Hungary's Transition to the Market: The Case against a 'Big-Bang' Comment to P. Hare and T. Révész

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control is feasible, then prospects involving a recovery and sustained economic growth accompanied by the deceleration of inflation are by no means unrealistic.

On the other hand, the possibility of a vicious circle of declining production and increasing inflation cannot be ruled out either. Which of these prospects is realized may depend as much on good luck as on good management.

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There was an old communist joke to the effect that Poland had the longest queues, East Germany the most impressive statistics and Hungary the highest living standards. There was a lot of truth in it – despite the problem of external debt and the usual problems of socialist countries, over the last 20 years Hungary has been a success story. Below the surface of the communist state, privatization advanced considerably in important sectors of the economy, and there is exceptional prosperity not caught by any statistics, which is clearly visible to an observant visitor.

Paul Hare and Tamás Révész give an impressive account of the success story. In the Introduction the authors say: 'Hungary has preferred a gradualist, step-by-step approach to a big-bang approach. ... Our aim in this paper is to justify that conclusion'. This is a strong and clear view, but it is stated rather than argued. How might we assess the case for and against a big-bang?

This year's Nobel Prize winner Ronald Coase made what was in effect a very strong case for a big-bang. You have to establish property rights quickly; how you do it is of secondary importance. Well-defined property rights and a firm legal framework that gives investors and other market agents reliable expectations for the future are essential for recovery and efficiency. Another argument is more political. Now, with the collapse of communism and the expulsion of a foreign occupying force, people's relief is so great that they are willing to sacrifice consumption and to tolerate hardship. Wise politicians know that this tolerance will not last for ever.

It may be feared that the big-bang approach overlooks the transactions costs of the transition to a market economy and enforces more rapid structural change than is advisable on efficiency grounds. I do not believe this fear is justified. Fast privatization and political reform do not necessarily mean fast structural change. If it is efficient to continue operating with the old structures in the transition phase until enough new plants are available, then this will also be profitable in a market

environment. I have no particular reason to mistrust the invisible hand's ability to optimize the speed of transition. However, there are many reasons to mistrust the ability of the political decision-making process to do so.

The only important argument for a gradualist approach is the extreme change in income distribution which a big-bang brings about. This change has an intersectoral and an intertemporal dimension. As to the former, many people will lose their jobs and become poor, while others may become extremely rich. Since the overall cake is growing, this problem can be overcome by an active redistribution of incomes and property rights. These problems have been apparent even with Hungary's gradualist approach. The politicians have reacted by introducing progressive income taxation at an early stage, and by attempting to emphasize justice and fairness in the privatization process. The more difficult distribution problem is the intertemporal one. The faster the reform, the larger the consumption loss the current generation has to accept. When this generation's tolerance of such a loss is limited the speed of adjustment chosen by the market process may be larger than is politically tolerable.

In principle, the current generation's liquidity problem could be overcome by borrowing for consumption and shifting some of the burden of transition to future generations. However, in Hungary's case, the scope for such a policy is at present limited. Hungary has already a debt/GDP ratio that parallels that of highly indebted developing countries. This should encourage the West to help by significantly expanding its credit lines. Generous consumption loans for the Hungarians may help increase the speed of transition to a market economy and be strictly welfare-improving.

It is interesting to compare Hungary's transition with that of East Germany. Hungary has definitely been wiser about the restitution of old property rights. As in East Germany people whose property was expropriated after 1949 have a right to restitution, and also as in East Germany, this rule covers only a minor part of the expropriations that have occurred. Large-scale industry was nationalized before 1949. However, unlike in Germany, there is no restitution in kind in the sense that the previous owners are given back the same properties they lost. Typically they will receive cash or vouchers, and if they receive compensation in kind, they will receive similar, but not the same properties. From an efficiency perspective this is a very big advantage because disputes over property rights will not inhibit investment.

However, Hungary shares with Germany the problems posed by the attempt to sell state-owned assets in the market place. In the absence of a significant monetary overhang, domestic residents cannot afford

to pay market prices unless sales of assets are used to cover the budget deficit. But this method cannot be quick. The Hungarian government has made use of this possibility by financing the budget deficit with money creation and then absorbing the money by selling state-owned assets. The policy is extremely slow, because the budget deficit is a flow while the assest to be sold represent a stock. Because of the stock-flow mismatch, sales to the domestic population can only occur gradually. The stock-flow problem may be the major reason why Hungary has chosen a gradualist approach. Selling state-owned assets to the domestic population is not compatible with a big-bang solution. If, as in Germany's case, rapid sale is nevertheless attempted, then the purchasers must be non-residents, or the sales prices must be so low that the assets are, in fact, given away rather than sold.

The disadvantages of the selling strategy can be avoided. The Czech voucher method is one way of privatizing the economy quickly without giving it to foreigners, though space forbids consideration of its merits here.

Finally, a major disaster in Germany's big-bang was the agreement between the West German trade unions and the West German employers' associations to prevent competition from the East by introducing Western wages there. It is clear that this will destroy East German industry. Fortunately no similar effects are operating in Hungary. Unless the Austro–Hungarian empire is reestablished and Austrians fix Hungarian wages, Hungary will be safe from the destruction that has been planned to be the destiny of the East German economy. This is a disadvantage of the special kind of big-bang exercised in Germany, not a disadvantage of the big-bang as such.

General discussion

Much of the discussion focused on how one could evaluate the merits or otherwise of a big-bang. Philippe Aghion pointed out that it would often make sense to move very fast in some areas (such as price liberalization) while being more gradualist in others (such as industrial restructuring, given the substantial costs of bankruptcy). Privatization was bound to be slow, and probably ought to be, given the need to train managers. Patrick Bolton registered a protest against Hans-Werner Sinn's characterization of the lessons of the Coase theorem. If it didn't matter how property rights were allocated they could simply be given to the government, and bargaining between the government and the private sector relied upon to produce efficient allocations. The fact that privatization was desirable at all was a sign that it did matter how property rights were allocated.

John Flemming pointed out that Hungary's privatization programme was in fact progressing faster than many had thought possible (though Tamás Bauer said there was no coherent strategy behind the programme). One difficulty, continued Flemming, was resistance to the transfer of enterprises to their managers, who might be good owners but were resented by others in society. Overall, he wondered why the costs of transition must inevitably be high: the fact that the planned economies were inefficient implied that there were potential Pareto improvements in resource allocation. If the answer lay in the timing of the gains, there was an obvious role for capital markets to play in smoothing consumption. He would have welcomed more explicit emphasis on the role of capital markets in the transition process.

David Begg wondered exactly which aspects of Hungary's experience might help policy-makers to choose how fast to undertake their reforms. It had been argued that Hungary's high external debt made consumption smoothing more difficult, but Begg doubted whether other Eastern European countries would find capital market access any easier. It had also been argued that Hungarians would be unwilling to take a fall in present consumption, but why should citizens of other countries be any more willing? Or did gradualism provide Hungary with a more credible means of commitment to the reform process? It was hard to see why this should be so.

Mervyn King wondered whether the paper had focused on the appropriate counterfactual. What mattered was not whether Hungary was better off than other countries as a result of having begun its reform programme earlier, but whether, once a programme was begun, it should be pursued more or less rapidly. There was plenty of evidence in the paper bearing on the former question, but not enough bearing on the latter.

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