* related to the purchases are different. It makes a difference where and how often the given goods can be purchased, how long it takes and how much it costs to get there, and what chances the members of the household have to go to the closest flea market.[26] Thus, we suppose that in the households of those settlements where the network of public transportation to the neighbouring larger towns and to the county towns is better developed, the ratio of unregistered expenses is higher. The situation is similar if there is a car in the given household (AUTO), because this can widen the range of easily accessible places for making unregistered purchases.

The rest of the variables used as indicators of availability show how many larger settlements within 40 kilometers of the household can be reached by bus (BUSZ), by train (VONAT), or either one of these (KAPCS).

Environment. When examining the shopping habits of households it cannot be left out of consideration that this can be influenced by contextual effects. The norms shown by neighbouring households can also influence the shopping habits of the given household. We assume that if the income standards of people living in the same settlement are high, then this fact decreases the ratio of unregistered expenses. To measure the income standard characterizing a settlement we divided the taxable income of all of the taxpayers by the number of inhabitants and according to this quotient we listed households into ten categories. The variable obtained (NADOALAP) shows which of the ten income categories the settlement of the given household belongs to.

State of development of the business network. Considering further the contextual effects, we expect that if the commercial infrastructure of a settlement is well developed, then there are more shops with a better chance for registered purchases and a wider range of goods, and this will decrease the affinity of the inhabitants of the settlement towards unregistered expenses. The deficiencies and under-development of the official commercial network contributed significantly to the formation and survival of flea markets which provide the opportunity for unregistered purchases. The flea markets can be considered as "supplementers", whereas if the official commercial network is well-developed, the chances for the formation of the former are not so strong.

The level of development of the commercial network is indicated by the number of department stores for every ten thousand inhabitants (ABCR) and the number of all retail stores—not including pharmacies—also for every ten thousand inhabitants (SHOPR).

[26] The relevancy of the assumption related to availability is verified by the results of János Köllő's study examining the conditions of local unemployment and commuting (Köllő 1997).

Results

Now let us take a look at the distribution of the households according to the ratio of unregistered expenses within the surveyed groups of expenses and within all the surveyed expenses! In the following we will analyse the amount of unregistered expenses one-by-one within each expense group (e.g. consumer goods, durable goods, clothing, services) and within all expenses, not including food (C2FH). We decided to exclude money spent on food because the method we used (i.e. household survey) was the least accurate when estimating the amount of unregistered expenses.[27]

The distribution of the households according to the unregistered expenses directs our attention to three facts:

First of all, the unregistered expenses have no, or hardly any significance in the recorded expenses of a large number of the households; secondly, all expenses of a considerable number of households are paid in the form of unregistered expenses; and thirdly, taking into consideration all of the recorded expenses, it can be seen that there is a decrease in the number of households where the ratio of unregistered expenses is increasing.

These all indicate that the phenomenon of unregistered expenses plays a role within the expenses of a limited group of households and only in the case of a small proportion of these households can we say that unregistered expenses have a dominant role within the recorded expenses. This can be clearly seen if the households we questioned during the two surveys are listed in two categories in relation to the amount of unregistered expenses (See *Table 3*).

Attention can now be turned to the examination of the relationship between the ratio of the above factors and the unregistered purchases. For this purpose we carried out logistic regressional and ordinate logit estimations; the subordinate variables of the latter were the ordinate variables which were calculated according to the ratios of unregistered expenses.[28] In the models we try to estimate to what extent and in what direction a unit change of the illustrative variables changes the probability that the ratio of unregistered expenses of a household's expenses will fall into one of the given categories.[29]

[27] In the case of expenses related to food we can only estimate the amount of non-registered purchases, because in the traditional vegetable-markets the farmers are not obliged to give receipts and also, in the case of the other salesmen not giving a receipt, this does not mean that the value of the purchase will not be declared in their tax return forms.

[28] On the other hand, due to the fact that the distribution of C2FHR is a Poisson-type distribution, it seemed appropriate to use Poisson regression. Also, for the values of variables showing the ratios of non-registered expenses as expense groups we also carried out simple linear regressional estimations to test the effect of each explanatory variable. The direction of the effects estimated on these bases do not differ from those obtained during the ordinate logit estimations.

[29] For a detailed description of the ordinate logit model see Computing Resource Center 1992.

Table 3

The distribution of households in relation to the unregistered expenses within the different groups of expenses

Groups of expenses	Average ratio of unregistered expenses	Ratio of unregistered expenses (percent)			n
	(%)	Zero (0)	Around average (1)	Above average (2)	
1. Consumer goods* (ELFHR)	11.2	85.5	14.5	–	1361
2. Clothes (RFHR)	36.4	52.2	9.5	38.4	1170
3. Other goods (VFHR)	14.0	71.4	6.6	21.9	1893
4. Services (SFHR)	53.8	14.8	32.4	52.8	1702
5. Surveyed expenses (1+2+3+4) (C2FHR)	27.0	16.2	45.6	38.2	1980

*In the case of consumer goods the categories are: 0 – there is none, 1 – there are some

The effect of the examined factors were tested by two models. In the first one those variables were used as illustrative variables which were at our disposal during both surveys (MODELL1). These were the following: VALLALK, HFOISK, AUTO, EHJOV, TELEP, and IDO. In the second one (MODELL2) the above variables were supplemented by those which characterized the settlement's level of development and the living standards of the people living there (which we only had during the 1996 survey). The former group included the number of larger settlements which were within 40 kms and were accessible by public transportation (KAPCS), the average taxable income of the people living in the settlement (ADOALAPO), and the number of department stores for every ten thousand inhabitants. The latter group includes the financial situation of the households and the perception of changes in financial circumstances (DEPRIV és CSAHELY).[30] Accordingly, this model only includes data of the 1996 survey on households outside of Budapest.

The results of the calculations are included in *Table 4*. These results show that there are no uniform effects between the different groups of expenses. The characteristics of the households have a different effect on the ratio of registered expenses in each group of expenses.

We cannot confirm our hypothesis concerning the presence of an enterpreneur in the family—although the estimation results in the same effect as was assumed—

[30] As we used the variable KAPCS, which we defined as having the value "missing" in the case of households in Budapest, results appearing in MODELL2 are only related to households outside the capital.

Table 4

Results of the logistic regression and ordered logit estimations (MODEL1)

independent variables	dependent variables					
	ELFHR (1)	RFHR	VFHR	SFHR	C2FHR	C2FHR2
VALLALK	−0.0849	−0.2102	0.1932	−0.1945	−0.1327	−0.0863
HFOISK	−0.0278	−0.2863**	−0.1014*	−0.0165	−0.0147	−0.0507
AUTO	−0.3913*	−0.0148	0.2319**	−0.2568**	0.0823	0.0148
EHJOV	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
TELEP	0.4192**	0.0069	0.2167**	−0.1084**	0.1004**	0.1075**
IDO	0.0700	0.0275	−0.0554	0.0551	0.1474*	0.1642*
Constant	−2.7672**	–	–	–	–	–
Cut point 1	–	−0.7486	1.3188	−2.2032	−1.3172	−0.6042
Cut point 2	–	−0.3358	1.7022	−0.5275	0.8147	0.1128
Cut point 3	–	–	–	–	–	0.8398
N	1298	1118	1831	1642	1912	1912
Chi^2 =	44.82	35.79	28.87	25.46	11.44	11.55
Log Likehood	−1036.093	−1030.7916	−1371.8288	−1623.3136	−1948.7978	−2548.9106
Prob > Chi^2	0.0000	0.0000	0.0000	0.0003	0.0756	0.0728
Pseudo R^2	0.0415	0.0171	0.0104	0.0078	0.0029	0.0023

(1): logistic regression

*$p < 0.10$

**$p < 0.05$

because the effect of the variable used for measurement (VALLALK) is not significant in any of the cases.

The effect of the social status which was measured by the education of the head of the household (HFOISK) is more unambiguous: households of high social status buy less clothing and other consumer goods in unregistered form. This confirms the hypothesis concerning the relationship between the choice of non-material advantages—material advantages and social status: *when making a decision related to a product, those of higher status value the non-material advantages higher, while those of lower status value the advantage of the price.* We can also say that those of higher status can be described by the model of quality-sensitive consumers, while those of a lower status by the model of price-sensitive consumers (*Galasi and Kertesi* 1991).

Since the flea markets offer mainly clothing (Czakó 1997) we can say that *in the trade of clothing, which makes up a significant part of the business of flea markets, the higher the level of education the lower the probability of unregistered purchases.*

A household's ownership of a motor car (AUTO), as has been mentioned among the assumptions, can mean two things: on the one hand, as a piece of prop-

erty it can measure the financial circumstances of the household and, on the other hand, as a means of transportation it can improve the chances of the household for shopping. The latter effect promotes unregistered purchases because it makes those markets accessible at which the household can have the advantage of a better price; such markets could not be reached without a car.

The proportions of the parameters we obtained are the same: the almost 68 percent decrease in the chance of unregistered purchases in the case of consumer goods can be related to the financial situation of the households. In the case of these goods the place of purchase—in the case of unregistered purchases—is the street itself, and this is a phenomenon which occurs mainly in cities. Due to this, the role of cars as a means of transportation can be neglected. The situation is the same in the case of services, for we cannot talk about the changing of the place of purchase as a precondition of the purchase.

In both cases (i.e. consumer goods and services) we suspect that the financial situation of the household is behind the decreasing influence that the ownership of a car has on registered expenses. Among the richer households the unregistered purchases from these groups of goods are more limited.

In the case of other goods the ownership of a car can also be considered as an improvement of the shopping possibilities and an indicator showing the financial situation of a household. The shopping possibilities of households which are richer and own a car are better than those of the poorer and they use this advantage to increase the ratio of unregistered purchases within their expenses. On the other hand, in the case of people living in bigger towns where—due to better public transportation—the transactional costs of purchases are lower to start with, a higher unregistered ratio can be estimated than in the case of people living in smaller towns or villages. *The negative influence of the social status of the household warns us that—similarly to buying clothing—households of higher status behave as quality-sensitive shoppers in the case of these goods, too.* Non-material advantages such as quality and guarantee are more important to them than lower price.

The negative influence of the size of the settlement can be related to the unified influence of AUTO and TELEP: more people living in larger settlements have cars, and the probability of a family using their neighbours' car or some relatives' car for shopping—who live in the same settlement—is also higher. If the non-possession is considered—since we assume a positive relationship between the goods offered in the markets and the number of people living in the settlement where the markets are—the place of the market also influences the demand.

Our hypothesis concerning the negative influence of the standard of income (EHJOV) is *not confirmed by the results obtained either in relation to the certain groups of expenses or in the cases of the aggregated expenses.* According to the models, a household's standard of income has no significant influence on the ratio of unregistered expenses regardless of which level is considered: people with higher

incomes are just as likely to buy at a higher or lower rate in unregistered form as households with lower incomes. This result corresponds to the one obtained during an earlier investigation (Tóth 1996a).

The absence of the income's influence can be linked with the fact that, while in the case of people with lower incomes shopping is more frequent at flea markets where goods are cheaper and of lower quality, the ratio of shopping in registered form is not higher among households with higher incomes (who shop here less frequently), because these people often buy more expensive and better quality products from craftsmen who also do not issue invoices.[31]

The size of the settlement where the household is located (TELEP), however—excluding the services—is in a positive relationship with the ratio of unregistered expenses in each case. According to this—in case there is no difference between two households with respect to all examined characteristics—this ratio is the highest in the households in Budapest and the lowest in the case of people living in villages. This result is due to the uneven distribution of the unregistered markets (flea markets) in relation to the types of settlements: *most of these markets (with the widest range of goods) are in the capital and in the county towns.* This means that these are more accessible for people who live in settlements where there is a market making unregistered purchases possible and the ratio of unregistered expenses within their expenses is higher than in the case of people who live in settlements where there are no such markets.

This is especially valid in the case of consumer goods because, in case of these goods, it is mainly in the streets and in the markets that cigarettes, alcoholic beverages or coffee can be purchased in unregistered form. Out of all expense groups estimations related to these come closest to the practical data (pseudo $R^2 = 0.0415$).

In the case of services, the above train of thought cannot be logically valid because, in this case, the place of transaction cannot be unambiguously determined: it takes place either in a shop, or at the seller's place of work, or at a place designated by the seller. The empirical results show another kind of relationship: *the ratio of unregistered expenses is estimated to be the highest in households in smaller settlements.* This result is probably related to the fact that services in villages are done on the basis of mutual help between the households in the form of a direct exchange of services or goods (a) or in the form of monetary transactions (b).[32]

[31] Zsolt Spéder called my attention to this fact. The results of a survey which covered the management of households in a provincial town and the surrounding area indicated the same (Spéder 1997).

[32] In the first case there is no money involved in the transactions (these are not included in our circle of observation) while in the second case money is used as the means of payment. Our analysis of the two recordings supply information on the amount of unregistered purchases within the latter. According to this, in the case of monetary transactions the amount of registered expenses increases with the size of the settlement.

A professional supplier living in the same village is looked upon by the buyer as a member of a household with whom they are in day-to-day contact. Due to this personalized relationship the ratio of unregistered sales is higher in the villages than in towns.

The effect of the IDO models is always positive and significant in the aggregated model. The direction of its effect is not surprising if we take into account that in 1996 the amount of unregistered expenses was somewhat higher in all households than in 1995. The only difference is that at the household level the model estimates a significant increase between 1995–96, while in the aggregated estimation this change was not found to be significant.

It must be added to the above that the reliability of the models used for the estimation of the unregistered ratios (C2FHR és C2FHR2) within the aggregated expenses is questionable. The models obtained do not really explain the differences in the amount of unregistered expenses. Knowledge of the analyzed household expenses contributed only in a small extent to a more accurate determination of unregistered expenses.

We expected a somewhat better result in the case of the second model (MODEL2), which also contained variables describing the financial situation of the households, the state of development of the settlements, and the living standards of their inhabitants. According to our results, however, in most cases the newly included factors did not improve the reliability of the estimations significantly. In the case of clothing it is also the effect of the social status of the household and the availability of the flea markets (AUTO) that are more significant. The higher social status decreases the ratio of unregistered expenses while the ownership of a car—which characterizes the financial circumstances of a household—increases this ratio. The model estimating the ratios related to other consumer goods does not supply an acceptable result: here the variants do not promote the estimation of the ratio of unregistered expenses significantly. In the case of services the obtained results were acceptable and it was the influence of the newly included variants that was significant. The negative influence of the size of the settlement stood out in the same way as in the previous model. *This can be supplemented by the fact that—as we expected—in settlements where the average income of the inhabitants was lower the ratio of unregistered expenses was higher within the expenses of the housekols.* The role of the other two factors (public transportation connections and number of stores in the area), however, is quite puzzling: according to both, higher ratios of unregistered expenses can be estimated in settlements with more developed infrastructures.

With relation to all recorded expenses (C2FHR és C2FHR2) it can be seen that the results obtained are not independent of how we determine the variable which shows the ratio of unregistered expenses. In the first case the estimation supplies a significant value while in the second case it does not. The results of the first estimation *confirm the role of availability in the amount of unregistered*

Table 5

The results of the ordered logit estimations (MODELL2)

Independent variables	Dependent variables ELFHR (1)	RFHR	VFHR	SFHR	C2FHR	C2FHR2
VALLALK	0.3065	−0.2102	0.5206*	−0.4089+	−0.2534	−0.1464
HFOISK	−0.0129	−0.3597**	−0.0880	−0.1083	−0.1084	−0.1316
CSAHELY	−0.3519+	−0.0149	−0.8241	0.0620	−0.0490	−0.0184
AUTO	0.4844	0.4568*	0.3226+	0.0235	0.3730*	0.2645
EHJOV	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
DEPRIV	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
TELEP	0.1568	0.1923	0.0865	−0.5079**	−0.2901+	−0.1883
ADOALAPO	0.0098	−0.1782	0.0500	−0.3458**	−0.0418	−0.0779
KAPCS	0.0158	−0.1025	−0.0858	0.3217**	0.2378**	0.1935
ABCRO	−0.0098	−0.0093	−0.1314	0.2737*	0.0780	0.0110
Constant	−1.8228	–	–	–	–	–
Cut point 1	–	−1.1635	0.8653	−2.8626	−1.7409	−1.0220
Cut point 2	–	−0.7340	1.1965	−1.0835	0.5037	−0.3206
Cut point 3	–	–	–	–	–	0.4695
N	490	435	713	639	748	748
Chi^2 =	8.719	29.89	13.50	54.82	21.33	18.08
Log likelihood	−179.7705	−393.0639	−499.30	−601.49	−745.75	−992.39
Prob > Chi^2	0.5562	0.0000	0.1968	0.0000	0.0189	0.0537
Pseudo R^2	0.0271	0.0366	0.0133	0.0436	0.0141	0.0090

(1): logistic regression
$^+p < 0.10$
$^*p < 0.05$
$^{**}p < 0.01$

expenses: both the ownership of a car and the better transportation possibilities point towards a higher unregistered amount. In this case the increase in the size of a settlement decreases the willingness to pay in an unregistered form. This probably results in the fact that—as has been mentioned—in the expenses of households in smaller settlements other households play a greater role, while the role of professional retailers or vendors are less important than is the case with households in larger settlements.

Conclusions

Our results show that in Hungary, in the middle of the 90s, the extent of the hidden economy as compared to the officially reported GDP is not negligible. During the first part of the economic transition, in the midst of the recession—

when the living standards of a significant number of households decreased or were at risk—an important characteristic of the behaviour of a very large proportion of households was that they obtained some of the necessary goods in unregistered forms.

This fact, however, does not mean that all households take advantage of this possibility in an equal proportion. On the contrary, from the results of the analysis it could be seen that this *type of behaviour is only characteristic of a small proportion*, and this decreases parallel to the increasing ratio of unregistered expenses. This means that the proportion of households which depend significantly on the advantages provided by the hidden economy is very limited.

On the other hand, it must be mentioned that, considering the maximum ratios which we estimated in comparison to the official GDP (17–18 percent), the extent of the hidden economy in Hungary can be estimated to be lower than is shown by the results of other analyses. According to the model which uses the electric energy consumption of households as the basis for estimation (Lackó 1997), in 1994 the ratio of the hidden economy was around 31 percent. There can be two reasons for the significant difference in the results: 1) the difference in the calculation of the hidden economy; 2) differences resulting from the methods used for estimation. The first refers to the fact that our definition of the hidden economy is more limited than the one used by the method which makes estimates on the basis of electric energy consumption (e.g. "do-it-yourself" activities of households are not included in our definition of hidden economy, while in the other one they are included). The other reason for the difference might be due to the fact that estimations based on surveying households and assessing the structure of expenses usually show the extent of the hidden economy to be lower than ones based on other methods. In the United States, for example, when assessing the expense structure of households, the ratio of the hidden economy was 1.5 percent in 1981, while on the basis of cash demand it was 6.1 percent.[33] Among other things this could be the result of the fact that estimations assessing the expense structure of households only include some of the economic actors and transactions, and in this the household is one of the acting parties. On the other hand, when the estimation is carried out on the basis of direct questioning it can happen that the people questioned—because of the negative moral judgement of the phenomenon of the hidden economy—will not give (or, indeed, cannot give) the actual amount of their unregistered expenses.[34]

[33] Data sources: Willard 1989 and Morris 1993

[34] A similar situation can be expected when "economy" creates negative associations in the minds of the people questioned. In this case the households are more likely to estimate the sum of their expenses and loans more fully and accurately, than that of their incomes and savings. On the other hand, looking at the incomes of the members of the household as well as the items which appear or do not appear in their tax return forms, it can be seen that in the case of the two income groups the results of the household survey are different. In the case of the declared incomes the

The models estimating the amount of unregistered expenses provide several lessons for us.

The first of these is that the income and financial condition of a household or the perception of these, as well as the size and infrastructure of the settlement where the household is, can only partly explain the affinity of the given household towards unregistered expenses. The explanation for this fact could be that, besides factors describing the actual circumstances of the household and how the members of the household see it, *the role of the unintentional, ad-hoc decisions of the household can also be important.* The decision between the registered and unregistered form of expenses is not always based on a sensible argument. Frequently it is determined independently of the buyer's decisions that a transaction is considered to be a registered or an unregistered expense (i.e. will they be given an invoice or not). In some of the cases the buyer does not have the option to choose the unregistered expense (if he/she did, the vendor would refuse to do business with him/her).

On the other hand, the survey that was based on households can only show how unregistered transactions happen from the side of demand; we can only make assumptions about the reasons and structure on the side of supplies. The existence of unregistered transactions is influenced by the behaviour of the suppliers and the structural characteristics of the given local market.

Another lesson is that the determination of the amount of unregistered expenses in the case of some expense groups is influenced by various household and contextual characteristics—as a matter of fact, the same factor can have a different effect in the case of different expense groups.

Furthermore, the results obtained show that—contrary to public opinion—there is no discernible relationship between the income standards of a household and their affinity toward unregistered expenses. It is the same if we consider the per capita income characteristics of a household or the difference between the desirable and the actual incomes.

The surroundings, however, have a significant effect on the volume of unregistered expenses, thus confirming our previous results (Tóth 1996b). The influence of public transportation connections is significant and positive: if, out of two settlements belonging to the same category, from one it is possible to reach more large settlements, then this increases the possibility that in that settlement the ratio of unregistered expenses is higher within the expenses of the households. This relationship verifies the relevance of the assumption regarding availability.

Finally, we must mention a tendency that, in the long run, can influence the ratio of unregistered expenses in relation to household expenses. By this we mean the changing of shopping habits: as compared to 1995, in 1996 the surveyed

sums calculated for the households are the same as that shown by the macrostatistics, while in the case of incomes which were not declared the estimation based on the household survey supplied a sum which is over 30 percent less (*Kolosi et al.* 1996).

households shopped more in larger department stores. On the basis of this it is likely that, since the appearance of large shopping malls in Hungary, they have attracted a significant number of people who usually did their shopping in flea markets. According to this, the network of flea markets—which play an important role in the unregistered expenses of the households—will become scarce, not as a result of police actions or taxation measures but due to the increasing role of shopping malls built by large commercial companies.

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Appendix 1

Definition of variables used in the analysis and distribution of households according to the variables

Name of variable	Definition of variable	Explanation of categories	Distribution of households according to the categories of the given variable (percent) or average values
GAKTIV	Are any members of the family economically active? (n=2006)	1: yes	71.1
		0: no	28.9
CSTAG	Number of people in the household (n=2006)	average	2.9
GYEREK	Number of children (n=2006)	average	0.8
HFOFOGL*	Occupation of the head of the household (n=963)	1: independent	9.7
		2: junior manager	5.2
		3: physical worker in agriculture	8.7
		4: skilled worker	33.7
		5: unskilled worker	21.6
		6: senior manager	9.0
		7: professional	3.9
		8: other white-collar	8.1
VALLALK	Is there an enterpreneur in the household? (n=2002)	1: yes	15.5
		0: no	84.5
HFOISK	Qualification of the head of the household (n=1998)	1: elementary school	36.3
		2: industrial school	28.0
		3: secondary school	23.4
		4: college/university	12.2
MNELKR	Is anyone unemployed in the household? (n=2006)	1: yes	14.9
		0: no	85.1
HFODOL*	Position of the head of the household in the labour market (n=995)	1: inactive	37.0
		2: active, unemployed	7.9
		3: active, employed	55.1
HOSSZES	Total income of the household (n=2006)	average (HUF)	473,545
HVAGYON*	Total possessions of the household: house, valuable assets, money, securities (n=997)	average (HUF)	2,983,185
HVAGYON2*	Total possessions of the household: house, properties, valuable assets (n=997)	average (HUF)	2,943,614
EHJOV	Total yearly income for one member of the household (n=1948)	average (HUF)	181,218

Appendix 1 *(continued)*

Definition of variables used in the analysis and distribution of households according to the variables

Name of variable	Definition of variable	Explanation of categories	Distribution of households according to the categories of the given variable (percent) or average values
DEPRIV*	Opinion on financial circumstances: the sum which they think is necessary for an adequate standard of living, minus the actual total income of the household, divided by the latter (947)	average	1.168
SZAHELY*	Individual opinion of financial circumstances (n=992)	1: are managing well	15.7
		2: can hardly manage	50.8
		3: have problems	33.5
CSAHELY*	In what way have the financial circumstances of your family changed over the past 12 months? (n=997)	1: became significantly worse	27.3
		2: became worse	46.4
		3: have not changed	22.9
		4: improved	2.8
		5: improved significantly	0.5
TELEP	Type of settlement	1: village	35.4
		2: town	25.9
		3: county town	19.4
		4: Budapest	19.3
AUTO	Is there a car in the household? (n=2007)	0: no	60.2
		1: yes	39.8
VASUT	Number of train connections (n=1515)	0	27.5
		1	20.7
		2	31.0
		3	7.7
		4 or more	13.1
BUSZ	Number of bus connections (n=1515)	0	7.7
		1	26.5
		2	28.0
		3	27.3
		4 or more	10.6

Appendix 1 *(continued)*

Definition of variables used in the analysis and distribution of households according to the variables

Name of variable	Definition of variable	Explanation of categories	Distribution of households according to the categories of the given variable (percent) or average values
KAPCS	Number of public transportation connections (train or bus) (n=1515)	0	3.3
		1	23.6
		2	27.2
		3	22.3
		4 or more	23.4
SHOPR	Number of shops per 10,000 inhabitants (1901)	average number	152.4
ABCR	Number of department stores per 10,000 inhabitants (1901)	average number	0.779
ADOALAP	Taxable income calculated for one inhabitant of the settlement	average (HUF)	127,762.7
IDO	Year of survey	0 – 1995	1007
		1 – 1996	1000

*only had the data for the year 1996

Appendix 2

Variables related to the amount of unregistered expenses

Name of the variable	Definition of the variable
CFH	Unregistered amount with respect to all expenses
C2FH	Unregistered amount with respect to registered expenses, not including food
C2FHR	Unregistered amount with respect to expenses, not including food—at ordinal measurement level 0 – there is none 1 – average, at the most 2 – above average
C2FHR2	Unregistered amount with respect to expenses, not including food—at ordinal measurement level 1 – under 5 percent 2 – 5–15 percent 3 – 15–30 percent 4 – above 30 percent
ELFH	Amount related to consumer goods
RFH	Amount related to clothing
VFH	Amount related to other goods
SFH	Amount related to services

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KEEPING THE STATE AS A MINORITY SHAREHOLDER THE CASE OF A FOREIGN-OWNED COMPANY IN THE PUBLIC PROCUREMENT SECTOR

A. SZALAVETZ

This study investigates the mechanism by which a foreign, professional investor and the state cohabit as majority and minority shareholders in a company, and the expectations of both parties from the cohabitation.

The case study analyses the various aspects of marketing and sales, focusing on the consequences of the company's integration into the international production and distribution network of its multinational owner. It shows how an increase in intra-group trade has resulted from the Hungarian state's weak performance in providing a coherent, protective industrial and trade policy and creating the macroeconomic conditions for success. Looking at the company's investment policy, the study highlights the decision-making weaknesses common to multinational corporations. Finally, applying the methods of management consultancy companies, the study analyses how corporate efficiency evolved.

Introduction*

Although a worldwide consensus has rapidly arisen about the merits and benefits of foreign direct investment, specific privatization deals still tend to provoke hot debate about letting foreign investors gain a stronghold in "strategic" industries.[1] Analysts may well consider whether in principle, viable companies should be retained in domestic ownership, and who will turn out to be the best owner in the end, for the long-term national interest.

Transforming economies that opted for individual,[2] "market-based" privatization of their state-owned enterprises (SOEs) have rarely been able to consider *possible* trade-offs between long and short-term national interests.[3] Most of the enterprises offered for sale are severely undercapitalized, with exhausted assets. They have built up huge investment backlogs, met with baleful liquidity problems, lost their earlier markets, and so on. Without a well-capitalized investor, able to supply the resources needed for viability, they are bound to be squeezed out of the market. So short-term interests logically squeeze out any long-term considerations in these privatization deals.

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[1] This applies especially when the "family silver" (well-known, long-established national companies) is being sold to foreign investors.

[2] "Individual" as opposed to mass privatization.

[3] I stress the word "possible" to counter any assumption that the trade-off is automatic.

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Another ostensible area of trade-offs where real alternatives are rarely present is the value to be set on the foreign investor's global competitive position and corporate image. In some cases investors able to provide a familiar name—a virtue in a strategic alliance, since membership of a global group enhances the competitiveness of the privatized company[4]—make lower offers than others, for whom the good name of the purchased company may be worth more.[5]

There are some strategic industries where ownership, and the nationality of the owner, certainly plays a role in competitiveness—defined as an ability to acquire orders. This applies especially to the main competitors for *public-procurement* tenders.

In these cases there is a conflict between two opposing arguments about the most beneficial corporate governance structure, which causes some deliberation even among foreign privatization applicants. On the one hand it is clear to the seller (privatization agency) and the potential buyer that the survival and viability of the company depend on quick, determined action by a well-capitalized investor. In most cases, only a foreign investor would be capable of modernizing the firm and increasing its competitiveness through financial consolidation and the provision of technology, organization and management expertise, market connections, and so on. The large transfers of funds required call for exclusive control. The buyer wants 100 percent ownership. On the other hand, if the business is strongly influenced by public-procurement decisions, the advantages of having a national, minority shareholder, even minority state ownership, may in principle exceed any consequent constraints on control.

These are the strategic arguments that foreign privatization applicants consider when bidding for specific SOEs or accepting the outcome of privatization negotiations. The other side of the coin is why the *state* would accept such cohabitation.[6] What are the arguments for not offering all the shares? How can and should the state act as a minority owner in such companies?

The motivation of the state in retaining a minority shareholding has proved unclear in most Hungarian privatization deals. The influence gained over the company has been small. The intention may have been to sell the retained shares eventually at a higher rate, after the company has been restructured by the present majority owner. This, however, entails risks: (1) The interest of the majority owner in seeing a rapid, spectacular increase in equity value may be diminished.

[4] More detail appears in *Török* (1996). However, the advantage can only be estimated comparatively, in relation to the global positions of the other privatization bidders.

[5] It is true, that Ansaldo offered far the highest price of the seven privatization applicants and assumed the most commitments (e.g. the relocation of the production from the central headquarters, etc.) but it is also true, that Ganz' name—as well as the associated corporate image is still an "intangible asset" of a high value at international tenders.

[6] In French political parlance, "cohabitation" denotes the mechanisms of joint governance by two politically opposed parties.

(2) The majority shareholder, having gained control, may see no reason to acquire the state's stake at a higher price.

In the second case, the possibility of attracting a second strategic investor, a competitor of the majority owner's, can be almost excluded. The only alternative to a sale to the present majority shareholder is to attract a financial investor. Whichever happens, a spectacular rise in the share price before the second sale will require the state's active participation in restructuring the company (through industrial policy, trade policy, or possibly a cash injection).

Ganz Ansaldo Electric PLC is a manufacturer of turbo generators for power stations, railway and public-transport traction equipment and other items saleable mainly through public-procurement tenders. The state has retained a minority shareholding alongside a foreign owner. As a case study, it exemplifies the relevance and the limitations of this reasoning.

The study has been based on in-depth interviews with various members of the company management, and on secondary source of information.[7] The interviews were made in November and December 1996. The object was to investigate the mechanism of cohabitation between a foreign investor and a representative of the state, from the Italian owner's standpoint, with special emphasis on the restructuring process and its results and shortcomings.[8] The study tries to identify the role the Italian investor has played in this restructuring process. It seeks to analyse the government-business interactions, in terms of the obstacles to increasing the company's international competitiveness and the prospects for doing so.

Privatization

Ganz Electric Works (founded by Ábrahám Ganz in 1844) was facing grave liquidity problems by the mid-1980s, well before most other large SOEs. Apart from the domestic market, Ganz Electric's sales were mainly to Comecon member-countries and certain developing countries supported at Comecon level for political reasons.[9] By the second half of the 1980s, the socialist countries were scaling down

[7] Company brochures, balance sheets and newsletters for 1994–6; *Forrás* (1996); *PKI* (1995); *Merényi* (1996); *Szakadát* (1996); Hungarian press articles on Ganz Ansaldo, 1993–6.

[8] This seemingly one-sided approach is partly explained by the passive, non-interventionist stance taken by the State Privatization and Asset Management PLC as a shareholder, and partly by the focus of the research. The aim is to uncover the role of government, not as an element in the corporate governance structure, but as a player in the government business interactions that inevitably take place in various business fields. This focus also means that apart from some references to events before the change of political system, the study deals only with the period 1991–6.

[9] In the 1970s and 1980s, Ganz had made considerable sales to Iraq, Egypt and India (and some to Algeria). All these countries were recipients of official Comecon development aid.

their support to favoured developing countries, with dramatic effects on the bottom line for certain enterprises heavily involved in them.[10]

The developing countries had begun to orient themselves more to the West. This induced, or simply coincided with the discovery of these countries as good markets by Western multinationals. The fall in the demand for Ganz Electric's products accelerated with the partial liberalization of investment-good imports into the socialist countries. Western competitors managed to squeeze Ganz Electric out by offering favourable payment conditions in public tenders.

Falling demand, increasing indebtedness, liquidity problems, and insufficient bargaining power by the management led to liquidation proceedings being filed against the enterprise. Although this was largely a propaganda move—a demonstrative example of how the regime was hardening the traditionally soft budget constraints of a state-socialist system—Ganz Electric later underwent a government-initiated consolidation programme. Despite this, the performance again worsened dramatically in 1990, when the enterprise had to be placed under direct government control. A crisis-management programme seemed essential: the enterprise had run up debts totalling HUF 3.5 bn, with vast useless stocks and a bulging portfolio of accounts due.[11]

The best option, according to government officials, was to interest a capital-rich foreign investor, and the privatization method chosen was a joint venture. This would ensure that instead of serving fiscal purposes, the purchase money would be a "real investment" serving restructuring goals. Part of the enterprise[12] was converted into a public limited company (Rt.) on January 1, 1991; 51 percent of the shares were bought by Ansaldo Sp.A, a member of the Finmeccanica group within the largest Italian state-owned holding company, IRI.

Organizational structure

A key element in any restructuring programme is to modernize the organizational structure within the company. Ansaldo followed a gradual, sometimes even cyclical policy of organizational renewal, with periods of accelerating change alternating with consolidation periods. The organizational changes were spurred by various corporate events:

[10] Hungary's proportion of overall development aid to GNP in the first half of the 1980s varied between 0.1 and 0.12. Alongside technical assistance in the form of grants and scholarships, Hungary specialized in infrastructural aid programmes, especially *railway equipment*, electrical engineering, aluminium and *power stations*, and in foods and pharmaceuticals. Source: *OECD development cooperation*, 1981, 1985 and 1987.

[11] The last amounted to about HUF 2 bn. (PKI 1995, p. 21.)

[12] Ganz Electric Works remained as an SOE. The final settlement initiated in January 1994 is still in progress.

— The contraction in demand in the early years coincided with a radical downsizing.

— Cyclical changes took place in the senior and middle management.

— A sudden increase in demand led to the emergence of growth problems that required further organizational renewal.

— Some of the production was moved from Budapest to Tápiószele, where a new factory—TEMM Tápiószele Electro Mechanical Works—was established as a "brown-field" investment.

Table 1

*Number of employees at year end**

1990	1991	1992	1993	1994	1995	1996***
3800	2302	1856	1612	1515**	2021**	2300**

* Excluding hired temporary employees.[13]

** Including employment at TEMM PLC, Tápiószele.

*** Estimate.

The first wave of downsizing occurred in 1991, just after the privatization deal, when about a thousand of the 3800 employees in the SOE were not taken over by the new company. In the next three years, the payroll fell by about 1400. White-collar workers were in a better bargaining position, which rapidly distorted the ratio of non-production employees to production workers. The tide turned after 1993, when it was mainly white-collar staff who were made redundant, parallel with a qualitative change.[14] However, the downsizing did not follow the textbook procedure, whereby each corporate function is re-evaluated according to the analysis of each separate (separable) part of the production process, to arrive at the functional and organizational solution that improves efficiency the most. (*Hammer and Champy* 1993) What happened instead was a blanket type of downsizing. This brought a spectacular improvement in productivity during the period of contracting demand, but caused bottlenecks once production started to rise, due to the abolition of certain functions.

[13] The company resorted to hiring employees from employment agencies when orders began to pick up at dramatic speed. These numbered about 140 in 1995.

[14] About 2000 employees were made redundant or left of their own accord between 1991 and 1994. Payroll growth resumed in late 1994, and by the end of 1996 the company had regained its initial size of workforce as a PLC, but with a much improved structure. The proportion of unskilled workers is a marginal, 2–3 percent of all manual employees. The first wave of radical downsizing and the "rejuvenation" policy pursued by some managers led to the loss of much company-specific expertise. This caused difficulties some years later, when the order books began to recover. One of the bottlenecks to further growth at Ganz Ansaldo is a shortage of suitably skilled personnel.

Table 2
Labour productivity (HUF mn)

	1991	1992	1993	1994	1995	1996**
Net sales/staff costs*	3.2	2.3	2.5	2.9	4.9	N/A
Net sales/employment*	1.44	1.5	2.26	3.13	4.9	5.2

Source: Own calculations from company balance sheets.
* Excluding temporary agency employees.
** Estimate.

Meanwhile the idea of flattening the corporate hierarchy, lessening the number of decision-making levels and decentralizing authority remained a strategic goal, rather than a reality. There were some changes in the senior management from time to time, and Italian experts arrived to manage the turn-round of the loss-making company. This brought language problems and frequent clashes of cultures at plant level, where Italian production managers supervised Hungarian and imported Romanian workers.[15]

The response to the rapid worsening of the balance-sheet figures was to centralize decision-making. Although this reduced the number of decision-making levels, it meant that strategic managers were involved even in minor operational issues.

The decision-making bodies at Ganz Ansaldo have mainly Italian members. Other major decisions are taken in Italy, at group headquarters.[16] Strategic investment, buying, financial and other matters are decided upon at headquarters.

Marketing and sales strategy and cohabitation

Ganz Ansaldo's marketing and sales strategy is determined by the following:
— The specific characteristics of its product range, which prescribe the formal framework of competition and the sales channels.

[15] Having been "socialized" in the communist period, workers (and skilled white-collar staff) found it difficult to accustom themselves to the more paternalistic, authoritarian style of Italian managers.

[16] For instance, the decision about where to locate the new factory, to which the present headquarters were to be relocated, was taken in Rome. All kinds of investment decisions are considered significant enough to require consultation with the multinational headquarters. Marketing and buying are more decentralized within the multinational organization. The sources for strategic products are determined in Italy, but the local Comitato is responsible for sourcing non-strategic inputs. (For more detail, see chapter on corporate efficiency)

— The radical contraction of its domestic market, which has transformed its sales orientation and introduced the goal of a global presence even at subsidiary level.

The latter factor has become more prominent. The fact that the parent multinational is a global company with a sales network present in more than 40 countries did not automatically bring a global orientation to the new Hungarian subsidiary. Ganz Ansaldo's presence in selected countries and its retained business connections and prospects there after 1990 did not alter the traditionally domestic orientation.

In the first couple of years of the joint venture's existence, most of the company's marketing efforts went into improving its position on the domestic market. (Domestic references in this branch of manufacturing are indispensable for success in international tenders.)

Table 3

Ratio of exports to net sales (percent)

1991	1992	1993	1994	1995	1996
29.7	38.5	40.5	54.0	64.0	69.3

Source: Own calculations from company balance sheets.

Up to 1995, a 50–60 percent ratio of domestic to total net sales was the company's stated objective. Ganz Ansaldo adopted an active approach to winning more domestic orders. It ran professional presentations for potential customers, while lobbying for more public investment projects (to improve market conditions) and for governmental financial support (export promotion), so as to be able to offer better payment terms in international tenders.

The main advantage Ansaldo expected from co-ownership of the company with the Hungarian state was to benefit from government industrial policy and trade policy. The biggest *disappointment* was not the drastic contraction of the Hungarian market, but the liberalization of the market and lack of local-content prescriptions in the privatization contracts of its main domestic customers. After the privatization of the cement industry and its receipt of the right to import investment goods customs free, Ganz Ansaldo was crowded out of one of its traditional markets, where had sold significant numbers of industrial motors for various kinds of plant.

The second blow was the privatization of the local electricity networks and power stations. The Public Procurement Act is incompletely formulated, so that it does not apply to this sector at all. The management of Ganz Ansaldo considers

there is a real danger that these privatization deals will lead to a further radical fall in its domestic orders.

So while lobbying at the highest levels for a more coherent industrial and trade policy, Ganz Ansaldo started to build up its global presence. The Hungarian subsidiary participates in some tenders independently, and in others as part of the Ansaldo Group.

In either case, it may deliver its products *directly* to the end-user. (As a subcontractor in international projects it delivers, installs and services its products abroad.) The third possibility is for it to deliver directly to other subsidiaries of Ansaldo, in a global production cooperation.

The second most frequent marketing channel covers sales through the world-wide distribution channels of Ansaldo. This, in other words, is *intra-firm trade*, in which Ganz Ansaldo products are incorporated into Ansaldo's complete systems. The best indication of its importance is that 90 percent of Ganz Ansaldo's export sales transactions take place in Europe, while only 35–40 percent of exports have a final destination in Europe. According to the original ideas of the multinational owner, Ansaldo's role in providing orders for its Hungarian subsidiary would be significant only in the first, "consolidation" phase of restructuring. In the second, "development" phase, Ganz Ansaldo should acquire increasing autonomy, reflected by a steady fall in the share of intra-firm trade and a rise in direct sales.

Besides acquiring orders independently, Ganz Ansaldo is supposed to represent the whole Ansaldo Group in some markets: neighbouring Eastern and Central European countries, and some Northern European countries where the Hungarian firm has long-standing connections.

Ansaldo's planned shares in Ganz Ansaldo's total sales have been revised several times in the strategic plans. Instead of the original plan—a high initial share and a steady decrease thereafter—Ansaldo's role as a main contractor has started to show a significant increase only in the last two or three years. The share of intra-firm trade reached about 40 percent in 1994 and 45 percent in 1995 and 1996. This causes liquidity problems for the Hungarian company, as Ansaldo's payment deadlines are longer than the average for Ganz Ansaldo's contractors, and Ansaldo does not accept any advance-payment stipulations. (The usual sequencing of payment at Ganz Ansaldo is an advance of 10–20 percent on signing the contract, 10–20 percent when technical documentation is completed, and a further 20–25 percent payment for purchasing the materials and components.) Ansaldo, on the other hand, pays only after the delivery and installation of the ordered product—with a payment deadline averaging 120 days.

According to some members of Ganz Ansaldo's marketing staff, the most important competitive advantages, apart from a good financial position, are local connections (and of course quality, strict observation of delivery deadlines, and so on) and an active approach. Some international tenders are formulated in a way that benefits certain bidders more than others. To achieve a better position in

international tenders, bidders have to know in advance where tenders are going to be invited (in which countries and which areas). Moreover, they need to monitor the global market opportunities, identifying the potential needs in specific fields and the sources of finance (the EBRD, World Bank, *etc.*) they can propose to governments and companies.

So it is crucial to have agents in various countries who know the main players in the market and can keep an eye out for the opportunities that emerge.

Another kind of active approach is to hold presentations abroad, with the help of Hungary's commercial representatives, for the benefit of relevant ministries or ministers. Plans for necessary infrastructural projects in the country can be presented, along with Ganz Ansaldo's potential role in the realizing of these. Such presentations may prompt foreign governments or ministries to invite a tender formulated in a way favourable to Ganz Ansaldo.

A further possibility is to examine Ganz Ansaldo's product reference lists. These go back to the 1950s, recording the year of sale, the technical specifications of the product sold, the client and the destination. By calculating product life spans, Ganz Ansaldo staff can forecast when specific market opportunities may arise.

Supplier relations

Like most Hungarian enterprises under the state-socialist system, Ganz Electric Works' production was almost completely *vertically integrated*. It had its own foundry, welding plant and galvanizing plant. It manufactured its own bearings and insulated cables, and most of the machinery need for production. This astonishing proportion of in-house inputs began to diminish some decades before privatization, and the process accelerated significantly thereafter. Even today it remains higher than at Ansaldo or its international competitors despite the aims of establishing optimal out-sourcing proportions, and buying whatever can be bought from specialized companies, rather than producing in-house.

Apart from the "make-or-buy" issue, the purchasing strategy of a company is usually analysed by examining whom the company buys from, whether there have been any changes in sourcing and preferences since the change of ownership, and what factors influence buying decisions.

In terms of *strategic material inputs* there have been no radical changes in Ganz Ansaldo's sourcing policy. Many of the strategic input items have always been produced by no more than three to four producers worldwide. This means that even in periods of strict import controls, the same producers would be used. Specific sourcing decisions are taken primarily on the basis of the technical specifications. Compared with these, even prices, delivery dates and delivery have secondary im-

portance. Under these circumstances, rules of origin, tariff considerations and so on will not have a great influence. Only when all other circumstances are equal will Ganz Ansaldo opt, say, for a European or an Italian supplier.

The number and proportion of Ganz Ansaldo's *Hungarian suppliers* fell by some 10–15 percent in the initial years of the joint venture's operation. This was due to the slowness of suppliers in adapting to Ansaldo's requirements on price, quality, delivery and payment deadlines.[17]

Since 1994, Ganz Ansaldo has laid considerable emphasis on increasing the proportion of domestic suppliers. It may rent plant to its suppliers (often under a rent-free agreement), and pre-finance some of their production by delivering material inputs. This is part of the company's overall cost-cutting policy. With exported products, Ganz Ansaldo can reclaim the supplementary customs duty on imported items, which its suppliers (delivering to Ganz Ansaldo) cannot.

A management-textbook method of cost-cutting is *centralized sourcing*. Increasing the purchased quantity improves the bargaining position of the buyer. Ansaldo Industria operates a data bank that includes the main suppliers to Ansaldo's various subsidiaries, and some information about the prices and specifications of the various inputs supplied. This makes it possible to combine purchasing needs and find the optimal supplier. The same objective is served by efforts at product standardization.

The strategic principles of sourcing are overshadowed by the grave *liquidity problems* of the company, detailed in the next chapter. Faced with long payment arrears by its major customers, Ganz Ansaldo has been forced to increase drastically its stock of commercial payments due. The lack of a coherent payment strategy[18] and foreseeable payment conditions prompted Ganz Ansaldo's suppliers to adopt unilateral measures to urge payment, or stop further supplies. This causes unnecessary changes in Ganz Ansaldo's supplier circle. A liquidity management programme adopted in September 1996 prescribes longer payment deadlines, which the company undertakes to keep.

[17] The insolvency of several suppliers in the early 1990s and the streamlining efforts of the survivors also contributed to lessening the local content of Ganz Ansaldo's products. The Hungarian Cable Works exemplifies the second case. Bought up by Siemens, it phased out some items of its product portfolio, including diesel-oil resistant cables. Ganz Ansaldo had been a long-standing and regular customer for these, but in relatively small quantities. When the product was dropped, Ganz Ansaldo faced difficulties in obtaining the same small quantity from a foreign company.

[18] There was no "systematic" discrimination among the various suppliers in this respect. The usual differentiating factors (size of supplier, nationality, importance of input supplied, existence or lack of a traditional business relationship or of an annual supply contract, existing debt to the supplier, etc.) have not seemed to affect Ganz Ansaldo's decisions on whether to pay now or later.

Corporate efficiency

The *financial consolidation* of a company, with the restructuring and improvement of its debt portfolio, is a key element of restructuring. When corporate growth resumes, after a necessary period of downsizing, it must rest on an increase in corporate efficiency, a renewed marketing, sales and product policy, and a sound financial basis. Otherwise, according to the management textbooks, there will be the well-known pitfall of growth-related negative liquidity. This chapter considers the initial financial consolidation of the company, before going on to analyse its cost policy and rationalization measures. After examining its investments and liquidity problems in the light of growth resumption, the chapter concludes with a look at the indicators that highlight the improved corporate performance.

As mentioned in the introduction, Ganz Electric Works was in a difficult situation in 1990, when its main markets having radically diminished (Hungary) or collapsed altogether (the GDR and the Soviet Union). This left it as an enterprise with depreciated, worn-out assets. (Even basic maintenance activities were being postponed "until better days", and no new development was being undertaken.) Without Ansaldo's massive capital injection, the new markets brought by the multinational, and the restructuring measures imposed, the company would probably have been crowded out of the market and gone into liquidation before its 150th anniversary.[19]

The new joint venture did not take over the SOE's huge stock of debt. The initial issued capital of HUF 2083.3 mn was 51 percent-owned by Ansaldo and 49 percent by Ganz Electric Works. The State Privatization Agency (SPA) holds a golden share with a face value of HUF 10,000. Ganz Electric Works' made its capital contribution in kind: plants and assets, but no inventories. The existing stocks remained the property of Ganz Electric Works and were gradually taken over by Ganz Ansaldo. The joint venture took over the headquarters site in Budapest and four other premises. The former is only rented, because it was stipulated in the privatization contract that Ganz Ansaldo should relocate its production away from the centre of Budapest.

The huge trading losses (to be detailed later) meant that *capital injections* were required in every year except 1992. The issued capital rose to HUF 4050 mn in 1993, HUF 5706.4 mn in 1994, and HUF 7683.1 mn in 1995. Although Ansaldo explicitly required that the original ownership proportions should remain, which was accepted at the time, the Hungarian state has not contributed to any of the subsequent capital increases. This means that Ansaldo's share in the equity rose to 74.8 percent in 1993, 82.13 percent in 1994, and 86.7 percent in 1995.

[19] Ganz Ansaldo came 111th in the 1996 list of the top 200 Hungarian companies by net sales revenue. It was among the ten firms moving up fastest, having been 196th on the 1994 list.

This leads back to the question, raised in the introduction, of the arguments for and against preserving a minority share in state ownership when a company is sold to a foreign professional investor. Why is the state content to remain as a passive owner, refusing to take any strategic steps implying an intention to obtain a better price when it sells its remaining shares? Why has it allowed its stake to decline?

Even the parent company was expecting trading losses for several years, due to the restructuring and huge capital investment required. These factors, along with the dramatic shrinkage of the overall market demand, obviously meant that the company would not break even for some time. However, the actual losses exceeded the most pessimistic expectations, continuing to grow each year up to 1994:

Table 4

Profits before tax (HUF mn)

1991	1992	1993	1994	1995	1996
−528.5	−1339.1	−1656.3	−1963.6	10.2	29.48

Source: Company balance sheets.

In the light of these results, it is more interesting still to see how the state fared while passively allowing its stake to diminish. Strangely enough, in spite of the passive nature of the transaction and the disappointing company results, the state brought about a dramatic *increase in the effective price* paid by its partner for increasing its stake. The initial value of Ansaldo's investment when the joint venture was founded was HUF 1062 mn, for 51 percent of the shares, so that each 1 percent of Ganz Ansaldo cost HUF 20.82 mn in 1991. When the first capital injection was made by Ansaldo in 1993, the issued capital rose by HUF 1966 mn and Ansaldo's share of it by 23.8 percentage points. The cost of obtaining 1 percent of the shares had risen to HUF 82.6 mn, an increase of 396 percent. When Ansaldo made its second capital injection in 1994, its share of the equity rose by 7.33 percentage points. The cost of 1 percent of the shares was then HUF 225.9 mn, which meant a further increase of 273.5 percent. Finally, the third injection in 1995 cost Ansaldo HUF 1976.7 mn for an increase of 4.57 percentage points in its stake: each 1 percent had cost HUF 432.5 mn, representing a 191.4 percent increase.

However, if the calculation is made in the more usual, backward direction,[20] the increase in the cost of 1 percent of the equity is less dramatic. It corresponds

[20] Calculating how much a "further" 1 percent share costs is a kind of "forward" calculation. The usual way of calculating the value of the shares acquired is to divide the cumulative investment into the increase of issued capital by the cumulative amount of the shares owned.

more closely to the increase in the total issued capital: HUF 20.82 mn in 1991, HUF 40.48 mn in 1993, HUF 57 mn in 1994 and HUF 76.8 mn in 1995.

Why did Ansaldo accept such a seemingly bad bargain—an increase at a time when the company's results would have warranted a sharp fall in the value of its shares?[21] Why did Ansaldo insist on retaining the presence of the state and the label of a partly state-owned company? One aspect may have been the benefits ascribed to state ownership, although these have yet to materialize:

— The state authorities have lobbying powers that may help to obtain orders at home.

— The efforts of Hungary's economic diplomats may gain extra orders in countries with which Hungary has good diplomatic relations.

— The company increases its chances of benefiting from various state funds aimed at increasing exports, local capital formation, regional development, employment, etc.

— There is a greater chance of retaining the hitherto rented headquarters office building in the centre of Budapest, which the state provided as a capital contribution in kind.

Ansaldo also hopes that the Hungarian state (now represented by the State Privatization and Asset Management PLC) may change its passive approach and participate in further capital increases.[22] For instance, after the relocation of production to Tápiószele and the sale of the valuable central Budapest property, the proceeds could be the state's contribution to Ganz Ansaldo's future. (Merényi 1996)

Meanwhile Ganz Ansaldo is making every effort to break even. As a manufacturer of one-off products, the company's operating results may vary widely

[21] General Electric chose a "usual market-economy method" under similar circumstances. When losses at its Hungarian acquisition, Tungsram, exceeded its expectations, and the future viability of the company required a further capital injection, it decided to write down the value of GE-Tungsram's shares. GE was likewise forced into a unilateral capital injection, as its Hungarian partner, the state-owned Hungarian Credit Bank, refused to follow suit. In this case, General Electric's unilateral capital injection squeezed out the Hungarian partner.

[22] It is worth considering to what extent Ganz Ansaldo can be considered a partly state-owned company at all. When the joint venture was formed, 49 percent of the shares went to Ganz Electric Works, an SOE that is currently being wound up. So the state ownership has been indirect (apart from the symbolic golden share held by the SPA). This ownership distribution—the fact that the minority shareholder is not the SPA, but an SOE undergoing liquidation—may amply explain the state's passive behaviour, in corporate governance, and in refraining from contributing to the capital injections. Ansaldo's expectations have been thwarted in this respect. Ansaldo had also expected the state to play a more active role in producing macroeconomic conditions favourable to the company's growth. The state's performance in "protecting" national industries with apt and coherent industrial and trade policies has been very weak. The same applies to its efforts at economic diplomacy. Lobbying for international business opportunities for national companies is a widely used instrument of economic diplomacy. International experience, however, does not suggest a correlation of this with state ownership. This again means that Ansaldo's expectations of "cohabitation" were misconceived.

according to the mix of orders and products in a particular year. However, the huge fixed costs mean that operating profits are greatly determined by the volume of sales.

Table 5

Net sales and operating profits (HUF mn)

	1991	1992	1993	1994	1995	1996
Net sales	3317.7	2806.7	3651.4	4752.4	9977.9	12816.7
Operating profits	-500.9	-1052.3	-1308.4	-1314.6	1017.2	1161.5

Source: Company balance sheets.

These figures raise the question whether Ganz Ansaldo has already managed to break even with this marked increase in orders and net sales.

The answer requires further consideration of the figures. Insofar as the operating profits in 1995 exceeded HUF 1 bn, the company indeed broke even. However, it is worth considering net sales alone, without other income, which grew considerably, and without the changes in the stock of the capitalized own performance (i.e. changes in the stock of self-produced assets and self-manufactured inventories), which increased more than tenfold in 1995. The resulting difference between net sales and total costs ("operating profit") will be negative: HUF −944.67 mn in 1995 and HUF −1327.6 mn in 1996. Assuming similar shares for the various cost items (*Table 6*), the break-even point that guarantees a stable operating profit (with capitalized own performance) comes at a level of net sales of HUF 14–15 bn.

The figures in *Table 6* show that the sum of the cost shares directly influencing operating profits exceeds 100 percent of net sales in every year. (It is also apparent that the drastic contraction of demand—net sales—distorted the individual cost proportions in 1992–3 and the radical changes in the proportions when net sales more than doubled in 1995.) To calculate the potential break-even point, account must also be taken of some other items of income and of the value of capitalized own performance. The share of these altogether was 9.8 percent of net sales in 1994, 19.6 percent in 1995 and 19.4 in 1996.

The item of financial costs—expenses on financial transactions—is the one considerable item that can be modified relatively easily in a cost-cutting programme. Since 1991, Ganz Ansaldo has had no long-term liabilities. It finances its production and exports with short-term loans. Although there was a radical improvement in 1995, the indebtedness (equity/liabilities) is still far from the relatively favourable initial proportion.[23] (See *Table 7*)

[23] The favourable initial proportion arose because the newly created joint venture had been cleansed of earlier financial obligations.

Table 6

Various cost items compared with net sales (percent)*

	1991	1992	1993	1994	1995	1996
Materials	75.9	62.5	63.8	60.2	63.5	67.9
Labour	31.2	43.2	40.3	34.3	20.2	20.5
Depreciation	1.6	5.4	6.5	6.7	3.8	3.2
Other costs	17.3	17.6	13.6	17.0	9.9	8.0
Other expenses	2.9	13.0	19.9	19.2	11.9	10.6
Sub-total**	128.9	141.7	144.1	137.4	109.3	110.2

Source: Own calculations from company balance sheets.

*In this table I analyse only the costs that influence operating profits. Financial costs are detailed later. "Materials" means material-type costs, not just materials in the strict sense. "Labour" means gross labour costs.

**I call this a sub-total, because there are many items not detailed here that influence the bottom line of the company. This line analyses the trend in the share of costs that directly influence the fictive category of the operating-profit (other-income) value of capitalized own performance. This I created as an indicator to work with when calculating the break-even point.

Table 7

Equity/liabilities ratio (percent)

1991	1992	1993	1994	1995	1996
87.5	14.9	15.9	7.3	25.1	19.5

Source: Own calculations from company balance sheets.

The indicator for profits on financial transactions relative to operating profits is even more telling:

Table 8

Profits on financial transactions/operating profits (percent)*

1991	1992	1993	1994	1995	1996
−5.5	−27	−27.9	−50.8	−96	−90.2

Source: Company balance sheets.

*The minus sign indicates that the loss from financial transaction diminishes the operating profits or increases the losses. So if the operating profits were themselves negative, I did not change the minus sign, to indicate that the balance of financial transactions was always negative.

As can be seen from these figures, the loss on financial transactions almost consumed the operating profits in 1995 and 1996. This provides some justification

for the argument of Ganz Ansaldo's management that costs could be radically cut and the company's performance and profitability improved by a further considerable capital injection, not simply to finance the losses, but to improve the current assets position or the liability portfolio.

Ganz Ansaldo is trying to improve its *current-assets* position by introducing a strict inventory-control system that will curb the velocity of individual inventory items and try to discover frozen items. In the early years of the joint venture, inventory management was facilitated by a stipulation in the privatization contract. Ganz Ansaldo would not take over Ganz Electric Works' inventories automatically, only gradually, as specific needs arose. The share of inventories relative to net sales has been a remarkably stable 28–9 percent every year since the new company was founded. The situation is much more difficult with another component of current assets: receivables. Ganz Ansaldo's trade receivables have always made up a considerable share of its current assets. The proportion improved significantly in 1995. (See *Table 9*)

These data show (1) an improving current-assets position, with the volume of current assets exceeding or very close to net sales since 1993, but (2) a relatively unfavourable current-assets portfolio, with a high share of trade receivables.

Table 9

Trade receivables as a proportion of current assets and of net sales (percent)

	Trade receivables relative to	
	Current assets	Net sales
1991	42.0	33.5
1992	39.0	27.2
1993	38.6	39.9
1994	31.8	34.1
1995	19.9	18.9
1996	15.2	14.7

Source: Own calculations from company balance sheets.

The dramatic improvement in 1995 looks much less favourable if the item "other receivables" is considered. The item includes receivables from partner companies, such as other Ansaldo subsidiaries and the Ganz Electric Works, now undergoing liquidation. Figures for the receivables from partner companies are available only for 1993, 1994 and 1995, when they made up 57 percent, 91 percent and 93 percent of the 'other receivables' respectively.

Table 10

"Total" trade receivables as a proportion of current assets and of net sales (percent)*

	"Total" trade receivables relative to	
	Current assets	Net sales
1993	51.5	53.2
1994	67.0	71.9
1995	63.0	59.8
1996**	52.0	50.3

Source: Own calculations from company balance sheets.
*Trade receivables + receivables from partner companies, data for 1996 are estimated ones.

These figures show not only the increasing proportion of intra-industry trade, but the especially intense liquidity pressure on Ganz Ansaldo's operations.[24] The other side of the coin is best reflected by the customary indicator: the ratio of trade receivables to trade payables. (See *Table 11*)

Table 11

Ratio of trade receivables to trade payables (percent)

1991	1992	1993	1994	1995	1996
1.35	1.40	2.70	1.40	0.76	0.59

Source: Own calculations from company balance sheets.

The dramatic worsening of this figure since 1995 is worrying. This is an indicator that sheds light on the company's ability to cover operating costs out of current revenues. It has more relevance to daily operational issues than any of the operative indicators calculated "in principle".[25] The problem could be solved by an additional cash injection from the multinational shareholder. This, after the huge amount of previous investment aimed at restructuring and modernization, would "capitalize" the company by improving its current-asset position.

[24] The situation improved substantially in 1996.

[25] The concerns are reflected on the business pages of Hungarian dailies, where false alarms about liquidation proceedings against Ganz Ansaldo have already appeared more than once. The situation is not as bad as that, of course. In reality, liquidation proceedings are a bargaining tool often used in debt collection by Hungarian companies. A creditor who loses patience applies for the liquidation of the debtor company. This may prompt the debtor to pay, so that the suit is withdrawn. For more detail, see *Szanyi* (1997).

Ansaldo has certainly invested a large amount in modernizing its Hungarian subsidiary: a cumulative total of HUF 10.4 bn till the end of 1995, which equals 8 percent of Ansaldo's global investment. (Merényi 1996) Besides loss-financing[26] the biggest item of investment was the construction of a new factory to which production is being relocated from the Budapest headquarters, in line with a contractual stipulation of the 1991 privatization deal.

The locational choice fell on the premises of the previously state-owned Metalworks Construction Enterprise.

The existing premises proved unsuitable for Ganz Ansaldo's purposes and had to be completely rebuilt to meet its technological requirements (a "brownfield" investment). The new factory, tailor-made to the company's technological and logistic requirements, brought a spectacular increase in efficiency. Instead of production and machinery on three floors, which led to logistic chaos, it became possible to apply optimum methods of production organization from scratch.[27]

The investment required was considerable, however. The site was short of basic infrastructure, which added to the relocation costs. When the problem was viewed from Rome, the distance of 80 km from Budapest did not appear to be an insurmountable obstacle. But in a poorly developed area of the country, the journey takes two hours by car or bus, which precludes daily commuting. Employees had to accept either weekly commuting (with weekday hostel accommodation) or a move to Tápiószele. The Hungarian workforce is characterized by low mobility, with a particular reluctance to move away from Budapest. It was expected that many of the skilled workers would quit when the relocation of production was complete (by the end of 1996).

Looking at the composition of Ansaldo's investment, it turns out that after the grandiose investment in the new plant, the next biggest item—HUF 10.4 bn—has been creation of a viable[28] current-assets position. (The inventories had not been carried over into the joint venture.)[29]

[26] The cumulative amount of the unilateral capital increases made accounts for about 55–8 percent of the total investment.

[27] This gave Ganz Ansaldo the kind of clean slate enjoyed by countries that were late in industrializing.

[28] In an industry marked by a long period of return on products, a viable current-assets position would be a level of at least 100 percent. Better still would be 110–120 percent for the appropriate indicator (current assets to total assets).

[29] Much of the initial cash injection of capital by Ansaldo went on acquiring outputs and building up acceptable inventory levels.

The following table provides some evidence for the claim that the huge amount invested went mainly into creating a viably operating company, rather than acquiring new machines and equipment.[30]

Table 12

Ratio of current assets to total assets (percent)

1991	1992	1993	1994	1995	1996
70	52	65	71.6	82.4	83.9

Source: Own calculations from company balance sheets.

These figures support the claim that it takes a long time and a large investment to build up a viable company. In Ganz Ansaldo's case, the process is far from over. Nonetheless, after worsening rapidly, Ganz Ansaldo's profitability indicators took a spectacular turn for the better in 1995.[31] The differences between the indicators in *Table 13* show that the main bottlenecks are of financial character:

Table 13

Some indicators of profitability

	1991	1992	1993	1994	1995	1996
Operating profits/net sales (percent)	−15.0	−37.0	−35.8	−27.6	10.2	9.0
Pre-tax profits/net sales (percent)	−15.9	−47.5	−45.3	−41.3	0.1	0.2
Operating profits/equity (percent)	−28.7	−244.1	−178.1	−298.8	44.8	50.7
Pre-tax profits/equity (percent)	−30.3	−309.4	−225.5	−225.5	0.45	1.28

Source: Own calculations from company balance sheets.

These data underline the assumption made in the introduction. Without a well-capitalized foreign investor able to finance the initial losses of the company and invest huge amounts in restoring the viability of its operations, the company would have gone into liquidation long ago. The indicators (especially those comparing gross profits with the various corporate attributes) do not return to what can be considered normality even in 1995, while in previous years they issued increasingly alarming signals. It must not be forgotten that the company is carrying forward

[30] Due to the special character of the products, Ganz Ansaldo invests a great deal in research and development and workforce training. Members of the research and development staff spend months and years at the Italian headquarters, participating in joint development programmes.

[31] The reason, as mentioned before, was a dramatic increase in orders, or to put it another way, a dramatic improvement in the company's ability to obtain orders.

huge losses from previous years, and still faces huge costs before its grandiose investment programme is completed. Here it is worth recalling that Ansaldo is owned by the Italian state. It might be hypothetically assumed that if this had not been the case, and the foreign investor had been subject to stronger short-term profitability constraints, the company might have been left to its fate before the turn-round took place.

Conclusions and prospects

Ganz Ansaldo's foreign majority owner has made sweeping changes to the company's organizational, control and operational structure. The new market opportunities it brought have reoriented Ganz Ansaldo's market relations. It has taken the initial steps towards ensuring viable financial and technological conditions for stable growth. Ganz Ansaldo's ability to acquire orders has been dramatically improved by the ISO 9001 quality-audit system, creative management of the product mix, and provision of the infrastructural and technological background for improving efficiency. The changes have brought Ganz Ansaldo much closer to the break-even point.

The benefits have not all been on one side. The investor has gained on international markets from the well-established Ganz brand name. It has acquired Ganz's skilled and inexpensive research and development staff, many of whom have worked for periods of several months at the Italian headquarters. Ganz Ansaldo's full inclusion into Ansaldo's worldwide marketing and distribution channels will cause a synergy that improves the global market position of the multinational investor as well.[32] Although some aspects of the strategic management policy have had negative side-effects,[33] the presence of a well-capitalized multinational investor financing Ganz Ansaldo's losses and its restructuring and investment requirements vindicates the privatization decision in 1990.

Still, confidence between the Italian and Hungarian management needs to be restored. If Hungarian middle management had the powers to provide a realistic feedback, their hitherto frustrated energies, ideas and local knowledge could contribute greatly to improving the still mixed prospects facing the company.

[32] One of Ansaldo's main reasons for making the investment was that the SOE's product portfolio was complementary to its own. A complete portfolio of products is indispensable these days for a bidder for international turnkey projects.

[33] However, what medium-sized or large company is ever free of mismanagement symptoms?

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BANK RESTRUCTURING IN HUNGARY

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In this study the authors describe the process of bank restructuring in Hungary. They argue that the "desertion" of the state exacerbated the financial distress of the enterprise and financial sectors. Moreover, the delayed responses of the government were inadequate in many respects. The recapitalization of the banking sector was rather costly, partly because the occurrence of moral hazards were not prevented. Nonetheless, some positive signs can also be seen. The respective portfolios of banks improved significantly and this made the privatization of state-owned commercial banks possible. In fact, the sale of these financial institutions was completed in 1997. The controlling-stakes of privatised banks have mainly been obtained by strategic investors and therefore the state no longer has direct control over credit allocation in the Hungarian economy. All these factors suggest that Hungary is, so far, the most successful in transforming the banking sector in the Central European economies. Eventually, this may help the development of the economy as a whole.

This study reviews the development of the Hungarian banking sector since the late 1980s.[1] The process has not been at all smooth and steady. The political decision to reform the banking sector was taken under the auspices of the old regime in 1983. However, the transition was completed in 1997, with the privatisation of all large state-owned commercial banks (SOCB). Privatisation of the former SOCBs was nowhere on the agenda of the socialist government in the 1980s. Since then private banks have become dominant and a significant part of the Hungarian credit market is now controlled by foreign banks. Here we will focus on the restructuring of state banks; this process has resulted in an almost fully-fledged private commercial banking sector, the first in Central Europe. We will sketch the development of the banking sector before 1992, discussing the evolution of the bad debt problem, and the various policy measures Hungarian governments have taken in order to stabilise domestic banks. We will also try to show the alternatives policymakers had to choose from. Although the process has been long and expensive, the respective portfolios of the SOCBs have been cleaned. We will argue that this development was more or less determined by the liberalisation of the entry of foreign banks in 1989 and by the adoption of the Banking Act in December 1991. As a result of this process, many SOCBs were privatised. The controlling stakes of privatised banks

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have been obtained mainly by strategic investors and therefore the state no longer has any direct control over credit allocation in the Hungarian economy. All these facts suggest that Hungary has, so far, been the most successful among the Central European economies in transforming the banking sector, and this should eventually help in developing the economy as a whole.

Reforming the Hungarian banking sector, 1987–1991

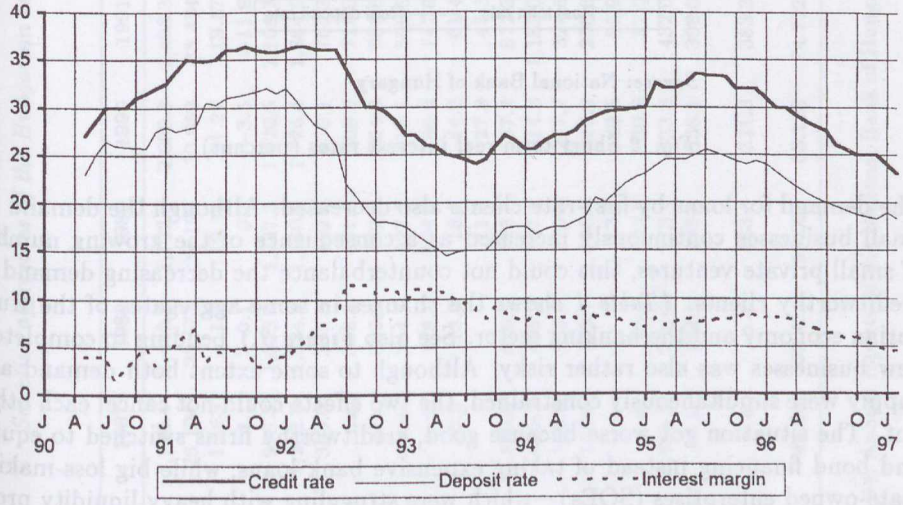
In 1987, following a political decision, a two-tier banking system was artificially created by decrees. The credit departments of the National Bank of Hungary (NBH) were split into three, creating the respective foundations of the three large commercial banks. Gradually the central bank withdrew from the direct financing of enterprises.[2] The primary goal of the reform was to create a competitive environment for credit allocation (free from state intervention), and to establish a proper structure for effective monetary policy. This early phase of transformation was reviewed in *Estrin et. al.* (1992), *Spéder* (1991) and *Spéder and Várhegyi* (1992); *Nyers and Lutz* (1992) provides good source of data.

The newly-established commercial banks—the Hungarian Credit Bank (MHB), the National Commercial and Credit Bank (K&H) and the Budapest Bank (BB)—inherited their portfolios and clientele from the central bank. The equity base of these banks was inadequate at the time when they were formed. In the early 1990s a significant part of their loan portfolios became non-performing as a consequence of the economic recession. The problem was exacerbated by the weaknesses of the management and staff, who were unable to secure prudent operation, properly evaluate new loan applications, make correct risk assessment, or conduct other evaluations. Moreover, banking regulation was poorly designed and effective supervision did not exist. This latter fact made banks vulnerable to political interventions.

[2] However, indirect control through central bank refinancing temporarily played an important role in the short-term borrowing of enterprises and is still significant in long-term financing. At the beginning of 1987 the gap between the assets, equity and deposit stocks of the newly created SOCBs was entirely filled up with refinancing credits of the NBH. This stock amounted to 70 percent of the total liabilities of the large banks. Due to an increase in their deposits, equity, and the development of interbank money market, banks became more independent from central bank refinancing. However, in 1990 these sources still accounted for 15 percent of the banking sector's total liabilities.

How did banks accumulate bad loans?

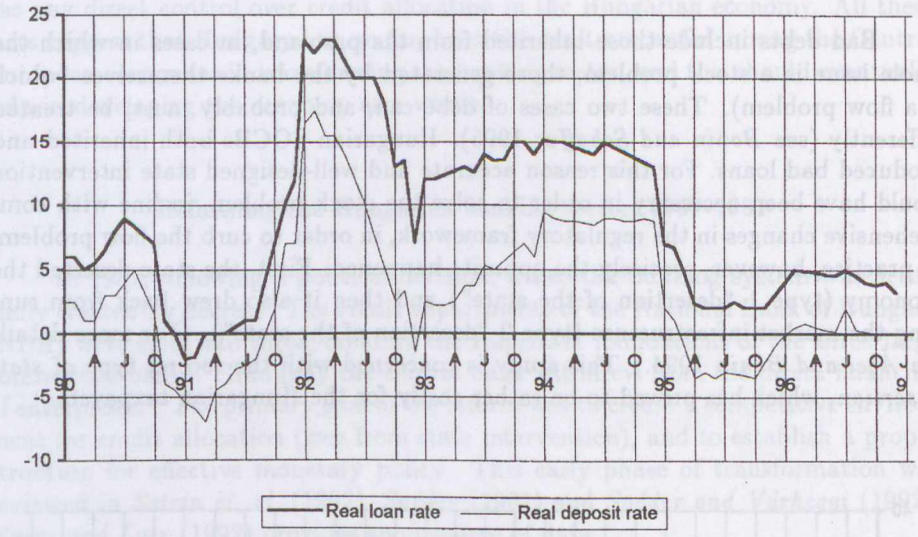
Bad debts include those inherited from the past and, in cases in which the whole issue is a stock problem, those generated by the banks themselves (which is a flow problem). These two cases of debt can, and probably must, be treated differently (see *Bonin and Schaffer* 1995). Hungarian SOCBs both inherited and produced bad loans. For this reason accurate and well-designed state intervention would have been necessary in order to solve the stock problem, in line with comprehensive changes in the regulatory framework, in order to curb the flow problem. In practice, however, precisely the opposite happened. First, the state deserted the economy (type 1 "desertion of the state") and then it also drew back from running the market infrastructure (type 2 "desertion of the state"). (For more details see *Ábel and Bonin* 1994.) This study is concerned with the second type of *state desertion*, which has proved to be rather costly for the Hungarian taxpayers.



Source: National Bank of Hungary

Fig. 1 Nominal interest rates and the interest margin (percent)

The switch to a two-tier banking system took place at that time when the economy fell into recession and inflation started to increase. (See *Figures 1* and *2*.) This development had a significant impact on both sides of the credit market. On the *supply side* long-term financing became riskier because of increasing inflationary uncertainty (making rational calculation for the longer term more difficult). As a consequence of all these facts, banks stopped extending more investment credits.



Source: National Bank of Hungary

Fig. 2 Short term real interest rates (percent)

The demand for loans by first-rate clients also decreased. Although the demand by small businesses continuously increased as a consequence of the growing number of small private ventures, this could not counterbalance the decreasing demand of creditworthy clients. (*Table 1* shows the changes in some aggregates of the Hungarian economy and the banking sector. See also *Figure 3*.) Lending to completely new businesses was also rather risky. Although to some extent both demand and supply were simultaneously constrained, the two effects could not cancel each other out. The situation got worse because good, creditworthy firms switched to equity and bond financing instead of taking expensive bank loans, while big loss-making state-owned enterprises (SOEs)—which were struggling with heavy liquidity problems and with no other alternatives—wanted to maintain their borrowing, and were thus dependent on bank lending. The short term credit supply did not meet the demands of financially distressed SOEs and, as a consequence, interfirm commercial credits started to evolve as enterprises stopped paying each other.

Firms in financial distress responded to the shortage of bank credits by forcing their suppliers to provide commercial credit and by delaying payments. The bulk of the arrears was concentrated in about 25–30 enterprises in engineering and light industry, mining and metallurgy respectively. However, this phenomenon became a feature of the whole economy. By the end of 1989 these arrears amounted to about

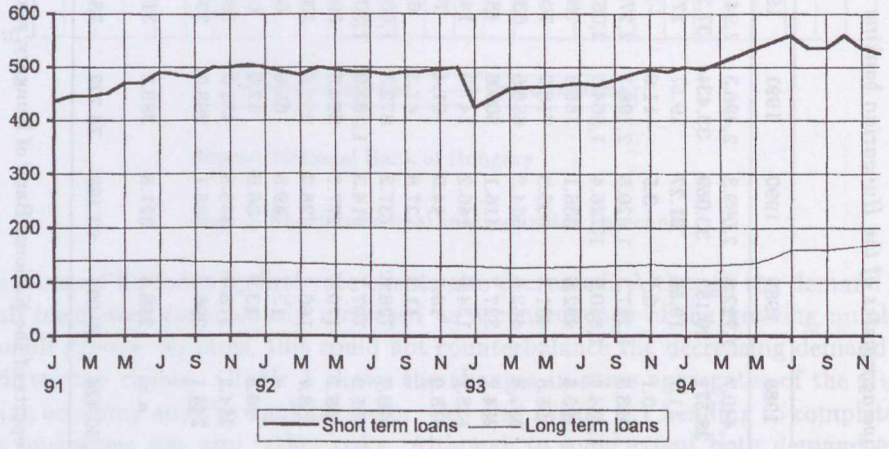
Table 1

Selective aggregates of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Nominal GDP (bn HUF)	1,226.4	1,440.7	1,722.8	2,089.3	2,498.3	2,942.6	3,548.3	4,364.8	5,499.9	6627.95
Nominal GDP (bn USD)	26.104	28.571	29.152	33.059	33.434	37.257	38.551	41.518	43.758	43.442
Nominal growth rate (HUF)	12.63	11.7	19.58	21.27	19.57	17.78	20.58	23.01	26.60	20.5
Real growth rate (percent)	4.1	−0.1	0.7	−3.5	−11.9	−3.1	−0.6	2.9	1.5	1.0
Total assets of banking sector	996.3	1,023.0	1,247.3	1,620.5	2,108.7	2,276.0	2,630.4	3,071.8	3,693.6	4,735.28
Total domestic credits (stock)	1,262.7	1,334.4	1,550.9	1,726.4	1,864.5	2,057.3	2,401.7	2,792.0	2,741.3	3010.2
Business sector	383.0	395.8	492.6	636.1	765.3	768.0	761.9	869.7	982.6	1,265.2
Business sector HUF credits	n.a.	395.8	481.3	608.3	718.0	706.2	696.3	777.1	764.8	914.4
Enterprise HUF credits	n.a.	382.8	462.6	564.3	656.6	630.0	610.6	687.9	693.7	852.0
Short-term	n.a.	254.7	327.7	418.1	509.6	484.9	475.7	520.2	n.a.	n.a.
Long-term	n.a.	128.1	134.9	146.2	147.0	145.1	134.9	167.7	n.a.	n.a.
Small entrepreneurs	6.9	13.0	18.7	44.0	61.4	76.2	85.7	89.2	71.1	62.4
Forex credits	–	–	11.3	27.8	47.3	61.8	65.6	92.6	217.8	350.8
Government	589.6	629.7	726.6	737.2	872.3	1,060.9	1,370.8	1,579.4	1,442.9	1447
Total deposits	420.2	455.9	707.7	914.3	1,183.0	1,505.8	1,758.7	1,994.9	2,355.6	2,846.3
Business (enterprise) sector	158.9	138.7	179.9	277.7	324.5	395.5	499.7	518.3	616.5	759.0
Forint	158.9	138.7	166.2	228.2	258.6	332.3	374.7	406.2	427.8	554.6
Forex	–	–	13.7	49.5	65.9	63.2	125.0	112.1	188.7	204.4
Small entrepreneurs	n.a.	20.5	23.9	36.6	57.5	61.8	33.2	32.0	34.4	47.3
Households	261.3	284.2	273.4	323.8	432.0	582.4	696.0	866.4	1,079.0	1,339.1
Enterprise HUF credits-deposits	n.a.	244.1	296.4	336.1	398.0	297.7	235.9	281.7	265.9	297.4
Business sector net liabilities to banks	n.a.	n.a.	288.8	321.8	383.3	310.7	229.0	319.4	331.8	458.9
Average exchange rate (HUF/USD)	46.98	50.424	59.096	63.198	74.722	78.98	92.04	105.13	125.69	152.57

Sources: National account 1991–94, Annual reports of the National Bank of Hungary, and Nyers and Lutz (1992)

HUF 127 bn (USD 2.1 bn), of which HUF 73 bn (USD 1.2 bn) was the accumulated debt of firms having arrears over HUF 25 mn. As a consequence of the deterioration of financial discipline, the value of inter-enterprise arrears simply increased further (see *Table 2*). Most of these firms also had bank debts. Therefore, some people expected the active participation of banks in the solution. However, the banks were rather passive for several reasons: (1) approximately one-third of the total amount of arrears was owed to banks, i.e. the major part of the debt was due to suppliers and state creditors; (2) banks had direct access to the accounts of their debtors and could automatically debit the accounts of their debtors, even without the consent of firms, if a positive balance appeared on them. Banks usually demanded such a creditor seniority when enterprises opened an account with them. (3) If banks tried to collect these debts, even the failure of collecting this one-third could have a detrimental impact on their own existence.



Source: National Bank of Hungary

Fig. 3 Corporate loans between 1991–95 (in bn HUF)

Nonetheless, where it was possible, banks sought to withdraw credits from less creditworthy enterprises. However, in the case of big debtors this would have immediately pushed them into the red. SOCBs were not interested in filing their big debtors for liquidation for several reasons: first, banks usually had access to their clients' accounts; second, due to the extended nature of indebtedness, a chain of liquidation would have devalued enterprise assets significantly and therefore banks could have lost even more; third, it is probable that in the latter case banks would have been the next in line to face liquidation; fourth, banks could rationally expect some kind of state intervention, since the failure of big SOEs in the short run had

Table 2
Arrears of larger firms between 1987–1992

	Arrears (HUF bn)	Firms
1987	14	82
1988	46	208
1989	73	314
1990	90	432
1991	159	1021
1992 April	197	1,097

Source: *Marsi and Pap* (1993)

huge economic and social cost implications, it was therefore more convenient to wait for the state to take the first step; fifth, in the short-run it was also more profitable, because of the existing accounting and banking regulation which enabled banks to earn interest income on overdue credits which they usually rolled over; sixth, if banks filed for the liquidation of their debtors, they would have acted against some of those SOEs which were the owners of banks and whose CEOs were members of the boards of SOCBs. (See *Table 3*.)

Table 3
Files for bankruptcy and liquidation

Year	Bankruptcy	Liquidation	
		Total	of which filed by banks
1987	–	65	
1988	–	144	
1989	–	384	
1990	–	630	20
1991	–	1,268	9
1992	4,169	9,891	93
1993	987	7,242	159
1994	189	5,711	113
1995	145	6,316	112
1996	80	7,397	113

Source: Ministry of Finance

Banks were also dependent on their borrowers because of the decreasing demand for loans by creditworthy borrowers, and because of the fact that they could charge default interest on top of their prime rate in cases of late payment. Ac-

cumulated bank claims in the form of default interest provided a better tool with which it was possible to capture the collateral. This was a better situation than the possible liquidation would have offered, when accumulation of unpaid interest stopped in the early stages of liquidation. Banks could not, and perhaps did not want to, stop financing large SOEs.[3] The old truth stated by *Dewatripont and Tirole* (1994) applied particularly to large Hungarian SOCBs: "If you owe the bank $100,000 you are in trouble; if you owe the bank $10 billion, the bank is in trouble." In the short run, banks were more or less interested in preserving the status quo.

As a result of the passivity of creditors, bad debts accumulated and were concentrated in domestic banks, but especially in large SOCBs. (On creditor passivity see *Mitchell* 1993.) In 1990, less than one percent of the number of clients held 40–50 percent of all credits; large loans had about a 50–80 percent share in the loan portfolios of large banks. Approximately two-thirds of bad (or potentially non-performing) loans were concentrated in about fifty large firms. The concentration of debts did not change significantly, even after enterprises were allowed to change bank. The financial distress of firms generated risk not only to creditor banks, but also to the entire banking sector and ultimately to the whole economy.

However, another legacy of the past was the sectoral concentration of banks' clientele. The three large SOCBs (MHB, K&H and BB) were formed from the, respectively, industrial, food processing and infrastructure financing directorates of the central bank. Instead of establishing these banks with diversified portfolios, they inherited portfolios and clients almost unchanged from the NBH. The MHB had about a 60 percent share in the financing of manufacturing (engineering) industry. The food industry and agriculture had almost a 50 percent share in the K&H credit portfolio. BB financed almost exclusively coal mines. These banks were very vulnerable to systemic risks stemming from economic recession or natural catastrophe, in principle as well as in reality. Because of stagnation and the recession between 1989 and 1992 (and the collapse of COMECON in 1991) all banks, but especially the MHB, found themselves in trouble. The drought in 1990 and the uncertainty created by political debates over land ownership in the early 1990s caused difficulties for the K&H. The unavoidable closing down of inefficient coal-mines made the BB's situation untenable. (Extension of syndicated loans could have helped to some extent, but they were rather exceptional because there was no other bank willing to share such a risk.)

[3] *Perotti* (1993) develops a model in which he shows a certain bias towards excessive allocations of scarce bank resources to (indebted) SOEs instead of more profitable private borrowers. This had the effect on slowing down the transition and produced the danger of a potential concentration of risk in banks, even after bank privatization. This finding may apply to these big SOEs. However, as Bonin and Schaffer (1995) indicate, on the basis of aggregate calculations showing that fresh credit was negative in 1992, in most cases banks tried to withdraw from lending to risky firms. Moreover, private firms, as has been pointed out, were at least as risky as their state-owned counterparts.

In part because of this heavy concentration, the Hungarian money market remained rather segmented.[4] In 1990, the "big four" granted 62 percent of short term, and 82 percent of long-term enterprise loans; the National Savings Bank (OTP) had a 65 percent share of the total stock of small private business loans (70 percent of long term and 38 percent of short term loans), while the "big four" had a 29 percent share of this market segment (46 percent in short term loans and 16.7 percent in long term loans); the "big four" and OTP had a 44–44 percent share in the deposit market. However, a majority of wholesale deposits was placed with the "big four", while 80 percent of household savings were deposited with the OTP (Spéder and Várhegyi 1992).

The entry of foreign banks has preserved this segmentation. (*Table 4* provides a summary of the institutional development in the banking sector over the last decade.) Foreign banks sought to avoid risky lending. They provided services for foreign firms and joint ventures, and competed for only the best domestic firms. The competition for creditworthy firms put pressure on domestic banks.[5] SOCBs could not compete with foreign banks, for the portfolio of the latter was not burdened with bad debts, they had access to the cheap foreign sources of their parent banks, and enjoyed some tax concessions. However, this was not price competition because, instead, foreign banks offered better quality services. Due to this market imperfection, the high interest margin has remained and, as a result, foreign banks could earn huge profits.

[4]Nonetheless, some development took place. In 1987, out of 21 financial institutions, only five large commercial banks were authorized to keep the accounts of business entities. Except for the Hungarian Foreign Trade Bank (MKB), which was established in 1950 and specialized in financing foreign trade, and three other banks operating with foreign participation, domestic banks were not allowed to transact in foreign exchange and nor could they collect household deposits. The OTP and saving cooperatives had an exclusive licence in retail banking (i.e. financing of households, small entrepreneurs and municipalities). These restrictions were gradually abolished. After July 1989 commercial banks were authorised to extend credits in foreign exchange to domestic firms out of their own foreign currency deposits at their own risk. In the first quarter of 1990, certain banks received a licence to carry out trade related transactions for their clients as well as international services and transactions when the money was transferred from their clients' forex accounts. (In March 1989, related to the gradual liberalisation of convertible imports, a limited foreign exchange market was opened. The central bank made foreign exchange available to economic entities, or private persons authorized to trade in convertible currency.) In the middle of 1988 the Post Bank and Savings Bank Corporation Ltd. (Postabank) was established in order to break the monopoly position of OTP in retail banking. Since January 1989 other commercial banks have also been authorized to provide services for households. At the same time the OTP and Postabank received a full licence for commercial banking. (In order to enable banks to pay the market rate of interest on household deposits, the interest rate on housing loans was adjusted to the market rate from the beginning of 1989.)

[5]Hungarian SOCBs frequently established joint ventures with foreign capital, or purchased shares of such financial institutions which, in many cases, operated in the same segment of the market. In other words, they created competitors for themselves.

Table 4

Institutional development of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Commercial banks	15	16	16	23	32	32	37	37	36	36
foreign	3	3	5	12	14	17	19	22	21	24
Specialized financial institutions	6	8	8	8	5	4	4	6	6	8
Investment banks	0	0	0	0	0	0	1	1	1	1
Banks (total)	*21*	*24*	*24*	*31*	*37*	*36*	*42*	*44*	*43*	*42*
foreign altogether	3	3	8	9	15	16	20	24	23	27
Savings and credit cooperatives	260	260	260	260	259	257	255	258	254	255

Source: State Banking Supervision (SBS), and Nyers and Lutz (1992)

In 1990, according to Spéder (1991), about 30 percent of the three big SOCBs' total loan portfolio could be considered as directly inherited. The stock of directly inherited *qualified* debts was about 35 percent. The directly inherited part of doubtful claims was somewhat smaller (21 percent), while irrecoverable (bad) debts amounted to 41 percent of all bad debts. This suggests that the new credit evaluation was not much better than the old one. However, almost half of the new credits were rolled-over old ones. Approximately one-third of qualified loans were newly created. This indicates that the bad debt problem in Hungary was a stock, rather than a flow problem in the early 1990s. Bonin and Schaffer (1995) and *Király* (1995) also argue for the characterization of the development as a stock problem. What seems to be the core of the problem is not the inherited portfolio, but rather the inherited clientele. Big SOCBs were simply in a deadlock. They could not cut off all the credits extended to big debtors. All they could do was to roll them over. Bonin and Schaffer (1995) concluded that Hungarian banks "did not throw new money after old"; nonetheless, we cannot say that the respective managements of these banks were entirely responsible for the situation that had developed by 1991. Banks sometimes acted under political pressure.

If banks—understandably—did not take significant measures in order to solve these problems, why did the government not intervene? The NBH, as the lender of last resort of commercial banks, although it more or less insisted on a strict monetary policy, always provided refinancing credits for problem banks facing an emergency situation. It was obvious already in the 1980s, that the problem grew over the limits of the monetary sphere. The Ministry of Finance (MoF) was short-sighted in its policies. Due to the inadequate domestic accounting and banking rules, banks earned huge profits that the MoF could tap in the form of profit tax or dividends (see *Table 5*). If the MoF ordered the banks to push those of their debtors

who did not pay into liquidation, then instead of collecting these revenues the MoF would have spent a huge amount on the banks (or on SOEs if the government had desired to save them). Before 1992, the MoF consistently chose the first option. To take another example, in 1989, after a modification of the annual budget, SOCBs were obliged to purchase housing bonds for 50 percent of their loan loss reserves. In 1989–90 the Ministry did not allow banks to accumulate tax-free provisions. The MoF attempted to shift all the responsibility on to the banks. For example, in the early 1990s, SOCBs were requested to make a "death-list" of big debtors which banks were contemplating for liquidation. Finally, the banks put the names of some fifty enterprises on the list and, in fact, SOCBs started to initiate liquidation. Nonetheless, these measures were rather symbolic and served as a warning only (see *Table 3*).

Fortunately, the government was somewhat divided on this issue. In 1989, the State Banking Supervision (SBS) stipulated that banks should write off 10 percent of their doubtful loans. As a result of this obligation, five big SOCBs wrote off a HUF 3 bn (USD 50 mn) loss.[6] In Spring 1991, SBS put pressure on banks to accumulate a loan loss provision, because they did not have enough reserves.[7] If all doubtful outstanding debts had become irrecoverable, then about HUF 30 bn (USD 500 mn) additional loss reserves would have been needed to write off this loss.

Having no better option, SOCBs—but especially the MHB—started to swap debt for equity (see *Table 3*). In the short run it was "good" for banks as well as for enterprises.[8] These investments, however, were usually less profitable. They earned about 10 percent dividend on average in 1990 (and even less in 1991), which was below the interest income of banks. Obviously, the purpose of these swaps was to reduce the expected loss; rather than maximise the return on investment, banks hoped that they could sell their stakes in the planned privatisation. Apart from some exceptional cases, such as the sale of TUNGSRAM's shares by MHB, banks had to keep these shares for a longer period of time. Before 1994 the banking rules

[6] As has happened both before and since, financial authorities—but especially line ministries—or state asset management agencies assume that it is sufficient to write off the debts of SOEs and then everything will continue smoothly. Firms' restructuring and loan conciliation have not been interlinked.

[7] There was only one bank (BB) which followed the instruction of the SBS, while all the other banks paid more attention to the MoF's tax motive. The ministry heavily criticised and blamed the management of the BB because, according to the MoF, the management wanted to hide the profit from the Treasury.

[8] Although in 1989 banks still invested more in other financial institutions (HUF 4.2 bn), swap transactions increased rapidly. At the end of 1989 the stock of investments in the real sector held by banks amounted to HUF 4.7 bn. The share of the big five SOCBs in this investment comprised about 70–80 percent. On the basis of non-consolidated balance sheet data, Spéder (1991) estimated that the MHB had a concentration of 46 percent of all investments in the banking sector, while K&H had a 15 percent share, MKB's portion was 13 percent, and BB's share was only 6 percent.

also induced banks to change debts into equity, since strict provisioning was not required on investment.

Ownership of SOCBs

In 1987, when banks were established, SOEs could subscribe for the shares of SOCBs. The big debtors of SOCBs became shareholders of these financial intermediaries and (heavily indebted) SOEs could delegate their CEOs to the boards of banks.[9] By the 1990s the state's direct share in large SOCBs (excluded OTP) was between 42 and 55 percent. "Cross-ownership" contributed to allocative inefficiency. In the case of the three SOCBs, the total value of credits extended to their own shareholders amounted to HUF 165.6 bn (USD 2.8 bn). It became a common view that although the state was a bad owner, enterprises should not be allowed to own banks. In principle, the state could have been a good owner, since in the long run it was interested in the sound operation of the banking system. In reality, the state always fell hostage to the short term (and short-sighted) aims of particular interests of lobbies (which undermined the long term prospects). The question was then raised: "Who should own banks?"

In principle, Hungarian private citizens could become shareholders. However, a dispersed ownership was not desirable. Anyway, small investors did not show a strong interest in buying the shares of SOCBs. The attempt of K&H to sell its shares to small investors failed. Low dividends, a weak (less liquid) capital market and a 20 percent tax on dividends, did not make bank shares attractive. (It is no surprise that under these conditions SOCBs suspended the trade of their shares in order to avoid a worsening of their reputation.) For similar reasons, domestic, private, and institutional (financial) investors did not show too much interest either. Institutional investors were almost non-existent in Hungary at the end of the 1980s and in the early 1990s. The same applies to strategic investors. The only other alternative solution was to sell shares of SOCBs to *foreign* strategic or institutional investors.[10]

[9] SOCBs frequently tried to persuade thier clients to subscribe to their shares and sometimes banks themselves granted loans to SOEs in order to reduce the dominance of direct state ownership. Firms probably subscribed to bank shares because they assumed that they could have better access to bank finance.

[10] Spéder and Várhegyi (1992) mention another alternative. In principle, SOCBs could have been privatised indirectly in the medium term. Privatization of SOEs holding shares of SOCBs would have eventually resulted in the privatisation of these banks. Moreover, if these SOEs had been decentralised, such a downsizing would have reduced the vulnerability of banks to their dependence on big debtors.

The advantages of the take-over of SOCBs by foreign investors were obvious to everybody.[11] Nonetheless, there was a fear that profit-maximising owners would repatriate all the profit, or even a part of the income. The main argument against foreign investors was that, if foreign owners obtained major banks, then the domestic control over strategically important sectors of the economy would have been lost. Given the hesitation on the supply side, the deep recession of the economy in 1990–91, and after a short audit of the financial position of the respective banks, the demand for Hungarian banks largely decreased.[12] The government remained without real alternatives. The "nationalisation" of SOCBs became the official policy. This policy also gained support for other reasons. Because of the increasing rate of interest on credits and the reluctance of banks to extend loans to new private businesses, a hostile attitude towards banks by certain politicians and the population started to evolve. Accordingly, the State Property Agency (SPA) sought to collect all the shares of the SOEs. The ownership rights over SOCBs were divided between the SPA and the MoF. The ministry retained the right to make strategic decisions.

Legislative shock therapy

During 1991 the attitude of the financial authorities (i.e. state owners) began to change. International financial institutions put pressure on the Hungarian government to solve inter-enterprise arrears and to put an end to the accumulation of bad debts of SOCBs. They strongly suggested that there was a need to create a comprehensive legal framework for the operation of the central bank and financial institutions. Nevertheless, the room for government intervention was seriously limited by the ceiling imposed on the budget deficit.

In May 1991, at the annual meetings of the SOCBs, with the consent of the MoF, the chief executive officer of SPA voted for a moderate dividend, against the wishes of corporate shareholders. Later, in the summer, the government issued guarantees for 50 percent of the credits extended before 1987. This guarantee amounted to HUF 10.3 bn (USD 140 mn). This measure was far from being sufficient to solve the problem of SOCBs, since about HUF 40 bn of bad debts still

[11] Besides usual benefits (such as fresh capital, technology, know-how, markets, etc.). The NBH and the MoF supported the sales of banks, since these transactions could have resulted in hard currency revenues, additional credit lines and an export-financing capacity for the country. Furthermore, the strong profit motive of new owners could also have had some positive spillover effect on borrowers. Yet the tax allowances that, presumably, would have been necessary, could have reduced the stream of future revenues, and the necessary liberalization of foreign exchange would have immediately reduced the discretionary power of the central bank.

[12] Sándor Demján, the CEO of the MHB, could find a buyer for his bank but the deal was stopped in its tracks by officials and later he was removed from his position.

remained in the banks' portfolios. Even so, at that time banks did not suffer liquidity problems. In the early 1990s, the short term insolvency of Hungarian banks was not a problem either. The money market could pass sufficient intermediate resources from retail banks to the large SOCBs and they could manage their short-term liquidity. At the same time, it became clear that this situation would not be sustainable forever. The immediate impact of the recession of the real sector was not yet reflected in the accounts of the banks. On the contrary, although in 1990 and 1991 GDP (and industrial production) declined by 3.5 percent and 11.9 percent respectively, (and by 7.7 percent and 17.9 percent respectively), the banks reported significant profits (see *Table 5* and *6*). This fact alone indicated that there must be some problem with the system of regulation, so the government decided to impose new laws on financial institutions.

In 1991, Parliament passed several new economic laws. In addition to the acts on, respectively, investment funds, the central bank, and the amendment on the act on foreign investment, three other important changes in the legislation must be mentioned here: (1) *Act LXIX of 1991 on financial institutions and financial activities* (i.e. the Banking Act) which became effective in December 1991 so that it could be applied in the final accounts at the end of the year. It gave rise to radical changes in the regulation of financial institutions. This Act, among other things, required banks to accumulate loan loss provisions, and prescribed an 8 percent capital adequacy ratio (CAR) by January 1994; it also introduced other elements of more prudent regulation. This new Act followed the BIS accords although, as it will be shown below, in some important aspects regulators deliberately "adjusted" the requirements to local conditions. The Hungarian system is not exactly Anglo-Saxon, nor is it German-like. Although policymakers paid attention to EU requirements, the current state of the capital market as well as the lack of expertise in risk assessment of investments made it advisable that universal banking should not be explicitly allowed. However, in practice, commercial banks could trade with securities and through their subsidiaries they could run investment funds. (See also *Várhegyi* 1994a and Ábel and Bonin 1994). (2) *Act XVIII of 1991 on accounting*, which became effective on 1 January 1992; this stipulated that economic entities must prepare balance sheets and income statements that showed a true and fair picture of their economic activities. In general, this law corresponded to international auditing standards (IAS). (3) *Act IL of 1991 on bankruptcy, liquidation and final accounting* (i.e. the Bankruptcy Act) came into effect in April 1992 and immediately increased the number of bankruptcies and liquidations (see *Table 2*). Policymakers believed that this strict rule, having an automatic trigger, could restore financial discipline in the economy and inter-enterprise arrears would thus be curtailed.

All these legislative changes had an unprecedented impact on the financial sector. SOCBs were unable to accumulate sufficient loan loss provisions, and they had HUF 30 bn (USD 400 mn) unprovisioned, even using the less stringent Hungar-

Table 5

Development of the portfolio of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Nominal GDP (HUF)	1,226.4	1,440.7	1,722.8	2,089.3	2,498.3	2,942.6	3,548.3	4,364.8	5,499.9	6,627.95
Total assets of banking sector	996.3	1,023.0	1,247.3	1,620.5	2,108.7	2,276.0	2,630.4	3,071.8	3,693.6	4,735.28
Total off-balance sheet items	n.a.	n.a.	n.a.	n.a.	n.a.	225.0	304.5	379.6	551.5	1,192.49
Equity	49.8	65.1	74.3	91.3	117.7	109.1	256.5	296	220.3	218.91
Own capital	60.0	75.5	93.9	122.4	*169.9*	166.9	147.8	209.6	295.8	397.63
Capital investment	6.2	10.1	20.7	30.3	50.3	n.a.	92.0	106.6	139.7	155.68
Pre-tax profits	28.3	35	49.7	63.3	35.5	n.a.	−149.1	25.57	53.91	84.539
Profit tax and dividends to the state	21	23.35	21.33	48.58	44.47	1.69	8.349	30.448	12.985	16.038
Total enterprise HUF credits	n.a.	382.8	462.6	564.3	656.6	630	610.6	687.9	693.7	852.0
Total credits to business sector	383.0	395.8	492.6	636.1	765.3	768	761.9	869.7	982.6	1,265.2
Total classified portfolio	787	800	671.7	994	1,230	1,610.7	1,828.1	2,504.5	2,731.0	3,817.9
Qualified loans	2.8	6.7	22.6	43.3	152	173.1	536	534.1	438.9	412.82
Under observation	–	–	–	–	–	–	124.2	194.1	193.4	222.39
Substandard	–	–	–	–	30	36.5	53.7	51.3	43.1	37.04
Doubtful	2.8	6.7	22.6	43.3	82	59.7	112.3	85.4	68.7	47.63
Bad	–	–	–	–	40	76.9	245.8	203.3	133.7	105.75
Provision—required	–	–	–	–	87	114.0	–	–	–	–
Provision—available	n.a.	n.a.	n.a.	n.a.	52.8	73.5	272.9	233.8	176.8	138.2
Qualified prtfolio/GDP (%)	0.23	0.47	1.31	2.07	6.08	5.88	15.11	12.24	7.98	6.22
Qualified prtfolio/Total assets (%)	0.28	0.65	1.81	2.67	7.21	7.61	20.38	17.39	11.88	8.71
Qualified prtfolio/Total classified portfolio (%)	0.36	0.84	3.36	4.36	12.36	10.75	29.32	21.33	16.07	10.81
Qualified prtfolio/Business sector loans (%)	0.73	1.69	4.56	6.81	19.86	22.54	70.35	61.41	44.67	32.62
Qualified prtfolio/Enterprise HUF loans (%)	n.a.	1.75	4.89	7.67	23.15	27.48	87.78	77.64	63.27	48.45
Bad portfolio/GDP (%)	–	–	–	–	1.6	2.61	6.93	4.66	2.43	1.59
Bad portfolio/Total assets (%)	–	–	–	–	1.9	3.38	9.34	6.62	3.62	2.23
Bad portfolio/Total classified portfolio (%)	–	–	–	–	3.25	4.27	13.45	8.12	4.90	2.76
Bad portfolio/Business sector loans (%)	–	–	–	–	5.23	10.01	32.26	23.38	13.61	8.35
Bad portfolio/Enterprise HUF loans (%)	–	–	–	–	6.09	12.21	40.26	29.55	19.27	12.41

Sources: Annual and monthly reports NBH, SBS, and Nyers and Lutz (1992)

Table 6

Selective indicators of the Hungarian banking sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
GDP nominal (HUF) growth rate	12.63	11.7	19.58	21.27	19.57	17.78	20.58	23.01	26.0	20.5
GDP real growth rate	4.1	−0.1	0.7	−3.5	−11.9	−3.1	−0.6	2.9	1.5	1.0
CPI	8.6	15.5	17.0	28.9	35.0	23.0	22.5	18.8	28.2	23.6
PPI	3.3	4.5	14.6	20.9	31.5	10.7	11.0	11.3	28.9	21.8
Nominal growth rate of total assets of banking sector	n.a.	2.68	21.92	29.82	30.68	7.47	15.57	16.78	20.24	28.2
Real growth rate of total assets of banking sector (PPI)	n.a.	−1.74	6.39	7.46	−1.1	−2.5	4.1	4.92	−6.72	5.2
Real growth rate of total assets of banking sector (CPI)	n.a.	−11.1	4.21	0.79	−3.6	−12.2	−5.6	−1.7	−6.2	3.7
Nominal growth rate of enterprise HUF loans	n.a.	n.a.	20.85	21.98	16.36	−4.05	−3.08	−12.66	0.8	22.8
Real growth rate of enterprise HUF loans (CPI)	n.a.	n.a.	3.29	−5.57	−13.81	−21.99	−20.88	−5.17	−21.34	−0.7
Real growth rate of enterprise HUF loans (PPI)	n.a.	n.a.	5.45	0.9	−11.52	−13.33	−12.68	1.22	−21.77	0.8
Total assets of banking sector/GDP	81.24	71.0	72.4	77.56	84.76	77.34	74.13	70.37	67.15	71.44
Total enterprise HUF loans/GDP	30.67	26.57	26.85	27.01	26.28	21.41	17.21	15.76	12.61	12.85
Total enterprise loans/GDP	30.67	26.57	27.51	28.34	28.18	23.51	19.06	17.88	16.57	18.14
Total business loans/GDP	31.22	27.47	28.59	30.44	30.63	26.09	21.47	19.92	17.86	19.08
Total enterprise loans/Total assets	n.a.	37.42	37.09	34.82	31.14	27.68	23.21	22.39	18.78	25.4
Total business loans/Total assets	38.44	38.69	39.49	39.25	36.29	33.74	28.97	28.31	26.60	26.71
Business sector deposit/credit ration	n.a.	n.a.	41.4	49.4	49.9	59.5	69.9	63.3	66.2	63.7

Sources: National Bank of Hungary and own calculations

ian banking rules which, at that time, did not require adequate provision against off-balance sheet items or investments. (According to the Act, general provisions had to be accumulated from after-tax profits to the value of 1.25 percent of the balance sheet total, and up to one percent of guarantees.) If international standards had been adopted, banks would have needed approximately HUF 60–70 bn more loan loss reserves: in this case the major banks would have lost their capital immediately. In order to avoid the collapse of the banking system as a whole, banks were allowed to build up loss reserves over three years. These economic and legislative changes hit SOCBs especially hard. Nonetheless, the CAR of most banks fell below 7 percent, and two major domestic banks had a negative CAR. However, the worst was still to come. (See *Table 5.*)

The recession worsened in 1992. As a consequence of the collapse of the COMECON market in 1991, many SOEs got into serious trouble. No legislative rigour had previously jeopardized their existence but, from April 1992, insolvent firms could not avoid bankruptcy or liquidation. All these economic and legislative changes led to a financial shock for Hungarian banks. Even if banks could perceive the difficulties, they could not do too much to avoid them, since the MoF had already diverted funds from SOCBs, and they remained seriously undercapitalised. The new Banking Act and the other changes in the regulations merely made visible what had before been hidden. Monetary authorities as well as commercial bankers feared that the losses would undermine the trust in banks, impair the chances of SOCBs to acquire funding, and would increase the costs of financing. In principle, banks could perhaps have managed to build up loan loss reserves—e.g. through widening the interest margin—but it would have taken too long. Nevertheless, banks increased the margins. As a consequence, high real interest rates (on loans) occurred, which obviously cooled down the economy. By Spring 1992 it was obvious that the government had to intervene in order to help out banks. In essence, the new Banking Act wrongly imposed a flow solution to the bad loan problem when it was essentially a stock problem.

Credit conciliation

The government had several alternatives with which to address the bad loan problem. Bad debts could be carved out from the balance sheets of the respective banks, or the capital of banks could be increased to an appropriate level. Such a policy can be carried out with cash, or risk-free government securities can be transformed to banks. To a limited extent subordinated capital can also be used. The government can provide guarantees, or the central bank may refinance banks' liabilities. In practice, the MoF rejected any idea of transactions in cash. The NBH also opposed any suggestion for refinancing. If the state had undertaken guaran-

tees, it would not have solved the short term cash-flow problems of certain banks. Moreover, their profitability would not improve either. Guarantees are less liquid than, for example, state securities, because necessary court decisions are time consuming, and Hungarian courts had been overloaded by the flood the Bankruptcy Act initiated. Moreover, the issue of state guarantees requires parliamentary approval. It is also difficult for the MoF to assess the amount of guarantees needed annually. To inflate away the deposits was not a practical alternative. The central bank rejected this alternative as well as any idea of a currency reform.

There were still two competing proposals. According to the market oriented (decentralised) version, banks could sell their bad debts or doubtful claims at market price to specialised firms with venture capital. The government could partially cover the losses of commercial banks. Unfortunately, the administration hesitated in its decision, which was postponed until the end of 1992. In December, acting under the pressure of time, the financial authorities decided on a hybrid solution: a portfolio cleaning combined with a firm oriented carve-out and a partially centralised work-out were implemented. The question which immediately arose was: why were firm restructuring and portfolio cleaning not carried out simultaneously? On the one hand, the Hungarian government worried about the reaction of the international financial market: "In 1992 the stock of qualified credits started to increase with a dramatic speed and according to international standards most of the Hungarian financial institutions would have lost their capital. A further increase of the stock of qualified credits could be expected from the logic of the process thus a quick accumulation of losses had to be stopped." (*Ministry of Finance* 1993, p. 10) On the other hand, the government and the whole financial community feared a possible bank panic because two banks and a saving cooperative went bankrupt in the summer of 1992, and three other banks became insolvent.

The government also had to decide which banks and what credits should be included in the programme. Since, according to the government, the main reason for the crisis was the economic recession which, in general, affected all financial institutions, the programme was extended to all domestic banks in trouble.

Bank oriented credit consolidation

The aims of the bank oriented credit consolidation were: to improve certain financial indicators of troubled commercial banks; to narrow the interest margin; to provide a sound basis for prudent banking activities that would also facilitate the privatisation of SOCBs; and to help the reorganisation of enterprises.

Banks having a CAR below 7.25 percent at the end of 1992 (prescribed temporarily by the Banking Act) were eligible to participate. Altogether, 14 banks and 69 saving cooperatives took part in this scheme. In order to avoid the moral haz-

ard, the government decided that banks could sell to the state bad loans (excluding housing loans, consumer credits and loans extended to foreigners or financial institutions) that had been extended prior to 1 October 1992.[13] Decision-makers speculated that "an important part of the substandard credits can be managed by the financial institutions and if they get rid of the bulk of credits qualified as doubtful and bad ones, they will be able to cover their credit losses". (Ministry of Finance 1993, p. 12)

Banks could decide what loans they wanted to offer for sale to the government. They wanted to get rid of debts amounting to HUF 150 bn, but eventually in March 1993 they could sell much less to the MoF. The classification and selection were monitored by the ministry and international auditing firms. The government purchased the bad debts at 50 percent of face value if the loan was classified as such in 1991 or before; at 80 percent of the nominal value if the loan was classified as bad in 1992, and in certain cases—to help the ongoing privatization of banks—banks could sell certain claims at full price. According to a decentralised version, workout firms could have purchased these claims from banks, but these business entities did not exist at that time, or the few that did were financially too weak to purchase claims reaching such a volume. Therefore, the state had to purchase these claims. Altogether, their nominal value amounted to HUF 100.1 bn (USD 1 bn) and the state paid HUF 79.4 bn (USD 830 mn) for them.[14] The government used long term bonds to replace loans in order to shift the burden to the future.[15] (Another consideration was that as time passes the capital represented by these bonds would be inflated away.) The government deducted the accumulated risk reserves from

[13] "The main cause—i.e. the portfolio-deteriorating effect of the shrinking of the economy—asserts itself even at present. On this basis it may be asked whether the consolidation should also be extended to credits granted at present and which become ≪qualified≫ later. This would, however, stimulate the banks to be irresponsible in their lending policies. We have, therefore, chosen the solution (as a compromise) that *credits granted prior to 1 October 1992 may be included in the system.* (At that time the banks hardly knew that the system of credit consolidation would be expected, therefore the Ministry of Finance could not influence them when taking decisions on extending credits.)" Ministry of Finance 1993, pp. 11–12.

[14] These claims were concentrated mostly in large banks. Large SOCBs transferred the credit stock of HUF 85.2 bn to the government and received bonds of HUF 66.7 bn in exchange. However, the debts of 2,647 firms were also concentrated in a smaller group: HUF 77.5 bn (75.6 percent of all claims) represented the debts of 709 firms facing bankruptcy or liquidation. At the end of 1992 banks got rid of 95 percent of the debts of those firms facing bankruptcy or liquidation. The debts of firms in the process of being liquidated amounted to HUF 63.6 bn, and those facing bankruptcy to HUF 13.9 bn. This high concentration is shown by the fact that 337 firms, out of 709 enterprises facing bankruptcy or liquidation, were clients of the big four SOCBs and owed the banks HUF 64.4 bn. (Marsi and Pap 1993).

[15] Banks received "A" series consolidation bonds, which bear interest similar to the market rate of interest and they received "B" series consolidation bonds for their outstanding interest payments. Although according to the original plan the treasury would withhold 50 percent of the interest payment on these "B" bonds in the form of a consolidation fee, it was later cancelled, and "B" series bonds were exchanged for "A" series ones.

the sales price in order to share the costs with banks. This amounted to HUF 20.6 bn. (See also Ábel and Bonin 1994 and Várhegyi 1994a)

As a result, the CARs of most of the banks participating in the programme, at least according to Hungarian accounting and banking regulations, became positive (although they were still mostly negative calculated by international standards). These banks still accumulated HUF 7.1 bn of aggregate losses. Without credit consolidation these fourteen banks would have had to accumulate almost HUF 50 bn loan loss provisions. Their total losses would have been even bigger and they would have lost two-thirds of their solvency capital, even applying the moderate domestic regulation which allowed banks to replenish their risk reserves in three years. The aggregate CAR of these banks would have been one percent instead of the 7.25 percent prescribed by the Banking Act, and the solvency capital of half of these financial institutions would have been negative. According to BIS standards, twelve banks would have lost their entire capital and reported a negative CAR. Their total losses would have amounted to almost HUF 125 bn (USD 1.6 bn), since the required level of loan loss provision would have been nearly HUF 200 bn (USD 2.5 bn). In sum, as a result of the state intervention, immediate bank failures were avoided. Although the capital adequacy of the banks was weak, on average they could meet Hungarian standards. (The MHB and Agrobank had negative CARs, and the K&H's CAR was 1.9 percent. Only BB, OTP and MKB could pass the limit among the large SOCBs.)

In addition to this normative part of the programme, the government also included three smaller banks in the process of consolidation in spring 1993. The MoF purchased the bad debts of these banks at face value for HUF 17.3 bn (USD 188 mn). Ybl Bank was one of the three small financial institutions which went bankrupt in 1992 and it was later liquidated. The other two banks (Konzumbank and Industrial Banking House), although they were technically insolvent, due to a quick state (NBH) intervention, did not have to file for bankruptcy in 1992. After the bankruptcy of the three financial institutions mentioned above, the financial community wanted to prevent the open failure of other banks at any price. Altogether, the bank oriented credit consolidation, including savings cooperatives as well, increased the state debt by HUF 98.6 bn (about USD 1 bn).

Firm oriented credit consolidation

In 1992–93, various government agencies and lobby groups became active and sought to obtain direct support for their "constituency". In 1992 the government decided to give support to certain SOEs in industry. The SPA proposed to select 200–300 firms for debtor consolidation, but the MoF strongly opposed this idea

and finally the government rejected this proposal.[16] Nonetheless, the effort was in part successful, because, albeit on a smaller scale, a similar programme was finally implemented. In the autumn of 1993, the authorities "based upon certain strategic considerations" first selected thirteen big SOEs from heavy industry. Then, under the pressure of the Ministry of Agriculture, eight additional (food processing) firms and several state farms and agricultural cooperatives were added to the list of the "dirty dozen". Finally, the Hungarian Railways (MÁV) were also included in the firm oriented credit consolidation. The debts of industrial and food processing firms were purchased at 90 percent of their face value—that is for HUF 32.4 bn and HUF 4 bn (USD 352 mn and USD 43.5 mn) respectively; the debts of the railway company (HUF 16.2 bn) and agricultural cooperatives and state farms (HUF 4.5 bn) were carved at their face value. In order to cover the costs of these transactions, the government issued consolidation bonds to the value of HUF 57.2 bn (USD 621 mn).[17]

It was not quite clear in this case what could be done with the debts that had been carved out from the banks. Policymakers assumed that no state organisation was interested in or prepared for work-out. It was taken for granted that banks could do a better job with the latter, but this view was unjustified as banks lacked both the necessary experience and skill.[18] Moreover, the short-term interests of banks in siphoning out from debtors as much as they could and as soon as possible in order to cover their losses were costly for the government.

It was accepted at the start that debtors would need a case by case treatment. In March 1993 the Hungarian Investment and Development Bank (MBFB), a 100 percent state-owned investment bank, purchased HUF 41.2 bn of the debt of 57 firms from the state at a discount price. (MBFB paid 4 percent of the sales value immediately after the transaction, and according to the contract between the MoF

[16] The NBH, the MoF and the SBS did not support the idea of centralized portfolio cleaning, because they did not want to see another top state asset management organisation responsible for SOEs besides the existing ones. They also argued that it would be difficult to recruit staff for this new agency, and the decisions of this agency probably would have been rather discretionary, raising problems of moral hazards in banks.

[17] The debts of these insolvent firms remained in the books of their creditors after the bank oriented credit consolidation. This means that they were not classified as bad at that time. So we may suppose that banks probably behaved strategically. They might assume that it was better to sell the debt of big SOEs at face value to the state than to include them in the consolidation scheme. Needless to say, this fact alone foreshadowed the necessity of another phase of consolidation, since the credit stock of these enterprises was significant and these debtors were really in bad shape.

[18] For the same reasons *Dittus and Prowse* (1996) argue against the claim that East European commercial banks could be successful in active monitoring of their borrowers (like the Japanese) or investments (like the Germans). They lack human resources and therefore financial institutions themselves are not particularly interested in investment banking activity. In the short run, credit allocation alone was already too big a challenge for them. Nonetheless, they also admitted that work-out of default firms might be a useful "exercise" for a bank to gain experience in the restructuring of firms.

and MBFB it was obliged to transfer 25 percent of work-out revenues to the Treasury.) A vast majority (90 percent) of these firms were in the process of liquidation, but only one-fifth of them were expected to be completely liquidated. The others were supposed to go through at least a partial restructuring. The other part of the debt carved out by the MoF was also, in principle, managed by MBFB. However, in fact, due to its limited capacity, these claims remained in the lender banks' books. At the end of 1993, the MoF and MBFB offered this portfolio for sale, but only one-tenth of the claims (about HUF 7 bn) found a buyer at a price which was, on average, ten percent of the face value. Until mid-1994 banks formally managed the claims on the basis of continuously renewed short-term contracts between the MBFB and the banks. The banks did not do anything effectively with these claims. From mid-1994 until the end of 1994 this portfolio remained without control. Finally, in early 1995, the MBFB took over HUF 63 bn debt, and was allowed to keep 35 percent of the net revenues from the work-out. Except for a few cases, the credit consolidation did not have any real impact on the financial conditions of firms. The Treasury did not benefit too much from the work-out either. Until the end of 1995, the state budget recovered only about HUF 6 bn. If we were to add a few more billion forints to these revenues, we can still point to a less than 10 percent recovery rate.

In the case of the *firm oriented bank conciliation* the approach chosen and the outcome were not significantly different. In 1992–93, the State Development Institute (ÁFI)—another 100 percent state-owned organisation—cancelled, rescheduled or capitalised HUF 15 bn of its loans to these firms. In addition, guarantees for these industrial enterprises were provided by the government and their tax- and tariff-arrears were forgiven. The MoF then sold the debts of these firms to the state asset management agencies and these agencies used privatization revenues to pay for these claims. Although the debt could have been rescheduled or swapped for equity, the State Asset Management Company (ÁV Rt.) chose to write off HUF 23 bn of debt in 1993 without requiring any restructuring on the part of the firms. Since the SPA was not authorised to forgive any debt without parliamentary approval, it silently accepted that debtors would not service their debts after September 1993.

It turned out (as early as spring 1993) that the bad debt problem of banks had not been solved, although the whole consolidation process was supposed to have been completed by the end of 1993. In 1993 the real growth rate was still negative; the number of bankruptcies or liquidations increased steadily; firms suffered from financial distress; the management of banks did not improve; and further tightening of the regulation was expected. As a result, the banks' portfolio deteriorated further. By autumn 1993 the solvency capital of major banks became negative. The high level of loan loss provisions (even according to the domestic rules) caused the major SOCBs to fall into the red. The balance sheet of the banking system as a whole showed a more than HUF 30 bn loss at the end of September 1993.

The government, relying upon the recommendations of foreign and Hungarian advisors, decided to continue the bailout of the banking sector. However, instead of carving out bad debts, now it was recapitalisation of the banks which received priority. (In March 1993, the IMF and the World Bank had already advocated the recapitalisation of troubled banks to the level where their CAR would reach 4 percent, but at that time the Hungarian government rejected this option.) In autumn 1993, banks were able to apply for the new round of consolidation. Out of 14 applicants, the government finally allowed 8 commercial banks to participate. The other banks were excluded because the government considered their performance relatively good, so state funds were not to be used to improve their situation. These eight banks extended 51 percent of all enterprise loans, but represented only 34.6 percent of the total assets of the whole banking sector. Nevertheless, they had more than 60 percent (HUF 211 bn) of the qualified loans, and more than 70 percent of bad loans. Two-thirds of the problem loans had already been overdue for more than a year, and the cash-flow of these banks was expected to become negative in 1994, adding another reason for intervention.

Bank conciliation

The Hungarian government opted for so-called "bank conciliation". However, at this stage bank restructuring and debtor conciliation were also part of the programme. (See *Balassa* 1995)

The main aims of bank conciliation were: (1) the elimination of loan losses from the accounts of banks, and the stabilisation of the banking sector (i.e. solving the stock problem); (2) helping to reduce lending rates in order to boost the economy by providing cheaper financing; (3) helping to restore the profitability of the SOCBs; (4) the creation of an environment for prudent banking operation; (5) the preparation of the SOCBs for privatisation, thus eventually solving the flow problem. The goal of bank conciliation was to reach an 8 percent CAR for all participating banks. This required an amendment of the Banking Act and the full adjustment of prudential regulation to international standards. The changes included the point that all shares had to be bearer shares. Another important change was that, instead of evaluating individual debts, clients were to be assessed and provisioning was also extended to investment and off-balance sheet items. Banks also enjoyed more flexibility in provisioning, within certain limits. Accounting principles were also modernized.

Four smaller domestic banks and four large SOCBs participated in bank conciliation. In addition to the eight banks, the OTP and OTIVA (the Deposit Insurance Funds of Savings Cooperatives) were also included at this stage. The MoF increased the capital of the large SOCBs (i.e. of the BB, K&H, MHB, and

Takarékbank) in three steps, thus enabling these banks to achieve 8 percent CARs. In the case of small banks (i.e. Agrobank, Dunabank, Iparbankház and Mezőbank) the government increased their equity only up to the point where it reached 4 percent. The total assets of these small banks represented less than three percent of the banking sector. It was assumed that, using a method of privatisation through capital increase, these banks would find a partner more easily and the CARs could be increased to over 8 percent.

The MoF increased the capital of troubled banks in three steps. The consolidation bonds which the eight banks received in December 1993 amounted to HUF 114.5 bn (USD 1.24 bn), out of which MHB and K&H received HUF 88.19 bn. The capital increase enabled banks to lift their respective CARs above zero, and this measure also restored a positive cash-flow for the banks. Since in December audited figures were not available, the amount each bank received was determined by the MoF on the basis of data provided by banks in September. Changes in the prudential regulations and the individual actions of the banks to increase their loan loss reserves were incorporated in the assessment. When the balance sheet for the whole year became available (late February), banks and the MoF recalculated the amounts used in recapitalisation. Loans extended before 30 September 1993 and qualified as bad at the end of 1993 were covered by the programme. The MoF's estimate was that banks needed to accumulate HUF 113 bn more reserves under the new regulations compared to the previous one. The equity of banks was increased again in May at the shareholders meetings of banks. The MoF, perhaps understandably, preferred a lower level (four percent) of CAR, while the NBH, SBS and SPA recommended the internationally suggested eight percent. At the same time IBRD experts advised that with a positive, but less than 8 percent CAR, the government could exercise pressure on SOCBs in order to speed up their restructuring. In May 1993, the eight banks received HUF 17.2 bn (USD 163 million) in total in the form of conciliation bonds. This was to help them reach a two percent CAR in the case of small banks, and 4–8 percent CAR in the case of large banks. In addition to this, small banks received HUF 896 mn of subordinated capital to reach 4 percent CAR.

In exchange for the recapitalisation, banks were expected to submit their medium-term restructuring programmes and a privatisation plan to the annual shareholders meetings. They were also expected to participate in a debtor consolidation which would address the financing problem of large enterprises. The government held back the strategic plans of the MHB and K&H and therefore their consolidation was a bit delayed. These two banks had to submit a revised strategic plan. Because the efforts of the management of these banks did not satisfy the government, the top management of MHB and K&H was replaced by a new one in late 1994 and early 1995. Eventually, the CARs of these banks were increased to 8 percent at the end of 1994, but they were still calculated on the basis of their 1993 balance sheet data. These two banks received HUF 15 bn (USD 142 mn)

of subordinated capital. As a result of these capital increases, the state became a majority owner of consolidated banks. State ownership exceeded 75 percent in seven banks.

Debtor conciliation

Enterprise indebtedness or restructuring was not addressed as the main issues in the bank conciliation programme. Bank conciliation did not remove any claims against the firms, although banks were free to make any decision concerning enterprise debt. As a result of the measures taken, banks had sufficient provisioning, and it was exclusively their own business decision as to what they intended to do with these claims. For policymakers the passivity of the banks was a main concern. Bankruptcy regulations did not allow banks to *forgive* any arrears against state creditors (e.g. tax, social security), although these arrears could be rescheduled. Debtor conciliation corresponded to the out-of-court agreements of bankruptcy procedures, or they functioned like pre-filing conciliation. Only representatives of banks and state creditors (i.e. tax and customs offices, social security authorities and the National Technical and Development Committee) could participate in conciliation procedures. Although banks, NHB and World Bank advisors strongly opposed the idea, branch ministries could also send their delegates to these committees. Nonetheless, the interests of small creditors could not be ignored. In this scheme state creditors were authorised, under a special resolution and within certain limits, to forgive debts. The main purpose of the conciliation was to help to reorganise enterprises in financial distress. In cases where agreement was not reached the normal bankruptcy procedure was initiated.

Conciliation procedures started in early 1994. The SPA and branch ministries (1) had the right to select firms for an accelerated debtor conciliation procedure and to lead or attend the negotiations with creditors; (2) if no agreement was reached, then the SPA was allowed to buy-out debts from the banks at net value (face value minus provisions); (3) the ministries had the right to set up inter-ministerial committees for resolving disputes among government agencies, or for monitoring the process. In fact, three different types of debtor conciliation were designed:

1. *Accelerated debtor conciliation.* Under this scheme, the SPA and the ministries (i.e. Ministry of Industry and Trade and Ministry of Agriculture) selected some debtors, and agreements had to be reached without delay. Out of 55 selected enterprises, conciliation took place in 46 cases. Nevertheless, in 1994, 15 firms filed for liquidation and 9 were privatised. 17 firms were able to reach an agreement with their creditor. The SPA purchased the bank debts in five cases. The bank debts of those 55 firms amounted to about HUF 40 bn, and these firms also owed about HUF 10 bn to state creditors. As a result of conciliation, a debt reduction of

HUF 18 bn was achieved. In the event, the accelerated debtor conciliation was not very successful, partly because the time available for preparing the restructuring plan and reaching an agreement with banks was short. Another important aspect of the process was that banks gained some experience in work-out. The deadline for completion of the procedures was extended to the end of April 1994.

2. *Normal debtor conciliation.* Firms having bad debts at the end of 1993 were allowed to apply for debt relief. An inter-ministerial committee then selected those who could participate in the programme. Finally 76 firms were deemed eligible, of which 41 had been supervised by the Ministry of Industry and Trade and 35 by the Ministry of Agriculture. These firms had a total of HUF 47.143 bn debts, of which HUF 28.4 bn were bank debts. The participating firms submitted a reorganisation plan. However, in most cases proposals were returned for revision. Some banks were active, some of them not. Strict deadlines again proved to be a drawback, and thus the deadline for completion was extended to the end of June 1995.

3. *Simplified debtor conciliation.* All other applicants (who did not take part in the previous two schemes) were eligible to participate in the simplified scheme under the same conditions. In this scheme government authorities did not participate in the negotiations.

Table 7

Main characteristics of debtor consolidation

	Banks	State creditors	SPA	Social security
Potential applicants (December 31, 1993)				
Number of cases	13,069	–	–	–
Debts (million HUF)	227,329	–	–	–
Applications (December 31, 1993)				
Number of cases	1,890	708	–	655
Debts (million HUF)	121,008	25,506	–	n.a.
Unsettled cases (December 31, 1993)				
Number of cases	1,536	559	–	754
Debts (million HUF)	77,039	15,909	–	–
Agreements				
Number of cases	354	149	31	81
Agreement with forgiving (million HUF)	19,536	3,890	267	966
rescheduling (million HUF)	6,649	5,562	–	4,345
swap (million HUF)	3,986	293	1,008	52
mixed (million HUF)	30,171	9,745	1,275	5,363

Source: various issues of *Privinfo*

Table 7 provides a summary of debtor conciliation. Out of 13,069 debtors, 1,890 firms indicated their interest in participating in the debt conciliation. Creditors reached agreement with their debtors in 354 cases. The total value of the bad and doubtful bank loans of these firms amounted to HUF 227 bn, and the banks had HUF 154 bn loan loss reserves behind these claims. The total debts of firms which finally remained in the debtor conciliation were HUF 121 bn, against which banks had about HUF 80 bn loan loss reserves. State creditors were involved in debt arrangements in 149 cases, while the SPA was involved in 31 cases.

According to Balassa (1995) in these debt settlements 29 percent of bank debt and almost 6 percent of the debt of state creditors were forgiven. Banks did not use all of their loan loss reserves for this purpose and a significant part of these reserves was transferred for other purposes. However, as can be seen from *Table 8*, the vast majority of debtors did not apply and therefore their debts had to be written off. Two major banks (the MHB and K&H) followed the advice of the IBRD and "split" into a "good" bank and a "bad" bank. They transferred bad debts to those of their subsidiaries who were specialised in work-out. Even if debtor conciliation did not come up to expectations, banks could eventually get rid of most of their non-performing loans. As *Table 5* indicates, the portfolio quality of banks improved significantly after 1995. This also paved the way for bank privatisation.

Privatisation of state banks

The Banking Act of 1991 stipulated that direct and indirect ownership of any single owner, with the exemption of financial institutions, could not exceed 25 percent of the equity. Although this restriction did not apply to the state until the end of 1996, the Act put a ceiling on the voting rights of the state as an owner after 1 January 1995. The 1995 deadline of the elimination of voting power was extended later.

At the beginning of 1992, financial institutions were obliged to renew their licences by law, and bearer shares had to be converted into registered shares. The state property agencies tried to collect the shares of SOCBs from SOEs. Although this effort was not fully successful, the ownership of banks became more transparent.

In the period of 1991–94 the macroeconomic conditions did not favour the sale of SOCBs. The net asset value of the major Hungarian SOCBs was negative, and the Hungarian government decided to clean up banks' portfolios, and to restructure troubled banks so as to make them viable for privatization. The authorities first envisaged a sequential privatisation: strategic investors could obtain control via a capital increase combined with the sale of the remaining shares of the state. The argument was that strategic investors would guarantee higher proceeds from such transactions.

Table 8

Bank and debtor conciliation in Hungary between 1987–1996

Year	Target	Target group		Method	Face value	Expenses (bn HUF)			
		Banks	Firms		(bn HUF)	G	C	S	O
1991	bank portfolio cleaning	3 banks	n.a.	guarantee (G)	20.6	10.3	–	–	–
1993	bank portfolio cleaning	14 + 3 banks (+69 savings coops.)	(2,619 firms & coops.)	buy-out	100.1 17.278 2.419	–	79.423 17.278 (1.895)	–	–
1993	bank portfolio cleaning	(13 banks)	21 firms + coops.	buy-out	61.308	–	57.292	–	–
1994	bank restructuring	8 + 1 banks (+saving coops.)	–	recapitalisation (C) & subordinated loan capital (S) & other (O)	–	–	114.45 17.207 10.000 (4.712) (1.724)	0.896 15.003 (0.388) (0.276)	1.882 12.000
1995	bank restructuring	2 banks	–	recapitalisation	–	–	0.800	5.000	5.951
1994 1995	firm restructuring	(8 banks)	1,890 firms	work-out (out-of-court conciliation)	121.008	–	–	–	–

Sources: MoF, National Auditing Office, and NBH

However, not everybody supported the sale of SOCBs to foreigners. Although foreign banks could enter the Hungarian credit market, they immediately enjoyed significant comparative advantage over domestic banks. Foreign and joint venture banks had a clean portfolio. In the first years they enjoyed certain tax concessions. They had easy access to cheap foreign sources and they could also take advantage of market imperfections. Consequently, these banks were very profitable.

Out of the five big SOCBs, the MKB was the first that the government offered for sale. The German Bayerische Landesbank and EBRD obtained, respectively, 25 and 16 percent stakes in late 1994 and mid-1995 (again, respectively). These two investors first purchased existing shares and then subscribed to newly issued shares. Another foreign investor owns 8 percent of shares, and the remaining shares are in domestic hands or in the bank's portfolio. After these transactions the extent of state ownership had decreased to 25 percent by 1995.

In 1994, 19.5 percent of the OTP's equity was offered for sale to Hungarian investors. A year later, another 21 percent of shares were transferred to Social Security and Pension Funds, and municipalities, while 20 percent were sold directly to foreign institutional investors, and employees purchased 5 percent. In 1995, domestic small investors purchased another 8 percent. These transactions resulted in revenues of HUF 10 bn (about USD 90 mn) for the government. (According to privatisation laws the state wants to retain 25 percent + 1 vote in the bank.) The reason why the OTP was not offered to foreign strategic investors was to enable this bank to retain its dominant position in retail banking.

In December 1995, the American General Electric Capital and EBRD purchased 32.5 percent and 27.5 percent of shares, respectively, of BB for a total of HUF 12 bn (USD 87 mn).[19] The Hungarian State had to buy back the Polgári Bank (a retail banking subsidiary of BB) from the new owners for HUF 1.1 bn (USD 7.3 million).

It was a generally shared opinion that the MHB and K&H were the two large banks in the worst shape of all the SOCBs in Hungary. Therefore it was a major success when the Dutch ABN-AMRO purchased 89.23 percent of MHB's equity for about HUF 14 bn (USD 89.23 mn) at 225 percent of the face value. (The MKB's shares had been sold at an approximately similar margin some years before, while the OTP's shares were distributed at 120 percent of their face value. The margin of BB's shares is not easy to assess because of other provisions in the contract, but in the first round it was roughly 100 percent.) Shortly after the privatisation, the Dutch investors increased the equity of the bank, and MHB became a really big bank again. In the privatisation contract the new owners promised a capital

[19] In 1995 the SPA transferred to BB capital reserves of HUF 12 billion in order to increase the warranty capital of the bank. Decision-makers expected that it would be possible to reach a better price by doing this.

increase of USD 100 mn by the end of 1997. It seems that MHB will become one of the major banks in the Hungarian market again, as it was in 1987.

In the spring of 1997 the Deutsche Genossenschaft Bank purchased a 61 percent share (HUF 818 mn) of the Takarékbank (Savings Bank) for HUF 4.4 (DM 41.3 million), at 532 percent of the face value of the shares. After this transaction the Hungaria Insurance Company had the task of subscribing shares of the bank according to an agreement among the current owners. As a result of this capital increase the insurance company obtained 5 percent of the shares. Employees can also subscribe to 5 percent of the shares with a 50 percent discount. The German owner (which is also a cooperative bank) provided strategic voting rights for the Hungarian cooperatives in the management of the bank making their position equal to that of a golden share. The current stake of 32 percent of Hungarian cooperatives will decrease to 23 percent as a result of the annual increases of the equity. Takarékbank currently has about 5.4 percent on the money market, and a share of about 15 percent in the retail (household) market.

The privatisation of the K&H started in 1997. Although the management of K&H sought to imitate the strategy of the OTP's management, the government was eventually able to resist and a significant stake of the bank's shares were offered for strategic investors. Two bidders were selected from five applicants in the first round of the tender. The strategic investors were expected to buy at least 25 percent plus one vote. Finally, the consortium of the Belgium Kredietbank and the Irish Irish Life insurance company obtained 10 percent of the shares (HUF 1 bn) for USD 30 mn at 567.3 percent of the face value. As with the case of the MHB, the government did not have to provide any special guarantees apart from the regular ones. The new owners will increase the equity of the bank by USD 60 mn by the end of 1997 at 105 percent of the face value. The EBRD has a swap option amounting to USD 30 mn. The employees can also purchase bank shares up to a value of HUF 519 mn. If all these transactions are carried out the bank will become the second largest commercial bank in Hungary, and the share of the consortium of the new owners will be around 45–48 percent. The remaining stake of the state of HUF 4.5 bn and HUF 3.115 bn of social security will be introduced on the stock exchange. The government hopes that this transaction, as well as the privatization of some smaller banks, will be completed in 1997.

Some lessons can be drawn from the experience of the privatisation of the large SOCBs: (1) the state has to take an active role in the privatisation of SOCBs; (2) the better the banks are prepared for privatisation and the more thoroughly the tender is organised, the more the benefit is felt by the state as well as by the banks; (3) competition for buying a bank should be maintained until the last round of the sale; (4) after portfolio cleaning, recapitalisation and restructuring, SOCBs must be privatised as quickly as possible; (5) if there is just one interested buyer, flexibility on the seller' side is crucial in order to avoid detrimental strategic behaviour by the buyers; (6) the government must resist pressures from political or interest groups.

The rival private banks (including already privatised SOCBs) will obviously lobby heavily against any deal because they do not want to see another strong competitor on the market.

Assessment and policy recommendation

With all of its defects, in many respects Hungarian bank restructuring has been able to meet its main aims. Although at a high cost, the bad debts of the SOCBs have been carved out. (*Table 8* provides a summary of the various stages.) As a result of various credit and bank conciliation schemes the portfolio of the SOCBs has resulted in lower lending rates in real terms and a narrower margin (see *Figures 1* and *2*). In 1994 consolidated banks had a positive cash-flow, and became profitable. This may have contributed to the fact that all major SOCBs have now been privatised. In order to cover, at least partially, the expenses of various schemes, the Treasury has been able to collect some revenues from the privatisation of SOCBs as well as increasing profit taxes. Since major banks are in foreign hands, the state has no direct control over credit allocation. For Hungary, as a small country with an open economy, the free flow of resources may substantially assist in the improvement of the allocative efficiency of the market.

The restructuring of the banking sector has taken place gradually. The whole process covered 18 banks altogether. Three big ones participated in all stages, seven in two, and eight banks in one phase only. This gradualism roughly corresponds to the Hungarian tradition. Nevertheless, in this special case, gradualism was not efficient. If banks had started their restructuring in 1992–93, the transformation of the banking sector would perhaps have been cheaper. Many authors argue that the stock problem was dominant, and the deterioration of the portfolio of the banks was a consequence of external economic or political factors, or it can be explained by changes in the system of regulation. According to Balassa (1995) the cost of the credit and bank conciliation could have been, in an optimal case, 20–25 percent lower. The lengthy multi-stage procedure is also now considered as a main reason for the high expenses. Without the consecutive stages, the moral hazard of various agents, especially commercial bankers and firm managers, could have been avoided. When some details of the debtor consolidation programme for businesses became known in the autumn of 1993, firms started to stop servicing their debts. In the case of the MHB the end of the year the interest payment and bank fee arrears of debtors had increased by fifty percent, compared to the end of 1992. According to some anecdotal evidence fraud at banks could not be excluded either. According to a report of a large SOCB prepared in early 1994, the loss in the whole banking sector due to fraud could amount to HUF 20 billion. These costs, being not properly identified, could not be excluded either.

Bond financing of these schemes was not the best choice either. Probably for political reasons, the interest payments on consolidation bonds started only in the spring of 1994 (when the mandate of the conservative government expired). Between 1994 and 1996 the MoF paid out interest of HUF 54.47 bn, HUF 96.61 bn and HUF 78.04 bn, respectively, on consolidation bonds.

The rules of the game matter a great deal. Regulation plays an important role. As most of the decisions were made by the Ministry of Finance, the fiscal considerations dominated the whole process. As *Tirole* (1994) and *Dixit* (1996) point out, in the case of multitask agency problems, the control of public enterprises (in our case SOCBs) can best be performed if multiple principals with different objectives are created. In this situation, as has been shown, external discipline, competition or transparency may also help in overcoming difficulties. When, under external pressure, the Banking Act and various elements of prudential regulation were introduced, the SBS gained more ground and could at least, to some extent, counterbalance the interest of other government agencies, even if the SBS did not perform perfectly.

On the other hand it was, in our opinion, a mistake to adopt BIS rules gradually. Moreover, the eight percent CAR for banks as a criterion for prudential operation became a fetish. For the government, this view could simplify bank restructuring to a one-dimensional issue which was relatively easy to handle. Nonetheless, the failure of small banks after their recapitalisation clearly shows that it is not true that below eight percent CAR everything is wrong and over eight percent CAR everything is fine. Dewatripont and Tirole (1994) treat comprehensively the problem of banking regulation, although in a different set-up. However, the practice of the Hungarian government corresponded to one of their findings. In macroeconomic recessions aggregate shocks may hit every bank simultaneously and therefore a temporary waiver of the eight percent CAR requirement can be advantageous.

The Hungarian banking sector has gone through significant changes. In many respects success has been achieved, but the bill has also been sizeable. Hungarian firms use less bank credit than their counterparts in other countries. This clearly shows that inflation should have been and still must be taken more seriously. Nonetheless, banks are supposed to, and hopefully, as a result of the consolidation measures, will take an active part in financing the economy in the future.

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AGRICULTURAL INVESTMENT AND UTILIZATION OF CENTRAL RESOURCES

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Agricultural investments fell back, considerably, in the first years of the nineties with the lowest ebb in 1993. A huge number of agricultural entrepreneurships which had formed at the time of the changing of the plant and ownership system were not able, from their own sources, to renew the technical basis and thus create a suitable background for farming. Also, technical bases were seriously endangered in many fields. Appreciating these difficulties decision-makers have developed various projects in order to encourage agricultural investments. Although the growth in agricultural investments since 1994 cannot compensate for the failure of developments in previous years, nevertheless it is a movement forwards and away from the earlier situation and indicates the growing activity of those who are involved in economy.

Agricultural investment

Investment in the 1980s

Agricultural investment took a downward trend in the early 1980s. The volume of investment between 1981–1985 dropped 14–15 percent at a comparative price against the previous five-year period. After a temporary boom in 1986–1987 generated by the Congress of the Hungarian Socialist Workers' Party, investment plunged. Except for this two-year period, the real value of investment also shrank. Comparing the periods 1981–1985 and 1986–1990, the drop was a total of 12 percent (Vissy-Takács 1985). Owing to the state of investment as described above, obsolete and worn out equipment was impossible to replace after 1983. In three-quarters of agricultural organizations the value of depreciation exceeded that of investment. On the other hand, withering investment released reserves and thus rationalization resulted in more efficient development.

The lack of development can be traced back to several causes. One was that, owing to cuts and an increase in the price of agricultural inputs as well as to efficiency problems, the profitability of agricultural enterprises dropped drastically in the 1980s while a tax was levied on investment. From the mid-1980s, agricultural companies were free to use depreciation to cover their losses. This snatched resources from development. Another important factor was the serious cuts in subsidies for agricultural investment during the 1980s coupled with an increasingly stringent fiscal and monetary policy. This made access to credits for agricultural businesses increasingly difficult. A large portion of investment was concentrated in development schemes supported by the World Bank.

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Investment between 1990 and 1995

In the first half of the 1990s, the reduction of agricultural investments continued and this process actually accelerated between 1990 and 1993. Owing to the strengthening support of investments and to a certain degree of stabilization in the transition process of the agricultural sector, investment activities took an upswing in 1994 followed by additional increases in 1995 and 1996. However, excessive utilization of equipment and the failure to replace and repair this equipment has had very serious ramifications to date. In 1987, agricultural investments contributed 12 percent to the total investment of the national economy; in contrast this contribution had dropped to below 5 percent by 1991. Despite subsequent enhancement, the trend could not be curbed and agricultural investment amounted to no more than 2–3 percent of total investment in 1994 and 1995.

The collapse of investment in the early 1990s (1990–1993) can be attributed to several interrelated causes, each stemming from an unfavourable economic environment:

— Profits of agricultural enterprises dropped drastically in the early years of this decade.

— While no capital injection was given to a large number of agricultural enterprises, revenues were continuously withdrawn from the branch of the economy owing to the implementation of the Compensation Act and the Act on the Transformation of Cooperatives; thus there were many uncertainties in agricultural operating conditions.

— By the beginning of 1994, about 600–700 agricultural companies were subject to bankruptcy procedure. Approximately 40–45 percent of the agricultural cooperatives and two-thirds of the state farms went bankrupt or near-bankrupt. Consequently, hardly any fixed assets were produced before 1993. At that time, foregone expenditures on development amounted to HUF 70–100 billion. Mounting liquidity pressures forced agricultural enterprises to use an increasing portion of depreciation for financing current expenditures. Agricultural investments which took place by the end of 1993 were *ad hoc* instead of being part of a long-term strategy.

— In the wake of the implementation of the Acts on Compensation and Cooperatives, land ownership and land use were increasingly separated. This made the establishment of agricultural enterprises more difficult and hampered, over the long term, the efficiency of existing ventures. The same applies to the Land Act, which bans or limits proprietorship and allows a maximum of ten years of tenancy.

— Achievements were modest as regards development of the market and its institutions (*Lányi and Fertő* 1993).

— Investments were impaired by the deterioration or disappearance of the relationships between agricultural and food industrial entities.

— Owing to the processes described above, a large number of agricultural businesses became insolvent by 1992–1993. Commercial banks considered businesses belonging to an unstable agricultural sector and crippled with financial difficulties to be high-risk debtors. This view was reinforced by the lack of transparency of relationships with suppliers and customers within the sector as a result of the transformation of operations. Some of the banks therefore tried to withdraw from financing the agricultural and food sector. However, because they lost the most of their agricultural links, banks have been unable to restore their agricultural financing activity despite the fact that operating systems as well as suppliers have started to become more clearly delineated. An indispensable prerogative for long-term (investment) credits for agriculture is the introduction of the land mortgage system and its institutions—a step which has been very slow to come. Uncertainty surrounding the ownership of land was another serious obstacle barring agricultural companies from credits.

— In the early 1990s, the major problem for agriculture in terms of the sector's relationship to the budget was not primarily the decrease of subsidies; rather, it was the shrinking of the real value of agricultural support. At the same time, investment subsidies were also clipped.

— The price of investment goods increased substantially in the early 1990s. While the liberalization of imports significantly facilitated the procurement of assets, their price was still a major obstacle for prospective buyers.

Summing up the details given above, agricultural investment downtrended significantly in the early 1990s (between 1990–1993). The technical basis of agriculture was in a critical situation in many operations. Investment bottomed in 1993 when the total value of projects accomplished during the year amounted to only HUF 6.7 billion, or a quarter of the 1988 investments at a comparative price. This meant a 60 percent drop in contrast to 1992. It was a drop which exceeded by far the level justified by the transition, decreasing production owing to the changes in sales markets, and the need to find new functions to make up for those lost. At the same time, the ageing and deterioration of assets was extensive. It was obvious that agricultural operations would be unable to curb these unfavourable trends on their own. On the other hand, the progress of the change in ownership in the food sector resulted in a gradual comeback for several sub-branches, which cast a sharp light on the problems of connections between the food sector and agriculture. Tensions in agriculture hindered full exploitation of the market potential in the processing industry. It became a major task for the investment subsidy system to create scope for the movement for businesses which were capable of looking into the future, and also to make this expanding entrepreneurial stratum conspicuous for the banking sector. Aware of this difficult situation, from 1994 decision-makers started taking steps to promote agricultural investment. The role of development support within the subsidy system increased. These measures contributed to the expansion of agricultural investment. The value of investments accomplished in 1994 reached HUF

13.4 billion at current prices (compared to HUF 7 billion in 1992 and 6.7 billion in 1993). Investment further increased in 1994. Its value amounted to HUF 18.8 at current prices, which increased to HUF 46 billion in 1996. This, however, is only enough to replace currently operating assets over a period of ten years.

Changes in the structure of the agricultural support system

In the second half of the 1980s and until 1991, expenditure on support for the food sector decreased substantially. This can be explained by the weakening of the agricultural lobby, the unveiling of efficiency problems within the industry, a structural change in exports (with the gradual disappearance of heavily subsidized exports denominated in roubles), and the liberalization of prices. Support from the budget for agriculture was again cut in 1992 (support being HUF 36.9 billion in that year), then it started to pick up in 1993 with HUF 50.0 billion, followed by HUF 74.3 billion in 1994 and HUF 73.3 billion in 1995. Due to the increase of prices, this rise in subsidies only partially increased the real value of agricultural support. The renewed expansion of support was to a great extent due to the fact that by this time the drop in agricultural production resulting from agricultural transformation reached exports and the country's need for currency improved the chances of support for agricultural exports. On the other hand, the problems of raw material production became so stringent that additional resources inevitably had to be involved if a slide in the quality of livestock production was to be avoided and agricultural production stabilized. It was also necessary to give a boost to agricultural investments which had been stalled for years.

The structure of the agricultural support system has been going through a gradual transformation since the early 1990s owing to changing economic priorities and the creation of a market economy. 1. *Price subsidies* which essentially preserved the situation of the industry were gradually dismantled. 2. Since 1993, a growing significance has been allocated to *export subsidies* as a result of the appreciation of agricultural exports; indeed the largest portion of the full amount available for support has been used for this purpose. 3. Another important feature of support was the so-called *intervention allocation*, which theoretically allowed state interference which was in accordance with the market. Together with export subsidies, market intervention amounted to over half of the full support in 1994 and 1995. 4. Sensing the problems of finance across various production systems and the partial collapse of high quality production, *production and income supplement support* has been increased since 1994. 5. In the wake of the agricultural transformation, new entities were formed and these had to be equipped. As mentioned above, *agricultural development support* aimed at the renewal and upgrading of ageing assets and facilities has become increasingly important since 1995, together with the so-called

"reorganization subsidy". The latter is aimed at the utilization of assets belonging to state farms and cooperatives. Various schemes, such as the reorganization subsidy and the Agricultural Development Fund were created; these are described in detail below.

Experiences of development support schemes

Support for promoting the reorganization of the agricultural sector

Aimed at promoting the structural and organizational transformation of the food sector, support for reorganization was first launched in 1992. The scheme was made imperative by the agricultural transformation which jeopardized a large number of assets, primarily livestock farms. The mobilization and renewed involvement of these assets had to be promoted through central allocations. Undercapitalization, a phenomenon widely prevalent in agriculture, coupled with the financial problems of old and new agricultural enterprises called for a special method of support. This method allowed the utilization of assets in a new structure and it transferred to the state a proportion of the interest costs—which were extremely high against the profitability (and load-bearing ability)—of the sector. In other words, if an enterprise considered purchasing certain assets, it was granted access to credits whose interests were for the most part covered by the national budget.

Banks also had to be made interested in extending reorganization credits. In order to alleviate the risks undertaken by financial institutions willing to offer this scheme, a Credit Guarantee Fund for Agricultural Enterprises was created with the assistance of the PHARE Programme. The Fund undertook guarantees on reorganization credits and on half of the interest payable for the first year. Credit coverage was assisted by the refinancing loan of the National Bank of Hungary—this amounted to a quarter of the reorganization credits. Credits were drawn from the European Bank of Reconstruction and Development (EBRD) with the government's guarantee; this became another important contributor to long-term agricultural credit sources. Commercial banks (a total of four) which met the EBRD's conditions received allocations from this credit scheme.

Applicants for reorganization support had to submit an application for long-term credit to a commercial bank participating in the scheme. A business plan, own resources, collateral, etc. had to be documented. The purpose of the credit was obviously the procurement and involvement of assets described in the programme. The application was rated by the bank and in the case of a favourable decision, a commitment was offered. Reorganization support could be applied for by completing a special application form in conjunction with the bank's commitment. The bank submitted the documents to the Inter-Ministerial Reorganization Committee

whose members were: the Ministry of Finance, the Ministry of Environment and Regional Development, the Ministry of Labour and the Ministry of Agriculture. The Committee assessed the applications and notified the banks of its decision. In the case of a favourable outcome, the bank concluded a credit contract with the applicant and opened the credit line and notified the Committee to that effect. Agricultural entrepreneurs could request support on the relevant form submitted to their local tax authority.

The subsidy scheme promoting the reorganization of the food sector has changed slightly in terms of means and objectives, but the main components of the reorganization support in terms of entitlement remain the following:

1. Natural persons considered Hungarian residents in accordance with the currency regulations;

2. Business associations and forest ownership associations whose majority owners are natural persons;

3. Transformed cooperatives with the majority participation of natural persons as well as business associations established and owned by a majority of such cooperatives;

4. Agricultural and forestry organizations where the state retains to some extent long-term ownership.

Two kinds of support appeared within the reorganizational scheme: *interest support* (which has been operating since 1992), and *non-refundable support* or aid (which operated between 1993 and mid-1995). In addition to interest support, an entrepreneur who started business within one year prior to submitting an application to a bank—and since 1994, all entrepreneurs who operate in an economically backward area—are eligible for non-refundable support also. The latter amounts to a maximum of 10 percent of the reorganization credit.

Operation of the reorganization programme. In 1992 banks offering the reorganization credit instrument granted commitment to some 200 projects, which were in turn passed on to the Inter-Ministerial Reorganization Committee. The new scheme worked in fits and starts at that stage, slowing down the contracting procedure. Consequently the majority of the HUF 1.5 billion undertaken by commitment was only allocated in 1993 to entrepreneurs setting out to reutilize cooperative assets. The total expenditure on reorganization credits in 1992 was HUF 33 million.

The reorganization scheme was expanded *in 1993*. The circle of applicants was more clearly delineated and application objectives extended. In addition to the reutilization of cooperative assets, purchase of assets from agricultural and forestry state farms or their legal successors was also made possible by the scheme. This is the time when non-refundable support was first granted. A decree was issued providing for subsidized reorganization interest for projects which aimed

at at least 25 percent of developments which had emerged from the large food industrial enterprises after decentralization and privatization. (This was the so-called "reorganization proportion".) In 1993 HUF 3 billion was available for the expanded scheme. In the course of the year subsidized reorganization interest was made accessible to applicants involved in the decentralizing privatization of grain, meat and dairy operations.

In 1993 the Inter-Ministerial Reorganization Committee dealt with over 1,100 applications. A total of HUF 15.6 billion was awarded to successful applicants as long-term credits. If the businesses' own resources are included, this meant that altogether HUF 22.3 billion was used for reorganization and development. The scheme contributed to saving jobs. Owing to a delay of up to 4 or 5 months between drawing the credit and interest payment on the one hand, and the drawdown of support on the other, HUF 1.8 billion was extended as reorganization support in 1993. This meant a saving of HUF 1.2 billion out of the HUF 3 billion available in total; the saving could then be deployed in other areas within agriculture.

In 1994 the reorganization scheme was further expanded by allowing enterprises (former state farms and forestry operations) which remained entirely or partially in state ownership to apply for an interest subsidy on credits for self-reorganization. In this way, these operations could upgrade their own assets and add new ones within the framework of the reorganization scheme. The order of applying for non-refundable support was changed. From 1994 start-up private businesses, as well as entrepreneurs operating in economically backward communities, could request that 10 percent of the credit in their project be allocated as an instant non-refundable support. Banks forwarded almost 800 applications to the Inter-Ministerial Reorganization Committee, which accepted about 700 of them. While the number of projects submitted dropped, the size of credit requested and granted per project increased (due primarily to the need to buy more expensive assets in the food sector). Consequently, the amount of reorganization credits reached HUF 15.5 billion in 1994. With the mobilization of the businesses' own resources and assets, the total development during this period amounted to HUF 44.1 billion. The amount of support called for during the year was HUF 5 billion.

According to the Ministry of Agriculture, *in 1995* HUF 8 billion would have been needed to continue with the scheme. Nevertheless, only HUF 6.5 billion were approved. This curtailed amount would have only been enough to cover the interest subsidy on projects approved in previous years and therefore the Ministry reallocated its resources. HUF 800 million was transferred from the intervention funds. Still, the HUF 7.3 billion made available in this way were only sufficient to finance 300 new projects. Coupled with a drastic limitation of objectives to be supported (due to the unavailability of funding), this was a serious hindrance for new applicants. From mid-1995 assets sold within the framework of the decentralizing privatization of the food industry were deleted from the set of objectives to be supported; non-refundable support to starting businesses and entrepreneurs

operating in economically backward regions was abolished; self-reorganization was no longer to be supported; interest subsidy on assets purchased from businesses in the process of liquidation was done away with; support for the refurbishing and upgrading of used assets was cancelled; and eligibility was narrowed.

As a result of these constraints, the real expenditure on reorganization (HUF 7.47 billion) involved about HUF 7.3 billion in terms of budgetary resources. This allowed HUF 4.8 billion to be allocated as credits. Together with the businesses' own resources and assets, this accounted for HUF 12.9 billion going to developments.

In 1996 no new projects were accepted under the reorganization scheme. Only those applications were dealt with which had been submitted prior to December 31st, 1995 but not assessed because of a lack of funds.

Evaluation of the reorganization scheme. During the period between 1992 and 1995 a total of 2,664 projects were submitted, of which 2,448 were accepted and some 2,200 are still running. About 200 projects had been accomplished, repaid before the due date, or stopped (owing to bankruptcy, etc.). On the basis of the projects still in process, the total amount of credit allocated was HUF 35.3 billion for a term of 5 to 7 years. Starting enterprises and businesses in backward regions received non-refundable support totalling HUF 369.2 million. The total amount of the applicants' own assets and resources involved in developments was HUF 52.6 billion. All told, assets amounting to HUF 88.9 billion were mobilized for reutilization, upgrading and purchases. Unutilized assets totalling HUF 59.1 billion were re-involved as a result of reorganization with the following breakdown: HUF 36.2 billion cooperatives assets, HUF 19.3 billion state farm assets, and HUF 3.6 billion food industrial assets. The interest subsidy on credits under the reorganization scheme amounted to HUF 30.2 billion. Of this, HUF 9 billion will be due between 1997 and 2000, upon the maturity of the last reorganization credits.

All things considered, the reorganization programme of the agricultural branch (with the interest subsidy and the non-refundable credits) *more or less reached its goal.* It expedited the reutilization of unexploited state and cooperative farm as well as food industrial assets (particularly of buildings and durable assets). At the same time, it promoted the utilization of entrepreneurs' tangible assets, the reconstruction and upgrading of used assets, the preservation of both existing and newly-purchased assets and a general and healthy change in the ownership and user structure of agricultural and food processing assets. In addition, it helped alleviate employment problems within the sector.

The budgetary resources deployed in the context of the reorganization scheme had a significant impact upon entrepreneurship. Besides mobilizing the businesses' own resources they promoted a more efficient use of existing assets. The new business structure, if viable, improved operation. In the majority of the cases

efforts were aimed at not merely acquiring support. The reorganization application had to be preceded by an application for a bank credit. Inclusion of the banks as intermediaries put caution into the scheme from the outset.

Of the projects considered by the banks 91.9 percent were accepted. Ninety percent of them are still running. Some of the credits have been repaid before maturity and the rate of accepted projects which have failed is under 10 percent. The figures suggest that the majority of projects which passed the initial filtering are viable and the applicants service their debts in a timely fashion.

Whereas banks tend to shy away from the financing of agriculture, they have been willing to participate in the reorganization scheme, particularly as they were in control "from moment one", being the first entities to rate, then pass on the project documents. Coverage for projects was also available and the heavily subsidized interest made a successful accomplishment more for the businesses.

The reorganization scheme contributed to *the structural change of agriculture*. Agribusinesses had access to long-term credits with an affordable interest, which laid the basis of future development for several operations. Criteria of eligibility helped smaller businesses to ascend and gain strength.

Similarly, according to the figures, the reorganization programme boosted the structural and ownership change in livestock farming. The change in ownership and continued operation of the biggest livestock farms put the brakes on the deterioration and loss of high quality breeding stock. In addition, the scheme had an impact on the restructuring of the infrastructure of agricultural production (e.g. storage facilities, mixing plants, etc.) and promoted ownership change. In contrast, it played a lesser role in the reallocation of machinery and equipment.

Agricultural Development Fund (Agricultural and Forestry Fund)

To energize agricultural investment which had shrunk to a fraction of its former value, a tool was needed which set policy guidelines and promoted small- and medium-sized agribusinesses (SMEs). This tool emerged in the wake of the changes in the sector when, in 1993, the Agricultural Development Fund (ADF) was created. Refundable and non-refundable resources of the ADF (from 1995, of the Agricultural and Forestry Fund, AFF) were allocated on an application basis. The following development goals had a priority: 1. Starting and developing agricultural SMEs; investments necessary for pursuing the basic agricultural activity. 2. Infrastructural development (e.g. water and power supply, farm drives, crop storage, etc.) necessary for continued agricultural activity. 3. Development and application of the biological basis (e.g. high quality breeds, propagating materials, seeds, etc.). 4. Promotion of forestry. 5. Development of the agricultural extension system. 6. Interest subsidy on credits needed to make purchases for development.

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Businesses eligible for funding included business organizations (companies), sole proprietorships, small scale farms, service providers and cooperatives where sales per year did not exceed HUF 150 million and the planned investment was not less than HUF 500 thousand but did not exceed HUF 60 million over a period of two years. These terms ensured access to funding for SMEs engaged predominantly in agricultural activities.

An apparatus was set up by the Ministry of Agriculture to administrate the Fund. Projects were rated by the Agricultural Development Committee attached to the Ministry, whose job it was to assess larger projects after 1994 (i.e. projects aimed at investments exceeding HUF 1 to 2 million, then HUF 5 million after 1995). Smaller scale projects were assessed by the county Agricultural Offices. Funding contracts were concluded by the National Development Institute and funds were channelled through designated commercial banks. The following types of support were offered by the Fund: interest subsidy, interest-free refundable capital loan, and non-refundable support. Applicants had to undertake an obligation to repay refundable loans. The investment, i.e. the plantation or tangible assets, were mortgaged. The subsidized funding extended by ADF was guaranteed by the Agricultural Enterprise Credit Guarantee Foundation. Allocations of ADF and investments under the projects awarded funding were supervised by the National Development Institute, the Ministry of Agriculture, the county Agricultural Offices and the village extension officers.

The Agricultural Development Fund was launched on January 1, 1993 but it did not start operating until the second quarter. In the first year 1,644 projects were submitted of which 1,351 were awarded funding. About 200 accepted projects were shifted to 1994. The ADF disposed of a total of HUF 4 billion in 1993. Non-refundable support could be requested amounting to half of the costs of investment into production (i.e. into buildings, equipment, plantations, forestry machines, etc.). Refundable loans could be requested amounting to 40 percent of the costs of development of services related to the basic agricultural operation. Non-refundable support was available to the amount of 40 percent of the costs of infrastructural investments (e.g. water and power supply, telecommunication, storage facilities, etc.) and 30 percent of farm road construction costs. In addition, the interest was subsidized on 50 percent of long-term stock financing (with a term of over 1 year) and investment credits drawn from banks.

The first months of operation of the Fund were surrounded by a great deal of uncertainty. It was conspicuous that the change in structure and ownership was still in progress and entrepreneurs who were otherwise eligible often could not decide whether or not their venture was viable in the long term. Thus despite ample and timely information, it was not until the second semester that projects started coming in. Businesses' own resources were scarce and often they were unable to present the coverage required for commercial bank credits which could have involved subsidized interest. Credit and support terms were not attractive

and elaborate enough to push large numbers of (starting) small- and medium-sized agribusinesses towards development. Therefore the support paid by ADF by the end of 1993 amounted to HUF 625 million, leaving the bulk of funds available (i.e. HUF 3.375 billion) unused.

The amendment introduced *in 1994* brought significant changes in the operation of ADF. As the Fund initially did not fulfil expectations, developments plunged to an aggravating level in 1993. Stronger motivating forces had therefore to be implemented to reserve this trend. In 1994 ADF received HUF 6 billion from the national budget and an additional HUF 3.9 billion were transferred from the Telecommunications Fund. While the 1993 support scheme was still in place, a new element was introduced whereby applicants could request additional one-time non-refundable support amounting to 30 percent of the development expenditures but not exceeding HUF 500 thousand. The assessment system was also changed: while in 1993 all projects were rated by the Agricultural Development Committee in the Ministry of Agriculture, from 1994 smaller projects were assessed by the county Agricultural Offices.

These new elements boosted the number of applications—primarily of smaller scale projects—submitted to the count offices. Ninety percent of these projects were awarded support. In order to filter out applications aimed at securing the HUF 500 thousand "free money", which required no guarantee, assessment of projects was suspended in late April and criteria were tightened. (For instance, vehicle purchase was deleted from the scope of support and a quantified statement of the ability to repay the refundable support was required.) Funds allocated to ADF were depleted by July. As a result about 500 applicants whose projects were awarded support received a commitment granting funding in 1995.

The approximately 7,000 approved projects envisioned a total investment of HUF 13 billion. The value of investment per project was HUF 1.5 million at the level of the county Agricultural Offices and HUF 4.8 million at the level of projects assessed by the Ministry of Agriculture; the average was HUF 1.8 million per project. Although the support per project was lower compared to 1993, the level of support to development increased to more than 70 percent. The breakdown of the support was as follows: 31.6 percent one-time non-refundable support, 61.6 percent interest-free refundable support and 6.8 percent non-refundable support.

Own resources contributed 21 percent to 1994 investments promoted through the Agricultural Development Fund, in addition to 70 percent various support schemes and 9 percent bank credits. The low rate of bank credits is explained by the fact that most projects indicated smaller investment figures not necessitating bank loans; on the other hand, banks tend to be unwilling to lend to small and risky businesses. The structure of resources differed at the level of the counties and the Ministry. In the case of larger projects assessed by the Agricultural Ministry the proportion of own resources and bank loans was higher, and support was requested primarily to avoid heavy involvement of own resources and bank credits.

The majority of projects relied on carefully conceived long-term economic considerations. On the other hand, the average investment of projects submitted to the county Agricultural Offices was lower with very modest own resources and bank loans. This is explained, apart from the poor credit rating of small farms and agribusinesses, by the fact that the projects' main intent was to secure short-term supplementary funds (of HUF 500 thousand) or interest-free refundable support. The majority of projects accepted in 1994 were targeted at crop production with livestock farming featuring much less prominently. Similarly to 1993, the main reason was low profitability and insecure markets in the livestock sector, coupled with the need for sizeable capital in the long term. The majority of projects therefore aimed at procurement of basic machines and equipment in field crop production in order to promote a quicker change in the product structure.

The year 1995 brought new changes in the Fund's operation. The Agricultural Development Fund and the Forestry Fund were combined under the name Agricultural and Forestry Fund (AFF). The scheme continued to be the most important promoting force for agricultural investment. One of the most important new features of AFF was the withdrawal of the one-time HUF 500 thousand support. Furthermore, investment support for machines was shifted to another subsidy scheme. The practicality of projects improved and long-term business considerations were clearly coming to the fore.

The efficiency of the scheme was hindered by the fact that it was not until April that the law pertinent to its implementation was promulgated and consequently the call for projects was issued late. Projects submitted in 1995 were not assessed until the second half of the year, as applications which had already been awarded support in 1994 had to be dealt with first.

A number of projects receiving the Fund's commitment in 1994 had no hope for support from the AFF because these particular projects intended to purchase agricultural and power machines—a project goal which in the meantime had been dropped from the scheme. Applicants requesting funding for projects not involving machine purchase were to reiterate their intent to invest and had to submit additional data. Rating of new applications was delayed until late October, thus contracts were signed only in late November early December. This meant that allocations were paid and investments started only in 1996. About 85–90 percent of the applications were deemed worthy of support. Half of the applicants were business organizations and one-fifth were cooperatives. Increasing participation of cooperatives was made possible by the fact that while there was no limitation with regard to the sector of operation or type of business, the maximum amount that could be applied for was HUF 20 million in 1995; this prevented the larger businesses' disproportionate dominance within the scheme. Seventy-four percent of the applications dealt with at county level were submitted by sole proprietors. Cooperatives and business organizations still represented a modest weight, although their proportion increased to some extent (to 7.4 percent and 17.3 percent respectively). Similarly

to its predecessors, the AFF maintained the principle of supporting starting businesses in 1995. On the whole, the government's intent to support investment met with the demands on the business and farming side. Rejection of projects occurred purely for professional reasons rather than on the grounds of insufficient funds. A large proportion of the projects were well-conceived and carefully prepared.

The businesses' own sources represented over 40 percent in the funding of the AFF projects, which was twice what the amount demanded by the relevant decree. Businesses which had adequate capital (at least in terms of the planned investment) were most numerous with applications made at both county and Ministry levels. Banks appeared more willing to contribute to financing projects initiated by stronger entities as the proportion of bank credits increased in 1995 (in contrast to 11.98 percent at the Ministry level and 3.35 percent at the county level in 1994, it was 26.9 percent and 13.9 percent respectively a year later). On the other hand, smaller businesses still had a highly limited access to the scheme due to either the lack of sufficient collateral or reticent and clumsy bank bureaucracy. As a result, the average level of support was around one-third, or half of the level in 1994.

Approximately two-thirds of the accepted projects were aimed at developments in crop production and about one-third invested into the less profitable livestock sector. However, the increase in the number of livestock farming projects showed an upswing in willingness to invest in this area of production—a positive development considering earlier reluctance. Most of the crop production projects envisioned storage facility construction whereas livestock projects aimed at upgrading livestock housing.

The 1995 AFF scheme triggered a total of HUF 27.5 billion investment—over twice the previous year's figure (HUF 13 billion). The bulk of the projects (76–77 percent) belonged to the Ministry's sphere of competence (in contrast to 30 percent in 1994). This meant a definite shift towards larger scale (and often more viable and long-term) investment projects, while a large number of smaller projects were equally supported. About 80 percent of the projects required investments under HUF 10 million, or 30 percent of the total development. At the same time, investments exceeding HUF 25 million and representing 8 percent of the applications carried more than 50 percent of the total investment value. The bigger the investment, the lower the level of support. Entrepreneurs mobilized their own resources and obtained bank credits to an increasing extent. Thus the level of support dropped to 32–33 percent as against 70 percent in 1994.

In 1996 agricultural funds were cancelled. Nevertheless, the former AFF's objectives again appeared in various support schemes. Only preliminary data are available regarding the 1996 operation of the investment support system but it is already clear that there was a tremendous interest in investments into plantations and buildings which involved a fixed amount of support plus subsidized interest. After the invitation for projects in March, applications were stopped in April. Over 6,000 projects were submitted up to that point, aiming at HUF 39 billion investment and

HUF 19 billion support. Many of the projects were inadequately conceived. In the case of feasible projects, support could be a maximum of 18 percent of construction costs and 36 percent of plantation costs, contrary to the originally envisioned 20 percent and 40 percent respectively. The Treasury commenced contracting with successful applicants in June.

Assessment of the Fund's activity. On the whole, the Fund played an important role in giving a new impetus to drastically shrinking agricultural investment. In addition it promoted the relative stabilization of small- and medium-sized agribusinesses.

Checking upon investments was the task of the *institutional system attached to the scheme.* Supervision improved over the years and abuse of the system was kept to a minimum (2–3 percent). Supervision, on the other hand, pointed out that many applicants had no clear idea about the investment envisioned—primarily in 1993 and 1994—which caused serious problems and consequently undermined the businesses' ability to service their debts. It also transpired that applicants and the village extension officers helping them, as well as rating officers, had acquired a routine by 1994 and particularly by 1995; this improved project feasibility and quality of implementation. Timely repayment was expected in the case of 50–60 percent of the projects. Rescheduling or temporary suspension of repayment (for 1 or 2 years) was foreseen for a sizeable group—i.e. 20–30 percent of the projects. In some instances collection measures had to be taken.

The application scheme was subject to various degrees of *criticism.* Applicants generally endorsed it as being useful. Objections were related to the implementation rather than the intent. Many applicants complained of slow administration at the rating stage, which created a problem as input prices soared. A recurrent problem was that *the scheme was launched late each year*—consequently, applications were submitted, then rated in haste. Many projects were put off to the following year, which compounded the problems resulting from the chaos.

The ADF and AFF *managed to mobilize businesses' own sources as well as bank credits.* In 1993 support was one-third, in 1994 70 percent, then again one-third in 1995 of the total value of investment of accepted projects. Thus, except for 1994, the scheme engaged mainly entrepreneurial and, to a lesser extent, bank resources, merging together to double the support. In 1993 and 1994 commercial banks had only a minimum share in financing. The proportion of bank credits was well below 20 percent of the value of investment. This rate climbed somewhat in 1995 (to 23–24 percent) owing to the appearance of larger scale projects and also due to the fact that banks could involve more resources in funding projects, including those from the European Bank of Reconstruction and Development. The guarantee offered by the Agricultural Enterprise Credit Guarantee Foundation also had a positive impact. The attractiveness of application-based investments was

enhanced by the involvement of the state through the support, which in itself was a kind of guarantee.

The Fund promoted *transformation in the agricultural sector* in several ways:

1. Parallel with the transformation and refining of the application system the number of *businesses with a long look* increased among the applicants. Notwithstanding the high standards of many project implementations, particularly of plantations, the quality of developments did not rise in any spectacular way. Still, the scheme contributed to the structural transformation in agriculture as it allowed access to central funding for those businesses which have the potential to build their future in their own areas, even if for the time being their activity is not at the highest level.

2. The Fund targeted small- and medium-sized agribusinesses and thereby strengthened *middle peasantry and medium size farm operations*—both being scarce in Hungarian society. Their existence is vital for an agricultural system which should be capable of integrating into a market economy.

3. The years of operation of the scheme triggered a *mutual learning process* with the participation of agribusinesses, state administration, banks, etc., which not only enabled these agents to learn about one another's intents and aspirations (and thus making better deals with one another), but gave rise to *attitudes* which are indispensable in long-term for making serious development decisions.

4. The scheme acted as a *selector*. It is not only that non-feasible projects were not supported but also that it offered an opportunity to agents which were culturally suitable for implementing the projects.

5. Transformation of the food processing sector was promoted because a number of suppliers assisted by the scheme were stabilized and the marketability of their products improved. In this way the *domestic input relationships of* a strengthening food processing sector *were reinforced*.

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REVIEWS

ASPECTS OF TRANSFORMATION AND PUBLIC OPINION[1]

R. ANGELUSZ—R. TARDOS

In many respects Hungary is a case on its own among the East Central European post-socialist countries with respect to the antecedents of the change of regime. Although the same as in the other countries of the so-called "Eastern bloc", the relations of ownership were formerly modelled on what was basically a socialist (state-redistributory) paradigm representing a pragmatic economic policy. The latter was asserted with shorter or longer intermissions from the second half of the sixties, and it assigned a growing role to market coordination as well as, within certain limits, private property. By the seventies and eighties, the "second economy"—by-passing the official routes of state re-distribution and becoming ever more legitimate—had spread to such an extent that an influential line of Hungarian sociology, such as *Kolosi* (1987) and *Szelényi* (1990) had actually come to consider it a structural element. From the early eighties on, its traditional forms (such as the household economy in agriculture, small industry/retail trade or housing based on the owner's own resources) were accompanied, in addition to enterprise-based private business partnerships (namely, the equivalent of "household economy" for industrial workers), by more modern forms of enterprise and association in the form of civil law and limited liability companies; by the second half of the decade, private enterprises with more employees and a larger equity also appeared on the scene, albeit sporadically.

Given the above, it can be seen that Hungarian society was not completely unprepared for the radical transformation of ownership relations following the change of regime. According to certain surveys, some three-quarter of all households were involved in some form in the quasi-private second economy.

Public opinion was somewhat ambivalent even with respect to these early, "tolerated" forms of private property. The relevant survey findings corroborate such common wisdom as "Hungarians like *lángos* (fried dough), they like those who fry it less". This inconsistent attitude, not devoid of envy, was basically a response conditioned by the central equality ideal of the prevailing ideology. Many of the wage and salary earner public employees, who play an important part in shaping

[1]The present study is an abridged and somewhat amended version of „A piacgazdaság társadalmi megítélése" (Social assessment of market economy), a study prepared in the framework of the "Competing the world" research project of the Budapest University of Economics. The chapter on the assessment of the influx of foreign capital was omitted from the English version for lack of space.

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public opinion, have found it difficult to put up with the idea that "outsiders" with an inferior education should sometimes earn several times their pay.

Nevertheless, these adverse feelings were not persuasive enough to hinder the gradual expansion of the market sphere. The special resentment generated by the "*maszeks*" (i.e. the class of more or less envied and maligned private entrepreneurs who were tolerated despite the communist principles) was counter-balanced to a large extent by the fact that, in many areas, small production eased the typical shortage phenomena of the state sector. As for the other forms of second economy generating secondary income or allowing self-subsistence, these obviously met with more widespread sympathy, being profitable in one way or another to most families.

Development of market attitudes, 1988–1995

In Hungary it can be clearly shown that the move to market economy following the change of regime was anticipated by two to three decades of Hungarian reform policy. This passed through many smaller or greater phases of wave-troughs. This tendency towards reforms supporting market-oriented economic structures intensified with the aggravation of the economic crisis phenomena in the second half of the eighties. Instead of being considered a heretical tenet, the propagation of a market-oriented attitude had, by that time, become more and more integrated into official policy.

Contemporary survey findings corroborate this development tendency of mainstream public opinion. In 1988, a comprehensive survey carried out by the present authors queried attitudes to market economy, among other things.[2] Some of the questions of the relevant block recurred in later surveys. In addition to allowing a glimpse of opinions held on the eve of the change of regime, responses to these questions provided us with a certain insight into the dynamism of the public opinion which could be expected in the future.

Of course, no interpretation of the findings could be considered valid without taking into account the modification of the sematic contents of the statements in the questions which had occurred in the meantime. As for the more general first item—i.e. the restriction/liberalisation of market competition—the limits it refers to had obviously been stricter and more numerous in 1988, both with respect to the scope of market relations and the freedom of price and capital movements (i.e. stricter than after the change of regime). Consequently, the approval or rejection of the imposition of limits on the market did not imply to the same issues as it

[2]The survey on cultural-interactional stratification was organised by the Research Centre on Mass Communication between 1986 and 1988. The panel-type surveys were carried out with a sample of some 3000 people by TÁRKI (Social Research Informatics Centre) and were published in 1990, edited by *Andorka et. al.*

does today. Nevertheless, the findings in question merit our attention. The 2.59 average score in 1988 (*Table 1*) indicated that, at that time, many more wanted to free the market than to maintain the limits imposed on it. Opinions for and against liberalisation levelled very shortly after the change of regime—in fact, already by 1991—despite the relative novelty of the decisive wave of market liberalisation that had, at that time, hardly reached certain areas.

Table 1

Opinions concerning market economy, 1988–1995 (average score between 5 and 1)

	1988	1991	1993	1995
Market competition in Hungary should be limited	2.59	3.01	3.29	3.40
Loss-making plants should be closed down	3.76	3.72	3.35	3.43

The perceptible strengthening of market-restricting attitudes, already present at that time, was obviously not independent of the marked rise of inflation from 1988 to 1991; this rise exceeded wage growth by far (in 1991, the annual rate of inflation was near 40 percent). Another important difference relative to the Polish or the Czech cases was the absence of the obvious advantage intended for the benefit of everybody: namely, the rapid expansion and diversification of market supply. While in the latter countries price liberalisation put an end to everyday commodity shortages at a stroke, in Hungary, the improvement was undercut, so to say, by its having been anticipated by the earlier reforms. The specific dates when all this took place are also relevant. In 1991, Hungary had already been over the first shock: that is to say, illusions concerning the fast improvement of the economic situation of the country after the change of regime, the slow-down of inflation included, had been shattered (the taxi cabmen's blockade occurred in October 1990). Considering the overall situation, it is quite possible that the strengthening of pro-restriction attitudes had been driven to a large extent by such nostalgic motives as the restoration of central intervention in order to halt price increases.

The predominance of the same attitudes in 1993 and especially 1995 suggests a strengthening of the motives in question. Let us remark, however, that by that time market-principle-based regulations had actually made considerable headway, spreading to areas of the economy which had hardly been affected by it formerly (e.g. culture, health care). Adverse feelings generated by this last circumstance may have contributed to the fact that the demand for market control now became a priority issue for public opinion. The tendency in question is discernible in practically every social group, with special regard to the pro-market professionals: while in 1988 the members of the best-educated stratum took a definite stand against restrictive policy (average score: 1.80), by 1995, they, too, had become

highly uncertain on this issue (score: 3.03). Those who have consistently advocated the liberalisation of the market are probably most the "winners of the change of regime"—i.e. the most successful people in terms of income. The average score of those in the highest income brackets (the top 1 percent) is a mere 2.41. In other words, attitudes supporting restraint of the market are rare among this group.

The elimination of loss-making production and the closing down of loss-making plants had also been present among the earliest slogans of the reform movement. In 1988, and even in 1991, the majority of the survey subjects supported this demand. The coming into force of the Bankruptcy Act, triggering a huge wave of liquidations in 1991 and 1992, signified an important caesura in this respect: although the majority still consider the financing of loss-making operations unjustified, the rapid increase in unemployment has reduced consensus on this issue as well among others. The social distribution of opinions largely follows the usual pattern observable in cases in which there is a break with tradition—i.e. decisive action against loss-making operations is urged more by the younger and better educated groups than the older and unqualified ones, but differences by economic branches show a rather peculiar image. Until the mid-nineties, those employed in the non-productive branches (e.g. culture, health and social care) had been the most ardent proponents of liquidating loss-makers, but recent developments provoking significant redundancies in the state-financed areas of the tertiary sphere may well modify the picture.

Attitudes to private property under the first coalition government (1990–1994)

Data available to Hungarian empirical social research on the relationship of property and public opinion after the change of regime are rather scant, given the importance of this subject. We know of no investigations which have monitored changes in public opinion in a recurrent and systematic way throughout the entire period in question. However, the findings of various surveys on this subject (cf. *Vásárhelyi* 1990; *Hann and Laki* 1992; Andorka et al. 1990) are in good accord in many respects, highlighting as they do reservations concerning the spread of private property and the rejection of certain property forms.

> On the basis of a Median survey, in 1990 Mária Vásárhelyi reported on reservations concerning large private property. As the survey continued, Endre Hann and Mihály Laki pointed out that the aversion in question continued, and in some respects even intensified, after the change of regime. This was in spite of the fact that the population was not radically opposed to privatisation in general. The Andorka et al. survey, on the other hand, called attention to the contradiction that, although people normally accepted privatisation as such, they adopted a much more reserved attitude—particularly due to the fear of being made redundant themselves—when it was mentioned in relation to their own workplace.

Our own earlier surveys and eventual longitudinal data also provide certain addenda to these issues. From 1992 on, several of our surveys included statements relating to the desirable role of private property. The relevant findings confirmed the ambivalence of public opinion concerning this topic. Although people who would "base economic development on private companies" are somewhat more numerous than those opposed to this idea in principle, when it comes to large industrial companies, only a minority finds the predominance of private ownership an acceptable solution.

Table 2.1

Economic development should be based on private companies (percent)

	May 1992	Nov. 1993
Agreement	35	31
Undecided	35	35
Disagreement	20	23
No opinion	10	11
	100	100

Table 2.2

Private property should become predominant in large industry as well (percent)

	May 1992	Nov. 1993
Agreement	25	22
Undecided	30	27
Disagreement	34	42
No opinion	11	9
	100	100

The above findings can also be related to the conclusions of Andorka et al. quoted above—namely, that people adopt a much more negative attitude than would be expected on the basis of their general stance when it comes to the privatisation of their own company (i.e. their own workplace). Negative attitudes to the privatisation of big enterprises are likely to have been motivated to a large extent by the fact that, traditionally, the majority of the wage and salary earners used to be employed by these organisations, and ownership transition was frequently associated with the transformation of "in-house unemployment" into real unemployment.

From among the various forms of privatisation, typical market transactions based on tenders and auctions—i.e. sales to the buyer paying the most—provoked

the most aversion. From 1991 on, several surveys querying opinions concerning four competing options of the transformation of state property—i.e. cash privatisation with the attraction of capital, re-privatisation benefiting the original owner, ESOP (the employee share ownership programme), and the upgrading of state enterprises (with the assistance of competent managers) provided us with data on this. Under the Antall government, cash privatisation was the main form of privatisation of state enterprises—if only to increase the revenues of the central budget—(although one of the coalition partners, the Smallholders' Party, actually declared re-privatisation their main objective). Survey data, however, repeatedly confirmed that public opinion was most averse to this form. As can be seen from the details presented below, the choice of cash privatisation from among the four options exceeded 10 percent in a single case only. This negative attitude was most probably due, among other things, to widespread aversion to privatisation by foreign capital—superior in strength—and this can be seen in the survey data to be presented below. On the other hand, tender/auction privatisation has most probably been discredited to some extent by various anomalies, the manipulation of the tender terms, and instances of suspected corruption which have been disclosed by the press.

Ideas and conditioning regarding "just" privatisation, on the other hand, have also contributed to the decreasing popularity of the alternative in question. Many considered re-privatisation—to which government had recourse in exceptional cases partly for theoretical, but also partly for practical reasons—a well-justified measure of redress ("the original owner is due what had been earlier on taken away from him"). As for employee share ownership, this goes back to the old ideal of workers' control, espoused at one time by the reform circles as well. This idea was not far removed from the employees themselves who, although distrusting the earlier slogan "the factory is yours", had been watching privatisation transactions carried out "above their heads" with, at least, a certain degree of suspicion. According to the people's historically conditioned common sense of justice, cash privatisation was probably regarded as the least legitimate form of interference into established relations.

More comprehensive data regarding the four choices, however, are indicative themselves of certain reservations concerning private property. The combined choice of sales and re-privatisation—the two forms clearly associated with private ownership—hardly attained one quarter. This tendency was further strengthened by the fact that, of the remaining two choices, the item "upgraded operation of state property" received the most votes. (The relevant data will be discussed in more detail in the following section.)

Data provided by other surveys, on the other hand, suggest that relatively few considered the promotion of privatisation a priority issue. As for the priority ranking of the problems to be solved by the government, the proportion of those considering the "restoration of the prestige of private property" (or the "significant increase of the role of private property"—an equivalent item in another survey) the

first and foremost task was negligible, and relatively few assigned it any priority at all (or ranked it after such problems of more personal relevance such as fighting inflation, poverty etc.).

Table 3

Percentage distribution of "restoration of the prestige of private property" being mentioned among the priority tasks

	Jan. 1991	May 1992	Nov. 1993
Top priority	4	3	2
Priority	36	21	19
Not chosen	58	73	76
No opinion	2	3	3
	100	100	100

Beside the tendency discernible from the basic distributions, the chronological development of the opinions also merits attention. Given accelerating expansion of private property after 1990 and the ever more emphatic assertion of the corresponding values by the "official ideology" (e.g. by financing a television series to popularise privatisation), it might have been expected that the aversion to private property and market economy would eased gradually. Data available to us on this issue, however, indicate just the opposite tendency: reservations concerning private property and privatisation multiplied rather than decreased as the previous administration cycle proceeded towards its end.

We shall return to certain correspondences between the various attitudes to property later on, but it seems worth mentioning a few facts here. In the early nineties, simultaneously with the transition to market economy, the number of the unemployed rose at a very rapid rate indeed. Although the state socialist taboo concerning unemployment had already been bidden farewell by the last pre-transition governments of Mr Grósz and Mr Németh, in early 1990 the official unemployment rate was still below 1 percent. The dramatic rise in unemployment figures occurred in 1991 and 1992 under the impact of the significant drop in Hungarian industrial and agricultural production and this situation was exacerbated by the simultaneous collapse of Hungary's eastern markets. The rate of unemployment grew to more than 10 percent over a very short period of time, and the number of those threatened with it expanded at a similar pace. Although the privatisation of the big enterprises did not necessarily entail redundancies—certain figures suggest that unemployment in the private sector actually lags behind that experienced in the public sector—new owners often initiated re-organisation by rationalisation measures and severe lay-offs.

Mention should again be made here of the inflationary processes and their social consequences. Although no shock therapy similar to that applied in Poland was attempted in Hungary, prices rose at an unprecedented pace in the early nineties, with wages, especially public-sector ones, lagging behind. At the same time, parallel with the deterioration of the economic position of the middle strata, successful private entrepreneurs acquired what, in the given circumstances, qualified as a fortune. The gap between the higher and lower income groups widened very significantly in the space of a few years (while the previous relatively small differences corresponded by and large to the levels of the Scandinavian countries, the current values of the difference indicators are more reminiscent of the Western European extremes). The traditional, partly ideologically motivated, resistance to differences in incomes was in fact intensified by the new polarisation. While in 1988, 63 percent of the population was of the opinion that income differences should be diminished, by 1993 the same ratio rose to 75 percent.[3] Over the same period, the proportion of those urging the differentiation of incomes declined from 18 to 11 percent.

Given the above, it can be said that in the first few years of transition to market economy, the population experienced the drawbacks of the process more than anything else. The majority were "losers" rather than "winners" in the alteration of the economic structure. As mentioned already, owing to the specific Hungarian antecedents of the process, neither did positive developments—perceptible to all in certain areas—(e.g. quality commodity choice, disappearance of many of the former anomalies of the shortage economy) exert such a strong influence as in some of the other former COMECON countries. Of course, attitudes to private property (which will be dealt with in a separate section of this study) have also been greatly influenced by the ways and means of privatisation and the social scope of the new forms of ownership. The above background makes it easier to understand the mixed feelings generated by the transition to a private economy among people from whose number the majority actually voted for such an economy in 1990.

Public thinking and privatisation under the second coalition government, 1994–1995

The previous section traced the development of attitudes to property and privatisation up until 1994. Thus it examined the objective processes of ownership transformation after the change of regime, the stratum-specific features of accession to proprietary status and the contradictory development of attitudes to privatisation. As a follow-up, our previous surveys were complemented by another

[3]The data are from national representative samples of 2500 persons in 1988 and 2000 persons in 1993.

one carried out at end-1995, bringing some of the more recent developments of attitudes to privatisation within our reach. These recent data are all the more relevant since a new socialist/liberal government has come to power in the meantime and their privatisation programme differs in several respects—primarily in the categorical rejection of re-privatisation—from that of the previous, conservative, coalition. The novel experiences are also of special relevance in that, theoretically, the gradual expansion of private property may well have different impacts on the various public opinion trends. Let us add that, since the period under scrutiny covers no more than one third of the current administration cycle, our view of the public-opinion-shaping impact of these developments is also much more limited, for obvious reasons, than that of the previous four-year period.

Although the 1995 survey encompassed only some of the attitudes being considered here, it did include the question that had reflected interesting changes earlier as well—namely, the four-choice question covering more or less the full spectrum of ownership alternatives in the transition. The first two choices referred to re-privatisation and traditional—auction-bidding-based—forms of privatisation respectively; the other two concerned employee ownership and the modernisation/upgrading of state enterprises, respectively.

Table 4

Who should the owners be? Percentage distribution of choices, 1991, 1993 and 1995

	1991	1993	1995
Confiscated property to be restored to former owner	16	15	12
State property to be sold to highest bidder	11	7	8
Ownership to be transferred to company workers	26	29	30
State property to be upgraded with assistance from competent professionals (i.e. managers)	36	41	47
Other/does not know	11	9	5
	100	100	100

Aversion to the traditional forms of transition to private ownership has not only proved lasting, but has even intensified. While, in 1991, the aggregate choice of the first two items still approximated to that of the other options, on the last occasion it was definitely in a minority. At the same time, preference for "modernised state property" has become more typical, so much so that in 1995 it was chosen by as many as the other three options put together.

In order to interpret the findings, one should take into account the practice of the recent past. As mentioned already, the government in office rejects re-privatisation more radically than the previous one used to do (although it still provides certain minimum return services to the owners of the compensation vouch-

ers introduced in the previous cycle). Auction privatisation still exists within a definite circle—primarily in the sphere of large-scale privatisation. This attracts foreign capital, but the privatisation of the small- and medium-size plants is dominated by management buy-outs. This latter type of privatisation is well-adjusted to the expectations of the economic and political élite, but it definitely has not involved large social groups. Furthermore, so far it has also failed to bring about such major economic achievements as could have dispersed the doubts of public opinion with regard to the transformation of property relations which were present from the very start.

Although certain public opinion priorities are clearly discernible already, differences in social position and political/ideological orientation are dividing opinions concerning the privatisation alternatives. We investigated the social/ideological background of privatisation preferences using a series of analyses (*viz.* four regression analyses), including the above four options analysis, by one as dependent variables (transforming them into so-called "dummy variables").

Table 5

Socio-demographic and ideological/political factors determining the choice of privatisation options in 1995 (regression analysis, beta coefficients)

	Re-privatisation	Auction sale	Employee ownership	Upgrading of state property
Education	−0.9	0.10	0.06	−0.10
Earning		0.11		
Residence (Bp:+)		0.07		
Age (old:+)	0.08			−0.06
Sex (female:+)		−0.07		0.10
Religion	0.06		−0.06	
TU membership			0.04	
HSWP membership[a]	−0.05	−0.04		0.06
Left/right[b] (right:+)	0.10			
Liberal/conservative (cons.:+)				−0.05
r^2	4%	5%	1%	2%

[a]more precisely, ex-communist-party membership

[b]For left/right and liberal/conservative attitudes, the 10-grade scale known from international literature was used.

Although the totalised sums above do not indicate a very strong regression, the findings do identify the contours of the social groupings behind the various privatisation options. The respective hinterlands of the two versions which definitely refer to the expansion of private property—i.e. re-privatisation and auction privatisation—are almost totally different (this social division probably also weak-

ens each group's influence). The main proponents of re-privatisation come from the social sphere of interest of the Smallholders' Party, from among the members of the older generations, and from those with inferior educational qualifications (i.e. former small landowners). Cash privatisation, on the other hand, is preferred by groups occupying a central position, who are high in the social hierarchy—i.e. people with a higher level of education, higher-than-average incomes, and usually living in the capital. Such people are in a better "launching" position to compete for capital goods. The ideological tenets of this group are also rather peculiar. The proponents of both re-privatisation and auction privatisation used to belong to the non-party group, but while the former now tend to declare themselves right-wingers and (probably not independently of the demand to restore church property) religious, a similar, traditional ideological profile is completely missing from the second. The proponents of the other two, more collectivist, solutions also show significant social differences. Those urging employee self-governance tend to belong to the better-educated strata (of the white-collar and skilled workers). Their ideological/political orientation is characterised by a non-religious attitude, and a higher-than-average trade union membership ratio.[4] The upgrading of state property as a possible privatisation variant was mentioned mainly by people with a lower level of education, many of them former members of the HSWP (Hungarian Socialist Workers' Party). As for the distribution of choices by age, members of the oldest age groups (affected more by re-privatisation than the rest and closer to the conservative pole of the liberal/conservative axis) rank this last solution low. Women, too, tend to give greater preference to the transmittance of modernised state property than active men who, for their part are more inclined to follow the routes leading to the classical forms of private property.

According to the Hungarian surveys, sex is a decisive factor with regard to attitudes towards property. Several surveys have shown that males have a more marked propensity for entrepreneurial activities than females. (Cf. *Lengyel and Tóth* 1993) This is a finding which corresponds to the objective tendencies—namely, that males are definitely over-represented among the new entrepreneurs. As for the attitudes to property (such as those presented above in *Table 2*), the sex parameter not only influences opinions, but is actually demonstrated by our analyses to be the strongest single determinant. Experiences relating to the expansion of private property and to the stratum of small entrepreneurs both suggest that men are more eager proponents of the spreading of private property than women. The

[4] The variable in question makes no distinction between members of the old and the new trade unions. As is well-known from the relevant statistics (and the distributions indicated by our own survey), the members of the traditional trade unions are represented in much higher numbers than those of the new-type unions established after the change of regime. Erzsébet *Szalay*'s (1994) book on the labour councils, on the other hand, paints a detailed picture of the—more or less vain—efforts of this more limited circle of employees to implement employee ownership in the first years after the change of regime.

other correlations fit into the usual pattern—namely, that the better educated and the urban strata comprise the group which urges the expansion of the circles of private proprietors and small entrepreneurs the most.

As for the development trends in public opinion in recent years, we have been witnessing an atypical process which indicates the certain inner conflicts in public thinking: despite the fact that groups playing a central part in shaping public opinion—e.g. professionals, people living in the capital, males—would accept to a greater extent than others, *faute de mieux*, that private property expanded (yet one could hardly say this were a rigorous support), the predominant trend is just the opposite. In 1995 a smaller number of people agreed that the number of small enterprises should be raised to a total higher than four years earlier and, answering a question asked for the first time, more—actually the majority—doubted the assertion that more private proprietors would be needed in future.

A comparison of the 1995 data relating to these two questions (which produced averages of 3.21 and 2.95 for small entrepreneurs and private proprietors, respectively, on a five-point scale) also indicates that Hungarian public thinking finds it easier to accept small than large private property. Concerns relating to the growth of the number of proprietors have probably also been motivated by the fact that, in the course of the few years which have passed since the change of regime, the number of entrepreneurs has risen extremely fast—to 800 thousand according to some looser definitions and to half a million according to some stricter ones. However, many of these small enterprises have since gone out of business (especially among the former unemployed who had been "forced" to become entrepreneurs). According to these considerations, the demand of the narrow (and in certain areas still shrinking) domestic market is not sufficient to support the further expansion of the stratum of entrepreneurs.

Social spread of private property; involvement in and attitudes to privatisation

Several references were made above to the interrelationship—plausible and corroborated by everyday experience and research findings—between personal involvement in the various forms of privatisation and a positive approach to the process itself. In what follows, we shall discuss these instances of involvement and their attitudinal consequences. The findings below have special implications for the social profile of Hungarian privatisation: the fact that property acquisition affected a larger circle could, in itself, render personal attitudes to privatisation more positive; the smaller the circle, the weaker the impact. Property acquisition accompanied by a market polarisation of wealth and the deprivation of those having acquired no property, on the other hand, could intensify the negative attitudes. The sum total of the impacts as reflected by the opinions expressed may indicate

whether the development of the middle-class or of the proletariat has been stronger in society.

In the programme definition period of the change of regime, prior to the 1990 elections, Hungarian political forces/parties held more or less unanimous views concerning the change-over to market economy and the role of the private economy. However, opinions concerning implementation already showed differences at that time. There were significant differences, for example, concerning the social base upon which privatisation was to rely and, a closely related issue, how exactly state property was to be transformed into private property. Certain options, which were to play quite a significant role later on elsewhere (e.g. people's shares, coupon privatisation), had only been supported by a limited circle of experts and economists in Hungary. The fact that the conceptions in question were taken off the agenda was due, to a large extent, to spontaneous privatisation: the transition of ownership, the division of state property into companies which were distinct with regard to the managerial stratum, and management buy-outs paved another way to growth in Hungary. Although the programmes of the future governing parties spoke of a "large middle class" in the form of a broad proprietary stratum, actual practice was very different. The original concept re-appeared as an episode of the 1994 election campaign, with the announcement of such schemes as the "small proprietors' share ownership programme" and the "employee share ownership programme". Another critical issue, the divergence of opinions concerning re-privatisation, had already been referred to several times in connection with the questions discussed above. Although practically all the major political parties rejected the idea of restoring property to former owners, the Smallholders' Party had, from the very beginning, put this on their banner and actually managed to realise this objective—to some extent at least and through compromises—during the first administration cycle. Compensation practice, not without constraints owing, among other things, to the political compromises involved, has thus constituted a rather firm and hardly somewhat impregnable endowment confronting the socio-liberal administration as well.

The resultant of these politico-economic bouts has been a complex privatisation practice, including one segment giving access to property to certain groups of the population as well. The majority acquired property in the framework of the compensation process, in the first place by exchanging compensation vouchers for land. The share-ownership programme for small proprietors was also early on targeted at compensation-voucher owners (with the banks, real estate investors etc. buying the papers in question below nominal value, and thus constituting an ever larger segment of this group beside former owners).

An end-1993 survey by the Research Group for Communication Studies of the Hungarian Academy of Sciences and Loránd Eötvös University of Sciences included a series of questions concerning personal involvement in privatisation and compensation, and social responses to the same processes. As for compensation,

one question block queried demands relating to former land property and other real estate. Self-assessment results essentially corresponded to the data published by the competent authorities after the processing and evaluation of the respective claims. Our investigation findings are actually quite close to the one million figure provided by these statistics. Accordingly, 11 percent of the adult population were compensated for former land property of their own or which had belonged to their ancestors, and 2 percent for other property (e.g. plants, outlets, real estate). Another question queried other family members who had benefited from compensation under some title. This wider circle included, the proportion of those involved in privatisation came to a total of 32 percent.

One of the declared objectives of the compensation policy of the conservative government was to provide some sort of moral compensation, in accordance with the, in many ways explicit, aim to improve the social climate. Our survey findings indicate good agreement with other experiences which suggest that these goals have not really been met. A small segment of the survey subjects, some 20 percent were satisfied with compensation policy, while 48 percent expressed definite dissatisfaction. Although personal involvement has probably influenced opinions, there were also marked differences in the degree of satisfaction/dissatisfaction among the beneficiaries themselves. Land acquisition through bidding jarred the sense of justice of many former landowners. The majority of the followers of the Smallholders' Party, the champion of this cause, were also disappointed; probably the followers of the MDF—the Hungarian Democratic Forum, the leading coalition party of the time—were the only ones who seemed satisfied to some extent with compensation practice. The half-hearted support of the beneficiaries and the pro-government group was definitely not enough to counter-balance the strong aversion of those excluded from compensation.

Another declared objective of compensation policy was to stimulate privatisation by introducing compensation vouchers. However, neither the circle of those entitled to compensation (especially those in possession of a more significant volume of vouchers), nor the supply of state property assets and production units was big enough for that. Many of the beneficiaries thought of no other type of investment than land acquisition or, incidentally, some sort of a pension-supplementing annuity or the purchase of a state-owned flat. Privatisation has actually been given a certain impetus by this method (e.g. through enterprises collecting the vouchers) but not to the desired extent and mostly not for the benefit of the group directly involved, i.e. those having received compensation.

In addition to the above, an almost openly declared objective and a main motive of government compensation policy was the establishment of the social base they aspired for: and old/new middle class. The results of the 1994 election allow us to draw certain direct conclusions with regard to the degree of success in achieving this objective, at least in the short run. The significant loss of ground of the MDF and the coalition itself obviously indicates that the endeavours in question did

not meet with success. Nevertheless, the achievement of certain partial election results, such as the higher-than-average score of the conservative parties among the older generations whose members had been affected most by compensation, or in certain élite districts of the capital concentrating the progeny of the historical middle-classes, suggest that for certain strata at least, the policy in question was not completely without effect.

Data based on another representative sample of 1000 of the same end-1993 survey allowed us to query the acquisition of private property, the forms of participation in privatisation, and the plans concerning these directly, through another question block. Questions covered referred to four possible forms of property acquisition. Until end-1993, 6 percent of the adult population purchased land and another 4 percent said they intended to do so. More—i.e. some 10 percent—said they had "founded a private enterprise or participated in one in recent years". In Hungary, it has been possible to found private enterprises—e.g. associations, cooperatives, civil-law partnerships—since the early eighties (not to mention the fact that, within certain narrow limits, property held by small producers, artisans and retailers also survived the decades of the socialist regime). These antecedents have probably contributed to the registration of relatively high levels of participation in these entrepreneurial/proprietary forms already in 1993. The largest segment (nearly half) of the new entrepreneurs were active in commerce and in the services, while the production sphere generated no more than a mild interest.

Distribution by occupation, on the other hand, indicated the tendency that only a minority (i.e. some 45 percent) of the new entrepreneurs were main-job holder artisans, intellectuals, agricultural producers or incidentally managers, while the majority considered the enterprise as a source of supplementary income (and kept their original jobs, which provided them with a risk-reducing "shelter"). No interpretation of the above-indicated 10 datum can disregard the fact that many gave up their entrepreneurial activity relatively soon after setting it up. (The number of active entrepreneurs is likely to be somewhat less than the 800 thousand corresponding to the 10 percent ratio. Despite some differences in accounting, Teréz *Laky*'s 1992 data indicated that there were 466 thousand self-employed, a figure which could hardly have risen significantly above half a million in 1993.)

As for the future, 11 percent of the interviewees indicated that they mere planning to embark on some entrepreneurial activity. Investigations based on time-series (Lengyel and Tóth 1993) indicated a certain decline of entrepreneurial ambitions (measured by the question "Would you like to be an entrepreneur?") relative to the turn of the eighties and nineties. Our survey findings corresponded by and large to these experiences: the first real opportunities and the first failures sifted those who were oriented towards such a career. According to our data, the majority of those hatching such plans are young people at the beginning of their career.

With the establishment of the Stock Exchange, the speculation/investment branch was also included among the new alternatives of private enterprise. The

purchase of stocks, a risky transaction, fit into the investment strategies of only 4 percent of the population surveyed on the 1993 national sample, and another 5 percent declared planning such purchases in the future.

Since the purchase of state enterprises—the *par excellence* form of privatisation—usually exceeded the capital strength of the Hungarian entrepreneurial stratum (despite their having access to sometimes quite significant credits) most of the applicants for the cash privatisation tenders for major enterprises were foreign investors. The 1993 survey also took into account in this respect the fact that, when it came to the privatisation of business organisations of a smaller importance, the government in office organised various special credit funds to assist domestic investors (such as the "E credit" or "Start"). However, a mere 1 percent of the interviewees indicated that they had partaken in such schemes personally, and another 5 percent showed interest in purchasing property this way. At the end of 1993, at the time of the survey, the share programme for small investors was no more than a draft planned to be published by the conservative coalition at the time of the election campaign. 4 percent of those questioned indicated that they were interested in being personally involved in the programme.

Summing up the various forms of property acquisition, one might say that (based on self-assessment survey findings) some 17 percent of the adult population took part, in some particular way, in launching one of the new forms of private enterprise in Hungary. Taking into account plans for the future as well, a total of 28 percent of the population was affected to a certain extent by the process of privatisation.

The survey mentioned above queried opinions concerning the property dimension (state/private) as part of another question series on ideological and political matters. One extreme of the seven-point scale consisted of "government should do its utmost to urge the development of private property", the other of "government should exploit the advantages of state property as best it can". Interviews were asked to place their own opinion between these two poles.

The average (on the seven-point scale) was 0.3 point closer to the private property pole. That is to say that, putting this question in such a straight way, more respondents tended to accept the spread of private property than the conservation of state property (26 and 16 percent of the interviewees, respectively, identified their place in each of the two extreme column-pairs of the scale). Neither did this distribution of opinions change significantly in the next two phases of the panel survey carried out within a period of a few months. One must not forget, however, that significant efforts had been made in the course of the previous four years by the media, in party policy and through the election campaigns, to establish private property in Hungary. If the answers were driven by any "desirability effects" at all, those must obviously have favoured private property. In relation to that, the distribution of opinions deviated only slightly from the mean value. This either reflected an indistinct indifference, or a combination of radically opposed social

standpoints—in this specific case, once again a general ambivalence regarding the entire issue at hand.

Analyses of the distribution of opinions confirmed our assumption concerning personal involvement. Multi-parameter analyses suggest that the privatisation activity parameter (i.e. the aggregate of the current activity and future plans indices) was the one exerting the strongest influence.[5] That is to say, those who expected most from the spreading of private property were people who had joined the process in some form or planned to do so. The importance of this correlation is emphasised by the participation data (mostly low occurrences) mentioned earlier.

Conflicts of value: social security vs. market economy

As is well known, according to the various theories of hierarchy of needs, physiological and security demands override those for freedom. Unless the expansion of market economy—along with its assumed economic liberty—is accompanied by confidence in the improvement of the basic conditions of living, the process will undermine the social legitimacy of the economic change of regime and hence loyalty of the masses with respect to the changes involved.

If, in the course of a relatively prolonged transition period, structural transformation is implemented by distributing a diminishing rather than growing "cake", possible conflicts will multiply. The many losers of the process will only overcome their obvious deprivation if they can be sure their turn will come soon (to use Hirschman's analogy, that "their car line, though still blocked, will soon be out of the traffic lam", just like the neighbouring one).

In the former socialist countries, the above general considerations are tinted by a special ideological heritage. These societies used to proclaim the basic ideological value of social equality, and actually allocated a relatively large segment of the resources available to them to the general satisfaction of certain basic needs. Insistence on the social protection net for both existential and ideological reasons may grow exceptionally strong in a period when the general economic conditions severely restrict individual endeavours to preserve one's social status.

Surveys carried out since the change of regime have repeatedly demonstrated a negative correlation between social security and personal attitudes registered in the market economy dimension. Thus those who considered the differences in incomes excessive gave less than did the rest to the support to economic development based on private companies, or the predominance of private property in large industry, or to the closing-down of loss-making plants. This negative correlation warrants the conclusion that growing sensitivity to social security has serious im-

[5] For details of the analysis see Angelusz and Tardos (1994).

plications for attitudes to market economy and privatisation as well. Therefore, the development tendency of personal attitudes to social issues in the period since the change of regime is certainly a significant issue. As for the perceived degree of income differences, some of the relevant data originate from 1988—i.e. from before the change of regime. In other areas (e.g. unemployment, poverty), our findings are based on surveys repeated several times from 1990 to 1995. The following table will show the development of answers to these questions (agreement rated from 1 to 5 corresponding to the Hungarian school marking system in each case—i.e. 5 responds to the most, 1 to the least important demand).

Table 6

Development of opinions concerning social security and income differences, 1988 to 1995 (average score between 5 and 1)

Priority	1988	1990	1991	1992	1993	1995
To decrease income differences	3.66	–	–	3.96	4.07	–
To fight poverty	–	4.03	4.21	4.20	4.26	4.14
To halt unemployment	–	3.98	4.08	4.24	4.26	4.13

In general terms, as witnessed by the average values around 4 in the highest band of the agreement scale, public opinion assigns very high priority to social security issues, whether this refers to the income gap, unemployment or poverty. As can be seen from the income gap data above, sensitivity intensified after the change of regime (either because of the structural changes or the worsening of conditions of living). Opinions emphasising the acute nature of the social problems at hand had become more general in every one of the investigated areas up to the 1994 change of government. The slight drop shown by the figures for 1995 is no small part due to the fact that those having voted for the Hungarian Socialist Party (HSP), a party which had shown a strong sense of social responsibility earlier, put less emphasis on the priority of social issues once the HSP came to power.

While, as demonstrated by our earlier analyses, the social base of privatisation correlated mainly with the more well-to-do strata, the inverse tendency observable in connection with the priority ranking of social security was even more marked. The most eager members of the group insisting on social security considerations were those with a low level of education, a low level of income, village dwellers and the old. In other words, these were people who had had little or no reserves at the outset of the change of regime, and whose labour market position and competition chances had deteriorated considerably owing to the structural transition to market economy.[6]

[6] *Ferge* (1996) reached conclusions that are similar in several respects, but on the basis of international comparisons.

The opinions in question are thus motivated, in the final analysis, by existential interest. Groups with a lower social status are more vulnerable and more in need of the protection provided by the social distribution systems—however poor that may be—and, understandably, they have more reservations concerning the expansion of a market economy. As for the other pole, those in a superior social position and more capable of profiting from the opportunities presented by market economy are less concerned about the weakening of the social net.

While the above attitudes are governed by interest in the first place, more general views emphasising the responsibility of the government in trimming social differences originate from the value system, and ideological traditions. Our survey carried out before the 1994 elections investigated the priority ranking of government activities in several areas. One possible choice, offered by a series of questions graded on a seven-point scale, was that "it is an essential task of the government to trim social inequalities"; the direct opposite of this choice was represented by "government should not concern itself at all with diminishing social inequalities". The intensity of the social charge and the strength of the conditioning involved is indicated by the fact that, for once, the majority of the answers concentrated on one pole, that of social responsibility. (The average score on the 1–7 scale was—i.e. 68 percent of those expressing an opinion on this issue urged a lessening of social inequalities and only 9 percent voted for the opposite.) The fact that the opinions in question show practically no correlation with the objective background factors is indicative of a strong ideological motive and the relative unimportance of interest in this case. On the other hand, lack of (either positive or negative) correlation may be a sign of the inconsistent nature of the opinions involved, or the co-existence of contrary views. Many of the most committed proponents of market economy agree that government should be held responsible for the reduction of social inequalities. Although this requirement cannot be considered a crucial organising element of the economic/social attitudes in question, it cannot be disregarded either. This is due to the simple reason that it allows representatives of the social security camp to refer to this "common denominator" as a generally accepted legitimate premise.

An empirical typology of attitudes toward transition to market economy, 1995

The above analyses have focused on certain partial moments of the various attitudes to transition to market economy (such as the property issue or the optimum scope of market relations). Mention has been made several times of their interconnections as well. Although, essentially, the empirical results are in good agreement with the theoretically posited "clear types", they are too loose for the attitudinal traits in question to fit into simple (e.g. pro-market/anti-market) patterns. As we have seen, the basic distributions themselves also suggest a quasi-permanent

co-existence of contradictory rather than complementary views in public opinion. Thus, for instance, many urge the closing down of loss-making plants *and* the elimination of unemployment at the same time. Others feel that assistance to market economy may as well be associated with preferences to the domestic proprietary stratum as with the encouragement of capital imports. Consequently, neither the possible configurations resulting from combinations of personal attitudes and views, nor the size and composition of the social groups associated with each are easy to identify.

It was in order to resolve these issues that we drew up an empirical typology based on the data of the last, 1995, survey (to be precise, on the eight items of the already mentioned question series, including two on FDI inflow and any preferences to be granted to domestic capital).[7] The 1995 database was selected for two reasons: topicality and the assumption that, in principle, attitudes would crystallise with the progress of privatisation and the enrichment of the relevant experiences.[8]

Five types were identified that could be assigned to three major categories by orientation. Two types—including approximately one-seventh of the sample of the adult population—belonged to the liberal field, the kernel of the supporter base of market economy. Types 3 and 4—i.e. some two-fifth of the those surveyed altogether—share a certain anti-capitalistic stand and thus a definite aversion to the spreading of private property. The largest population segment, nearly 50 percent, is characterised by the ambivalent attitude referred to earlier: they accept and support the introduction of private property in Hungary, but wish to limit market competition and are especially sensitive to the problems of unemployment and poverty.

Let us now have a closer look at the profiles of the five types.[9] Type 1, which gathers together the "pro-domestic-capital" 11 percent of the Hungarian population, differs markedly from the nearest category i.e. "socio-liberal" Type 2, which accounts for 3 percent. While members of both types consider the growth of the number of private proprietors and of small enterprises to be a highly desirable phenomenon, those in the "pro-domestic-capital" group, however, urge preferences to domestic buyers in company privatisation, and are not really enthusiastic about the influx of foreign capital. At the same time, they show a very liberal attitude to the social consequences of the spreading of market economy. They do not consider it imperative to halt unemployment, nor do they see poverty as a priority social problem.

[7] The last two items are as follows: a) The influx of foreign capital should be promoted by all possible means., b) Domestic buyers should be given preference in the selling-off of companies.

[8] As for the technical implementation, a five-cluster typology of non-hierarchical cluster analyses was used *via* the Quick Cluster application of the SPSS programme package.

[9] For the specific cluster components see Angelusz and Tardos (1996).

Members of Type 2, on the other hand, show a markedly liberal attitude to FDI inflow and, in accordance with that, definitely reject the idea of giving preference to potential domestic buyers. They take a firm stand on the issue of the closing down of loss-making plants, in spite of the fact that they are much more sensitive to the social concomitants of market economy than those in the previous group. They consider both unemployment and poverty very serious social problems indeed. The "socio-liberal" tag of this type actually refers to this special combination of attitudes rather than to a particular political orientation (although, as we shall see later on, it is not radically opposed to that either).

The opposite pole consists of Type 3, the "social anti-capitalists", who reject most definitely practically all manifestations of market economy and insist on maintaining a protective social umbrella. Members of this group put up the fiercest opposition to the spreading of private property, small property included, and they are the ones who protest most vociferously about the influx of foreign capital. They reject the closing down of loss-making plants—in that they are unique—and argue aggressively for limiting the market. In view of this profile, it is not surprising that they should consider poverty a top priority problem.

Although in many respects Type 4 gathers together the "anti-capitalists" and is akin to the previous type, its profile is more particular. Members of the group share the aversion of those in Type 3 to private property, but are less opposed to eliminating loss-making production. (A more detailed breakdown shows that there are less industrial/factory workers among them, and their personal involvement is less marked, too.) Let us remark that "efficiency" is a slogan that has been inscribed on the flag of reform thinking for two or three decades, and has become something of a cliché in the meantime; this is one of the reasons why only the strata most exposed to unemployment are prepared to oppose it head-on. Paradoxically, emphasis on the winding up of loss-making enterprises co-exists peacefully with the aspiration of this type to halt unemployment that is a direct or indirect threat to them as well.

Finally, the characteristics of Type 5 include the "inconsistents", who bear the traits of ideological movements of different roots associated with different eras, and demonstrate the typical eclecticism of everyday thinking even more. Members of this group, mostly belonging to the older generations, have a traditional respect for private property and insist on the social priorities of the Kádár era simultaneously. The predominance of one or another element of this mixture of superimposed ideological views in this far-from-atypical mentality group always depends on the situation.

A description of the socio-demographic characteristics of each type will make it easier to understand their respective profiles. The following table highlights the most typical representatives of each type.

The objective background of the two liberally-minded categories, Types 1 and 2, are clearly different from the block exhibiting ambivalent or negative attitudes to

Table 7

Socio-demographic characteristics of the typology of attitudes to market economy transition

	Sex, age and education										
	male	female	−30	30–44	45–59	60–	−8 forms	8 forms	secondary school	university degree	100 percent
"domestic capital"	**60**	40	**27**	**41**	23	9	2	23	**40**	**35**	100
"soc-lib."	51	49	22	40	26	12	0	44	30	26	100
"soc./anti-cap."	47	53	18	35	**33**	**24**	10	46	29	15	100
"anti-cap."	45	**55**	24	36	23	17	7	**49**	**35**	10	100
"inconsistent"	51	49	23	27	22	**28**	**11**	**56**	25	8	100

	Settlement type, earning, property status											
	capital	country town	village	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	100 percent
"domestic capital"	**29**	51	20	17	13	21	**49**	8	15	22	**56**	100
"soc-lib."	**27**	53	19	18	16	**28**	**38**	8	18	**41**	**33**	100
"soc./anti-cap."	20	51	29	23	25	24	28	26	29	26	18	100
"anti-cap."	17	48	**36**	20	28	24	27	24	27	25	24	100
"inconsistent"	20	42	**38**	**27**	**29**	24	20	**29**	**30**	22	19	100

market economy, the main distinctive features being possession/lack of resources (cf. education, earning, property). The majority of those belonging to the first types are urban people, with capital dwellers constituting a decisive segment.

There is also a certain difference in terms of resources between Types 1 and 2. From the point of view of property ownership especially, members of the "domestic capital" group are clearly quite well off, whereas those in the "socio-liberal" type are positioned lower than that. At the same time, on the basis of the relevant employment data (not quoted above) it could be said that the "domestic capital" type includes much more active people, and a much larger proportion of independents among them; the "socio-liberals", on the other hand, have more pensioners and skilled workers. The term "domestic capital" groups those segments of the population (youth and males especially) whose abilities/skills are most favourable for entrepreneurial activities and market participation.

From the point of view of resources, members of the "inconsistent" group are in the most disadvantageous position. The "anti-capitalists" tend to have a somewhat better education than the "socio-anti-capitalists", but are similar to them

in many respects. The latter, however, are mostly urban people and, as indicated by the employment data, the inactive groups are more highly represented among them. The "anti-capitalist" group, endorsing a somewhat more tolerant attitude to market economy in certain respects, consists of relatively younger people, with a larger segment of (medium-level) intellectuals. The proportion of women is also higher in this latter segment.

Finally, there is a certain correlation with party preferences. Two parliamentary parties, the SZDSZ (Alliance of Free Democrats), and MDF are overrepresented in the "domestic capital" type. As for the "socio-liberals", the followers of SZDSZ and of FIDESZ-MPP (Association of Free Democrats–Hungarian Civic Party) score higher than the average (the followers of the Hungarian Socialist Party are close to the average in both cases). The "anti-capitalist" attitude is most characteristic of the electorate of the Smallholders, while the "inconsistents" are relatively evenly distributed among the parties.

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MANAGERPATHS
Hungarian Enterprise and Bank Leaders at the Beginning of the Postcommunist Transformation[1]

A. BARTHA—J. P. MARTIN

Research into élite groups comprises one of the most important topics related to the present transformation of Central and Eastern European countries. Beside the obvious empirical relevance, the importance of élite theories can be attributed to their peculiar theoretical status: they make a bridge between the respective theories concerning power and institutions. The élite, by definition the minority which disposes the key positions in the most important decision-making processes of a society (*Aron* 1950), is not passive, but represents an active force in the process of institutional change; the social composition of élites, their social resources and behaviour strongly influence the path and the speed of this institutional transformation.

Our theses are based on two pieces of survey-type research;[2] we analysed the recruitment, the career patterns and the attitudes towards privatisation in two segments of the economic élite: among large corporation's managers and bank leaders, respectively. Beyond the description of these phenomena, we also tried to test the validity of some theories concerning the interrelation between the restructuring of ruling economic élites and the institutional transformation.

In this respect, we focus on four important theories. The theory of *structural compensation* (*Nee* 1989) emphasises the growing role of the meritocratic criteria, first of all with respect to education; in Nee's view, during the period of the transition élite recruitment is characterised by the dominant role of market mechanisms as opposed to the formerly unique state-bureaucratic type career patterns. Szelényi's theory (*Szelényi* 1990) about the *interrupted embourgeoisement* accentuates the importance of family background: according to this approach, the members of the

[1]The authors express their gratitude to György *Lengyel* and Péter *Vidor* for their useful advices.

[2]The recruitment, the identity and the value-orientation of the Hungarian economic élite were examined in the first months of 1990 and in the last months of 1993 under György Lengyel's research leadership. The subsample of company leaders is representative for state enterprises with over 300 employees and for private enterprises with over 50 employees with respect to counties and industrial branches. In the case of the bank segment, the data collection is complete. In each bank, and in each industrial corporation the chief executive officers or their deputies were interviewed. The files containing the collected data (HUMAN.SYS and HECEL.SYS) are at the Department of Sociology of the Budapest University of Economics. For the data interpretation we used the following statistical methods: crosstab analysis, loglinear analysis, analysis of variance, principle component analysis and logistic regression.

economic élite are often recruited among the people who have had "quasi-market" experiences in the "second economy", where they got an opportunity to survive their parental or even more grandparental heritages: namely, their precommunist market-compatible abilities and habits. In Szalay's theory (*Szalai* 1990), which focuses on the phenomenon called *technocratic continuity*, the technocratic cadres of the 80's, due to their professionalism, are able to maintain their leading positions. Finally, we have to mention *Hankiss*'s (1989) *power conversion* theory: according to this approach, the political capital coming from the state socialist period (e.g. state party membership, especially leading political positions) is a resource which can be converted into economic capital in the postcommunist period.

Recruitment types

In 1990 corporation leaders were recruited mainly from the middle or the older generation: their average age was around 48. Considering the focus of this research, the most surprising phenomenon was the high ratio (nearly 2/3) of engineers, which strongly surpassed the ratio of economists (22 percent). The ratio of incongruent leaders—those people who held an élite position, although their educational qualification was only elementary or secondary—was low (5 percent).

At the time of the change of the political system the social origins of corporation leaders provided evidence that there was in fact significant intergenerational mobility. More than half of their parents had, at most, a qualification from a primary school; those who came from qualified families (i.e. with at least an MA degree) amounted to a proportion of under ten percent. The occupational position of mothers indicates this mobility most vividly: 58 percent had gone into retirement after being a housewife, and nearly 20 percent were unskilled workers. Most of these corporation leaders were born in small villages, and a large majority of them were members of what was then the state party (i.e. the Hungarian Socialist Workers' Party).

There was no significant change in the age composition of managers until 1993: then their average age was about 46. On the one hand, we can explain the lack of generational change by pointing to rejuvenation which occurred during the 80's (Lengyel 1992). On the other, we have to accentuate that the development of the new market institutions and the private sector did not affect the managers' age composition to any great extent.

In 1993, the intergenerational mobility shows a lower level than at the beginning of the system transformation. The ratio of people who came from qualified families had grown considerably (by more than 20 percent). Therefore, the managerial segments of the Hungarian economic élite had become more of a closed formation than it had been in 1990. The ratio of people coming from industrial

and agrarian worker families had strongly decreased and the importance of former communist party membership was lower (the change was 12 percent). Since the first free parliamentary election in 1990, evidence suggests that managers prefer to keep themselves away from politics: only 7 percent were members of a political party in 1993.

Continuous or system change careers

Around about the period 1992–1993, the power conflict between the members of the "new technocracy" and the members of the "new clientele"—i.e. those people who came to power after 1990 thanks to the new government—became more acute (Szalai 1994), and caused sensitive political problems. The main issue of debate was whether the acquisition of an economic élite position was attached to the political transition or to professionalism.

The career patterns show that nearly 2/3 of the bank and corporation leaders of 1993 had held the same or a similar position before 1990: thus their careers can be considered to be *continuous*. On the other hand, we can define another significant managerial group: nearly 1/3 of the managers got their state-owned corporation leading position after 1990. We call these type of professional paths *system change* careers (*Figure 1*).

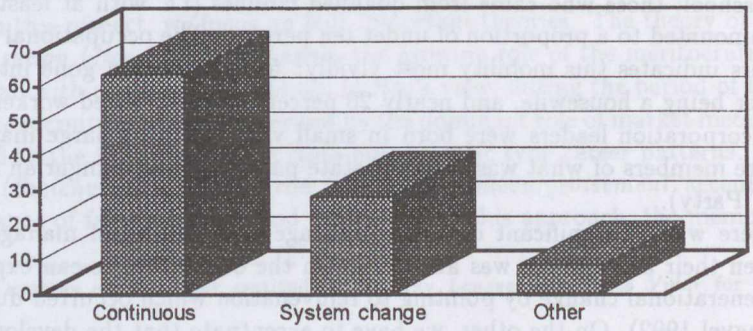

Fig. 1 Division of corporation leaders in 1993 (percentages)

The career patterns illustrate significant variance with respect to age cohorts; the average age of those managers with continuous careers strongly surpasses the average age of the managers with system change careers: the difference is about ten years. More than half of the managers with system change careers were under 40, while 51 percent of managers with continuous careers belong to the generation of

the fifties (*Figure 2*). The career types have a noticeable variance also according to qualification types: economists are strongly overrepresented among managers with continuous career patterns.

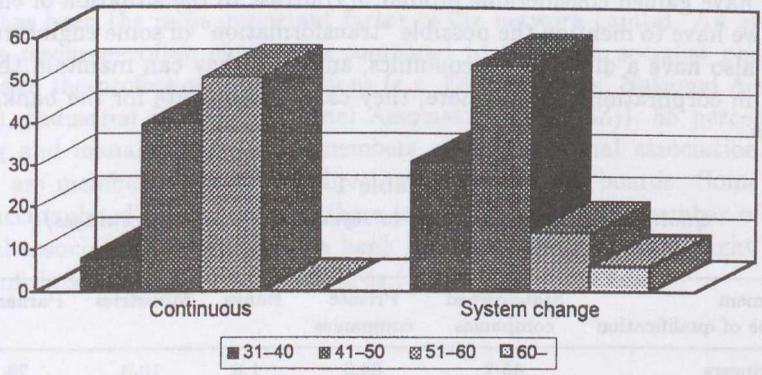

Fig. 2 Career patterns of managers in 1993 according to age cohorts (percentages)

There is a significant correlation between the career types and "multipositionality": this refers to managers with system change careers who are more likely to be members of a board of directors or some other supervisory board. Partly, this phenomenon can be explained with the positional redistribution. However, we have to emphasise that the system change career pattern correlates highly with the younger age cohorts and a qualification in economics or in engineering-economics. Meanwhile, the continuous careers correlate highly with the older age cohorts, the qualification in engineering, the smaller private-owned enterprises (from the perspective of the ownership type in which the élite position is fulfilled) and the absence of membership on boards of directors or supervisory boards. In this respect, we have to underline that the big state-owned corporations were still proving to be attractive in 1993; the young managers with system change career patterns were able to acquire their new élite positions mainly in state-owned companies.

Qualification: advance of the economists

At the beginning of the systemic change the level of educational qualification was one of the most important dividing lines within the economic élite. The career opportunities of engineers continued to deteriorate significantly in the 80's; meanwhile economists played a more and more important role: they were able to gain the new positions in the continuously growing banking sector and in the political

sphere. In the meantime, the engineers were pushed into the background, even in the sphere of corporations. This tendency has continued throughout the period of transition (*Table 1*). In the sphere of Parliament, and to a lesser degree in private enterprises too, besides economists, lawyers also form a considerable group. Lawyers have gained considerable ground in contrast to the situation of engineers. Finally, we have to mention the possible "transformation" of some engineers: many of them also have a diploma in economics, and thus they can maintain their élite position in corporations; furthermore, they can also compete for the banking élite positions.

Table 1

Qualification types according to segments in 1993 (percentages)

Segment Type of qualification	State-owned companies	Private companies	Banks	Ministries	Parliament
Engineers	45.2	34.3	1.6	10.9	28.2
Economists	2.8	40.3	77.4	71.7	28.2
Engineer-economists	17.5	1.5	6.5	2.2	2.6
Other	13.5	23.9	14.5	15.2	41.0

From the Hungarian Household Panel analysis (*Kolosi, Szívós and Bedekovics* 1993) we know that in the period 1989–1992 the rise in the higher and middle leaders' respective nominal salaries was very significant: it strongly surpassed the rise of the Hungarian average. According to our data, the average of the economic élites' personal net income is twice that of the average of the higher and middle leaders in general. However, the qualification types show strong differences even inside the economic élite: for example, the average income of economists is 1.5 times greater than that of engineers. This is partly because of the sectoral division—the salary of the bank leaders is particularly high, and in this sector the economists are overrepresented. However, the economists' average income is higher even in the sector of corporations; moreover, the estimation of future income patterns showed a clear pessimism among the engineers of state-owned companies.

Network capital and multipositionality

The formal network capital of postcommunist managers is based on positions in professional associations, on boards of directors and supervisory boards. On the other hand, we can draw important conclusions from the respective advisory activities of the central government and local governments. The managerial élite

rarely gives advice; this phenomenon is rather an element of the political élite. Nevertheless, the government advisors are recruited only from the economists, who are bank leaders in most cases.

Right from the beginning of the transition, the multipositionality—i.e. membership of the boards of directors and supervisory boards of banks and corporations—has been the most important factor of the network capital. An alternative network resource—often continuous compared to the state socialist period—has its roots in the professional associations (e.g. Entrepreneurs' National Association (VOSZ), Industrial Leaders' National Association (GYOSZ)). 55 percent of the banking and managerial élite are members of a professional association, and 51 percent are members of boards of directors or supervisory boards. Some of them have "accumulated" the positions: there is a manager who is member of six professional associations, and there is a bank leader who is member of eight different boards of directors or supervisory boards (*Fig. 3*).

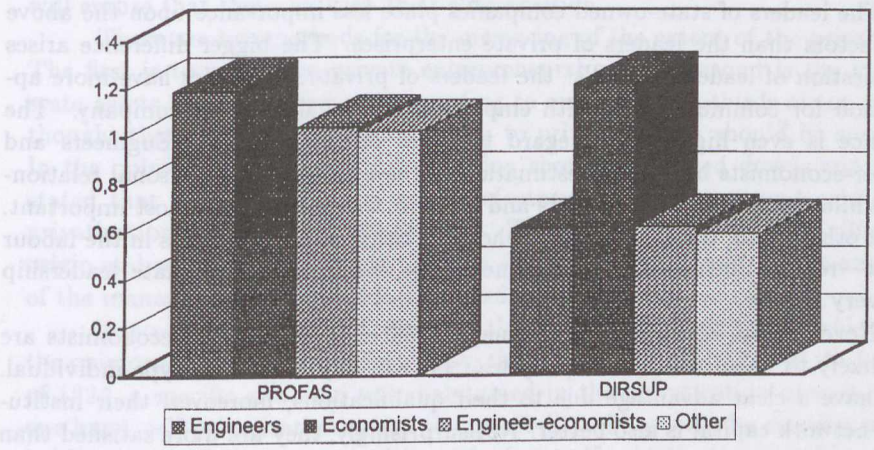

Fig. 3 Average membership in professional associations (PROFAS) and boards of directors or supervisory boards (DIRSUP)

Multipositionality, as well as membership of professional associations, has a significant variance according to the type of qualification. Multipositionality characterizes economists; meanwhile, engineers, engineer-economists and the leaders with other qualifications are more likely to have a position in professional associations. This phenomenon can again be explained mainly with the sectoral effect: 4/5 of bank leaders had a multiple position in board of directors or supervisory boards; furthermore, they generated connections between their own bank and other corporations. These connections provide—besides the significant formal power—bigger

personal income to the bank leaders, and thus we can repeat our hypothesis about the privileged situation of bankers (and economists).

Criteria of success

The network capital is an important, but not exclusive criterion of the success of corporation leaders. According to the self-evaluation of the managers we can differentiate three success-factors: qualifications, network capital and leadership skills.

Among the qualification factors the managers stressed the importance of economic knowledge. In their opinion, the usefulness of the engineering type of knowledge is low, while legal knowledge is nearly as important as economic knowledge. They consider the role of the networks to be even more important; they emphasize especially the importance of business relationships, although they also mention the significance of power (i.e. political-administrative) networks.

The leaders of state-owned companies place less importance upon the above three factors than the leaders of private enterprises. The bigger difference arises over question of leadership skills: the leaders of private companies have more appreciation for communication with employees and loyalty to the company. The difference is even higher with regard to types of qualification. Engineers and engineer-economists have a low estimation of the importance of personal relationships while, according to economists and lawyers, this factor is the most important. On the other hand, the economists—who have the best qualifications in the labour market—regard the qualifications as negligible, while they appreciate leadership skills very highly.

Nevertheless, opinion of the manageral élites is unanimous: economists are more likely to be successful company leaders than any other élite-type individual. They have a clear advantage due to their qualifications; moreover, their institutional network capital is also better. Not surprisingly, they are more satisfied than engineers (who also have to cope with their complex "lack of education").

Attitudes towards privatization

The overwhelming majority of the economic élite were already in favour of the dominance of private ownership in 1990 (*Bartha and Martin* 1997). Although during the three years up until 1993 the reality changed significantly, the opinion of managers hardly changed at all. According to almost half of the managers, the dominance of private ownership was desirable. One tenth of the leaders voted for the dominance of state ownership, while 41 percent said that the state should not

own anything at all. The opinion with respect to the desirable form of ownership was influenced by the variables of origin, age, qualifications, financial situation and ex-communist party membership. Our research work shows that managers with working class origins *ceteris paribus* prefer state ownership significantly more than other groups. They do not have any sympathy for a "watchdog" role for the state. This can be explained by the way in which managers with working class origins were raised in the period of state socialism.

Leaders above fifty also claimed to be more in favour of state ownership. Their opinions show that their accumulated resources could be better converted if there is a certain level of state ownership in the economy. The qualifications of managers also have an impact on their attitudes. Not surprisingly, economists prefer private ownership as opposed to leaders with other qualifications. As has already been pointed out, the value of a diploma in economics has increased considerably with the growth of the private economy. It might seem surprising that former communists prefer a dominantly private economic system. However, their hope is that the conversion of their political capital and the further expansion of the private sector will ensure that they can keep their élite position.

There are two methods for the increasing of the extent of the private sector. The first is to encourage private entrepreneurships, the second is the transfer of state assets to private owners. According to our data, two-thirds of top managers thought that the transfer of state assets to private owners should be speeded up. In the opinion of one tenth, privatization should be slowed down, and one fifth stated that the current speed was satisfactory. Only two percent said that the privatization process should be stopped. This attitude variable was influenced by origin and personal net monthly income. The higher the social status and income of the manager, the more market-oriented is his attitude.

It is not only the speed, but also the method of privatization which divides the opinions of enterprise leaders. From the second half of 1992 until the beginning of 1994, a specific situation was maintained in the privatization process. On the one hand, self-privatization meant the possibility of buy-outs by existing managers holding particularly strong positions. In fact, self-privatization was like a type of decentralization. On the other hand, the process was dominated by state centralization with respect to the field appointment rights (*Voszka* 1994). The notion of decentralized privatization has continued to find favour in the minds of economic decision-makers, in spite of the fact that the process of privatization has been led by the government.

In 1993, half of the top managers were of the opinion that privatization really should take place under the auspices of the government, and according to 44 percent the right to transfer state assets could be delegated to the enterprises. A significant proportion of corporation leaders wanted greater autonomy in the privatization process. Managers of working class origin and leaders with high incomes wanted the government to conduct the privatization process. For the former group

state intervention was very important in their "latent battle" against total privatisation. The second group were more interested in stabilizing their own financial situations. The multipositional leaders preferred decentralized privatization because they thought that in this way (i.e. without state interference) their privileges could be increased more easily.

The attitude of managers with regard to ownership form and privatization were fragmented first of all according to social origin, and to a lesser extent by multipositionality and income variables. The leaders of working class origin preferred privatization with moderate speed, and under the auspices of the government. However, leaders with multiple élite positions and also those with higher personal net incomes were in favour of rapid privatization. It is remarkable that the ownership form did not influence this attitude at all. There were no significant differences in the opinions of state and private managers.

*

The career types of the economic élite are structured according to three dimensions: their possibilities are influenced by social origin, qualifications and multipositionality. The managers with intellectual origins, membership of several supervisory and directory boards, and a diploma in economic sciences are the most successful.

Considering our theoretical starting point, we can state that on the one hand, the theory of technocratic continuity has a great explanatory force for our own findings; on the other hand, the descriptive element of the theory of interrupted embourgeoisement is also valid in the field of recruitment, with regard to career possibilities, and with reference to the attitudes of the managers. In contrast to the structural compensation theory, in the first years of the transition we cannot speak about the overwhelming importance of the meritocratic criteria, although the value of a diploma in economic science has increased and that of technical qualifications decreased. The structural compensation of private entrepreneurs recruited from the second economy was an illusion because evidence shows that their social capital has not been particularly effective during the privatization process. Power conversion became possible only for a small proportion of managers, who had high personal net income, a diploma in economic sciences and multiple élite positions. This group wanted quick privatization with minimum state interference.

Relatively quick privatization led by the government had reached its last phase by 1997. Also, in the next stage of the economic transformation we expect that the value orientation of top managers will adapt not to the laws of a latent economic order, but to the new challenges.

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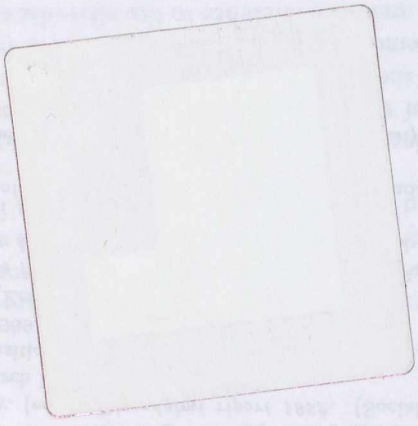

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