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# Double Deficit in Hungary in the 1970's and 1980's



## Summary

In the 1970's and 1980's, foreign trade deficit was accompanied by a high budget deficit. To understand the process, it is essential to answer two questions. One of them is: Was there a causal relationship between the two? The other is: How did they correlate with the investment cycle? After an analysis of the issue, it is concluded that the cyclical surge in investment was the common reason behind both deficits. Pick-up in investment projects and the increase in production required substantial imports. On the other hand, project financing also increased the budget deficit. By imposing restraints on CAPEX projects, imports could be temporarily reduced and budget expenditures could decline. In foreign trade, curbing was faster, while the improvement of the budgetary position took longer.

**Journal of Economic Literature (JEL) codes:** E62, F32, F42, P21

**Key words:** fiscal policy, current account, twin deficit, socialist economy

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## INTRODUCTION

Hungary's huge external debt inherited in 1990 was due to high foreign trade deficits in each year. The central bank passed on most of the external funds it had raised to the budget, in order to finance the high demand that resulted in excessive imports. Although the cyclical economic crises experienced in Hungary in the socialist period were thoroughly analysed already in the 1980's, these contemporary analyses disregarded the budgetary effects of the cycles. Since then, no in-depth analysis has been

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carried out to analyse the combined deficit of the budget and the current account, and their interrelationship. This study juxtaposes the balance of payments deficit and the budget deficit recorded in this two-decade period. A response is sought for the “hen or egg” dilemma: Did the foreign trade deficit cause the budget deficit or, conversely, was budget overspending the underlying cause of the foreign trade deficit? The authors also sought to understand the correlation between the twin deficit and the Hungarian investment cycle. The analysis relies on data from the budgetary background calculations for each year.<sup>1</sup> The article only refers to the role played in the budget deficit by the interest charges paid to the National Bank of Hungary before 1989.<sup>2</sup>

#### TWIN DEFICIT IN THE LITERATURE

The phenomenon of twin deficit has been analysed on numerous occasions in countries around the world. In the case of developing countries, for example, a study by *Furceri* and *Zdzienicka* (2018) provides a good overview. When twin deficit is mentioned, many economists think of the International Monetary Fund (IMF) and its projects right away, and this is no accident. Up to the late 1980's the IMF conducted its analyses on the basis of a simplified model, which assumed a close link between budget and balance of payments processes. Now we know that the correlation is looser in many countries, and that a budget multiplier of more than 1 could, in some cases, exacerbate the situation as a result of deepening the recession in that country. In Hungary, the announcement made by Prime Minister Miklós Németh in November 1989, establishing that data of the Hungarian government's debt was skewed, created a completely new situation for the analysis of the budget deficit. In its 1992 report, the State Audit Office presented the size of the hidden deficit in each year and determined the actual debt of the state on this basis. In 1993, the National Bank of Hungary (MNB) conducted an analysis of indebtedness, and specified the genuine budget deficit data of each year (Magyar Nemzeti Bank, 1993).

In the first half of the 1990's, the attention of experts familiar with the subject was drawn to the assessment of the current budgetary situation and the marketing of debt. Later, in 1997, the assumption of the central bank's foreign currency debt by the budget was another issue to be analysed. The experts who criticised IMF-oriented debt management did not address pre-1990 budget issues, they merely focused on the development of external debt and possible room for manoeuvre, and analysed the investment cycle (see *Soós*, 1986; *Bródy*, 1983; *Wiener*, 1985).

#### THE NORMAL COURSE OF THE CYCLE

The crisis was generally exacerbated by investments had “breaking loose” and a simultaneous increase in production for both the domestic and RUB markets. At the same time (and precisely because of these) there was a significant increase in imports in convertible currencies. As a result, the economic management frequently ordered

a partial (or complete) halt in CAPEX projects, and endeavoured to curb imports in convertible currencies and to increase exports, while real wage growth was slowed, and efforts were made to slow the rise in exports to COMECON countries. Tensions in the market of capital investment projects eased within a year or two due to more moderate construction industrial demand, and the foreign trade balance improved due to the slowdown in convertible imports.

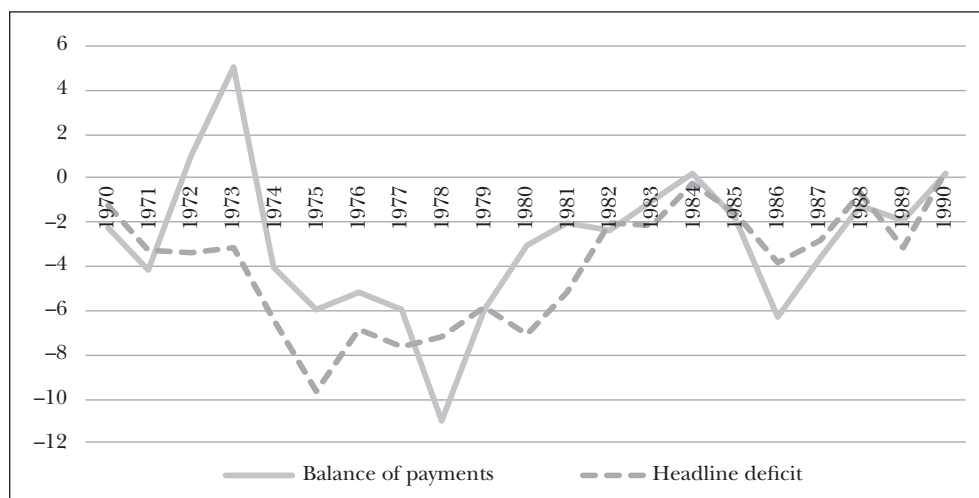
Three external shocks had a strong effect on Hungary's external balance:

- Its exchange rate loss, in both relations;
- Declining food export opportunities due to the constraints by the Common Market;
- A surge in international money market interest rates after 1980.

The expert analysts of Hungary's cyclicity focused on analysing the investment propensity and the resulting high convertible foreign trade deficit. Developments in the RUB-denominated balance were not highlighted, and this was justified in light of the processes at that time. The question arises as to whether, in order to correctly present the Hungarian twin deficit, the total current account balance of the USD–RUB relationship should be compared with the budget deficits, or whether it is sufficient to compare the convertible current account balance and the budget deficits. The two pairs of curves differ significantly in one respect: the significant balance of payments surplus of 1972–1973, taking total turnover into account. Figure 3 shows the reason for the discrepancy: the significant export surplus in the RUB turnover in these years, the figure shows developments in the RUB-convertible FCY trade balances and net interest expenditure. Two factors are worth highlighting: one is the significant positive balance of the RUB turnover, which explains why the two current account differences differed in the first half of the 1970's. The other factor was the high interest expenditure in the 1980's, which suggests that a convertible FCY trade surplus of 3-4 per cent per year should have been presented to GDP in order not to increase external debt further. Figure 1 shows that between 1970 and 1990, the budget deficit and the USD-denominated current account deficit moved relatively closely together. However, the period 1974–1975 was different, because at that time the budget protected producers from price increases through price subsidies.

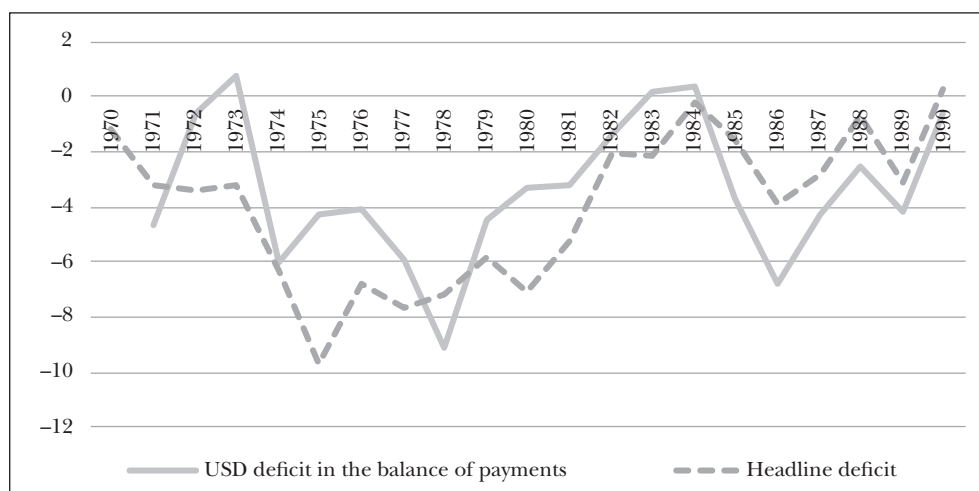
In the course of the cycle, the primary goal of interventions was to reduce investment problems, on the one hand, and to cut excessive imports in convertible FCY (or to raise exports to the high level of imports), on the other. The effects of the measures were generally more pronounced in foreign trade than in the budget deficit. In the case of developments, the procedure of the CAPEX project determined when the expected result was expected (at the time when construction had been completed or when the value of the projects under construction decreased in 1 to 1.5 years due to the investment stop). Note that up to 1983, the government generally did not bother too much to improve the budget deficit and reduce government debt. What mattered was the non-RUB foreign trade deficit and reducing the overheating of the investment project market. USD imports were also driven by the convertible FCY import demand of exports to the COMECON members and to developing countries. Hungary's ex-

Figure 1: Financial deficits to GDP (current account deficit in USD and RUB and headline deficit (%)



Source: Balance of payments: Kóczyán and Sisak, 2019; headline deficit: CSO, SAO, MNB

Figure 2: Current account deficit in USD terms to the headline deficit (to GDP)



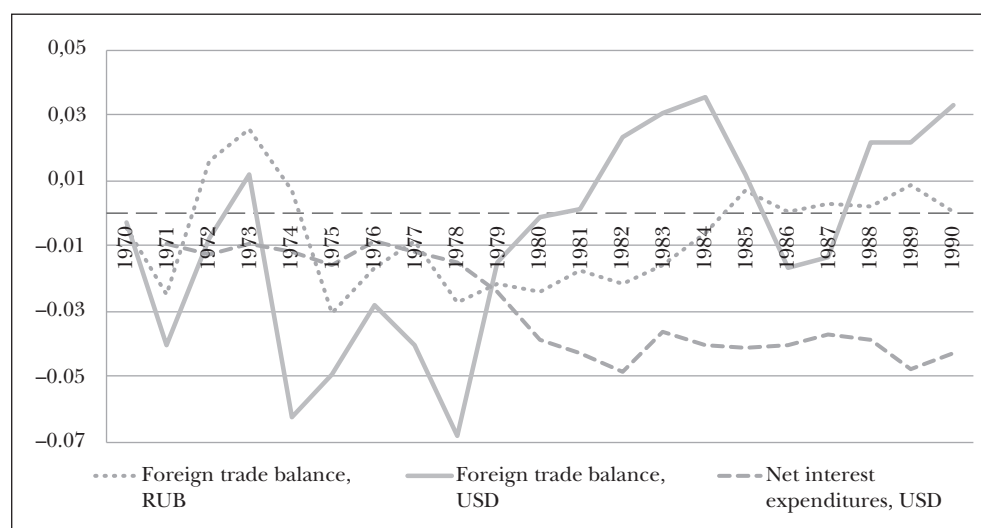
Source: SAO, 1992; Magyar Nemzeti Bank, 1993

ports to developing countries at that time demanded high-level borrowing.<sup>3</sup> Due to these, we had to take out even higher loans from the West. About 15–17 per cent of the value exported to other COMECON countries included materials, parts, etc. imported from a markets where Hungary paid in convertible currencies.

As for MNB, the financing of interest on external debt was a major task, from 1981 or 1982, it raised corporate lending rates to a high level.<sup>4</sup> Increase in the inter-

est rates had an adverse impact on debtors who had previously taken out loans or development loans at a nominal interest rate of 6-8 per cent. It was disadvantageous for sectors that relied on financing their stocks from credit (e.g. furniture and food industry). In addition to the interest rate hike, MNB also took other adverse actions. Such was the unification of the tourist and trade exchange rates in 1979–1980. Instead of the central bank committing itself to defending the double exchange rate against expected IMF criticism, it abolished this system. It standardised the trade rate set at the average foreign exchange output level instead of moving it towards the marginal rate. In contrast to the above, an example of MNB's action with a favourable effect was its loan package to develop convertible FCY exports and its successful implementation in the second half of the 1970's.

Figure 3: Foreign trade balance in RUB and USD terms and net USD interest expenditure to GDP



Note: Including shipping.

Source: Foreign Trade Statistical Yearbooks, Magyar Nemzeti Bank, 1993; Lóránt, 1981

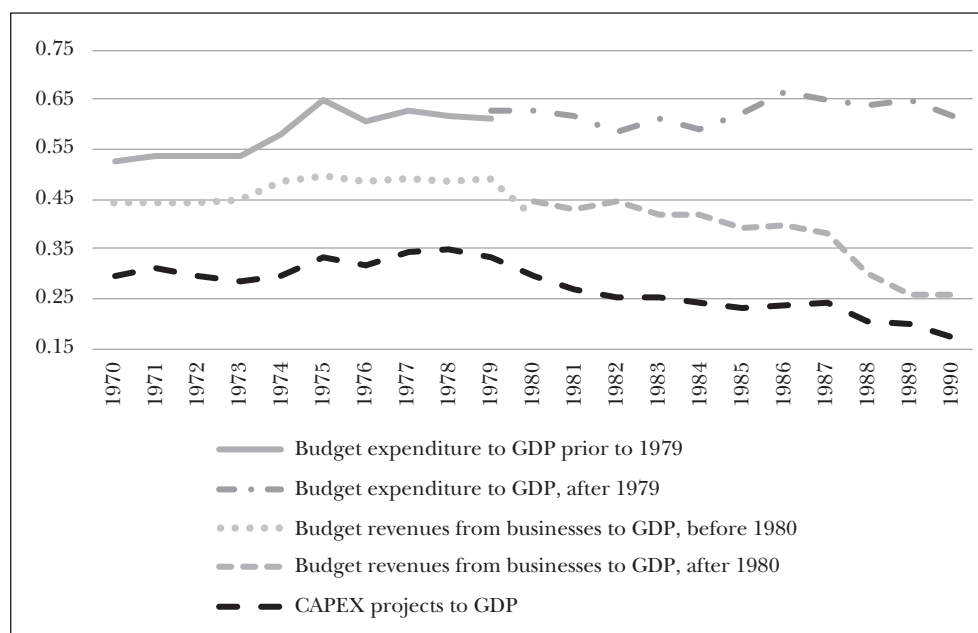
### CHANGES IN EXPENDITURE AND REVENUES

At the following points, budget expenditures changed in a systemic manner. In 1974, despite rising world market prices, the prices of fuels and materials remained unchanged, with substantial producer price subsidies (these subsidies had been reduced by 1976). As from 1981, the state withdrew from the high level of public housing construction. This was replaced by the application of the relatively high amount of soft OTP-loans to family home construction. In the late 1970's, there was a decline in large-scale public CAPEX projects (with the exception energy developments up to 1986). Business development opportunities were severely curtailed in 1979, by reduction in the resources available for this purpose. A reduction in the volume of

consumer price subsidies relative to GDP could be observed from 1984. There were examples for automatic growth in some items of the government expenditure. Such included a surge in government interest rate subsidies on fixed-rate retail loans from 1987–1988 due to the rise in inflation.

Changes also took place in the revenue structure. In 1975–1976, corporate incomes fell due to increased producer prices, and this was compensated by the government by reducing the payable asset allocation contribution. In 1980–1981, an export tracking price system was introduced, which increased costs for the corporate sector. To offset this, the asset allocation contribution was abolished. At the same time, the prices raised to the world market level eliminated the difference between the lower domestic production prices and the COMECON purchase prices.<sup>5</sup> PIT and VAT were introduced, thus the previously high corporate tax was reduced. External credit was needed both to finance the budget deficit (as there were no internal savings available for this purpose) and to cover the foreign trade deficit. One of the items in the current account, net interest paid to the rest of the world, was around USD 1 billion a year in the period following 1979.

Figure 4: Annual government expenditures to the income from entrepreneurs and to CAPEX projects, to GDP



Source: Author's own elaboration based on foreign trade statistical yearbooks

One of the curves in Figure 4 shows the value of the government expenditure (relative to GDP). Public spending accounted for 53-55 per cent of GDP in the early 1970's, rising to 62-65 per cent from 1974 and 61-65 per cent in the early 1980's. Regarding the

indicator, it is worth noting that a methodological change took place from 1979–1980, and that is why there is a break in the curve.<sup>6</sup> Social security expenditures to GDP steadily rose. This was mainly due to increase in pension expenditures, but family benefits also rose significantly (the family allowance were financed by from social security funds up to 1989). The net interest expenditure to GDP rose to 1.5 per cent in the mid-1970's, from 0.6-0.8 per cent in the previous years, and fluctuated around this level in the mid-1980's.<sup>7</sup> A quarter to a third of these interest expenditures were used to repay debt to various beneficiaries (e.g. as basic benefits or government loans to corporations). After 1989, the central budget paid 6 per cent interest on all its debts to MNB, which increased to 7 per cent from 1990. On the HUF 450 billion recorded at that time, this amounted to at least HUF 27-35 billion per annum, i.e. 1.5-2 per cent of GDP.<sup>8</sup> In addition, interest rate subsidies were paid to keep interest rates on housing loans low. In the 1970's this amounted to 0.4 per cent of GDP, but gradually increased due to inflation, approaching 1 per cent in 1987, and then 1.5-2 per cent per annum in 1988–1990.

#### ELBOWROOM TO REDUCE THE BUDGET AND FOREIGN TRADE DEFICITS

Prior to the change of regime, state redistribution was high. In principle, this could even have provided an opportunity to cut the budget deficit when the external deficit turned out to be large and there were too many CAPEX projects. However, the situation was not so simple: on the one hand, one-third of the taxes and contributions collected from the economic sector was needed for the central budget to pump it back companies, and on the other hand, one of the largest public expenditure items includes CAPEX projects, while any restraints only had their impacts felt after 2-3 years (on average, projects were completed in 4-5 years, and in the case of large public projects, 6-8 year construction periods were not uncommon).

A review of the budget balance in the 1970's and 1980's reveals the following:

- Curbing investment had a major role in cutting the deficit. In the mid-1970's, public investment spending was reduced by 2 per cent of GDP, and in the five years after 1979, a further cut was made by 5 percentage points of GDP.

- Typically, in the years of “overspending”, social security expenditures generally increased (relative to GDP). However, the subsequent restraint did not affect them, and their value remained at the higher level achieved. But only until the period of further economic easing, which took place within a few years, because then the rate rose again.

- The level of education spending increased in the first half and mid-1980's (despite this being a long period of restraint).

- The central budget could improve its position vis-à-vis the corporate sector by increasing withdrawals or reducing subsidies. Once in every 4-5 years, corporate management regulations and pricing conditions were redesigned, and each time withholdings were also modified and prices were changed. The key factor was the position of the corporate sector, the amount of resources the companies would have for financing pro-

jects and inventories, and the amount of money available for them to raise earnings. Improvement in the budget balance was considered as a problem of secondary or tertiary significance. During price and regulatory bargains, companies did not mention their efficiency reserves, however, within 1-2 years, they mobilised them and corporate revenues rose faster than expected. In other words, more resources were generated than recorded in the in the plans and in the budget, and they were spent on additional CAPEX projects and higher-than-expected wage increases, etc. Thus the state could run for its money, wondering how to reduce corporate incomes. This was done within 2-3 years, either by increasing costs unilaterally through price increases (and thus lowering profits) or by raising certain taxes. Subsidies were only reduced when prices were also changed (on such occasions the subsidy was usually included in the price).

– Another method, used in only certain years (1979–1980 and 1988–1989), was to expect a significant net debt repayment from the corporate sector (higher repayment than the disbursement of new loans). Thus, the corporate income that could be used for CAPEX projects and inventories decreased. Then (through the so-called national credit balance) this resource could be used by the budget to finance its deficit.

– In the event of a significant reduction in real household incomes, the budget deficit was reduced (because retail price subsidies were reduced on such occasions). Such a measure was taken twice: first, in the summer of 1979, including 16 per cent increase in consumer prices, and second, in the 1988 tax reform (16 per cent inflation in 1988). In both cases, real wages remained below the previous level for the next 2-3 years. Note, by the way, that really significant improvements in foreign trade always took place in the year or two following such drastic increases in retail prices.

– Reduction in the foreign trade deficit had the opposite effect on the development of the budget deficit. Rise in exports increased the amount of export subsidies. Decrease in imports resulted in a loss of revenue (customs and duties). In the aggregate, these two direct effects could increase the headline deficit by 1.2 to 1.8 per cent of GDP over a two- to three-year adjustment period.<sup>9</sup> In addition to these direct effects, there were, of course, indirect effects, above all on imports. This is because the reduction of imports curbed the expansion of production, which in turn reduced the amount of taxes and contributions that could be collected from the corporate sector.

For cutting the large foreign trade deficit, the following elbowroom was available. As a significant ratio of imports increased during the years of high imports, restraints did not significantly jeopardise current production, as the high amount of inventories could be used in the next year or two. Approximately one-third of the surplus earned on imports in convertible FCY in 1976–1978 fuelled increase in inventories (Boda, 1981). When domestic consumption was reduced, demand for imports became more restrained.<sup>10</sup> By 1978–1981, 80 per cent of the reduction in the import surplus was due to the effect of the restraint of domestic demand (Juhász, 1982). As the authorisation of imports (transacted in convertible FCY's) had been fairly liberal in the 1970's, a reduction in imports could be achieved in the short term by radically tightening import licensing. This is what the government did after 1980, with companies failing to build up significant amounts of import stocks after 1980.



## CHARACTERISATION OF THE INDIVIDUAL CYCLES

The following describes the economic processes in each cycle in terms of foreign trade and the headline balance.

### *1970–1973*

This period can also be called the golden age of equilibrium compared to the subsequent hectic fluctuations. Naturally, a normal cycle also took place at that time, and it was characterised by imbalance in the investment market in 1971, with too many CAPEX projects being launched. At the same time, stockpiling (in the interest of production safety) was high. As a result of the above, imports from capitalist countries soared in 1971, and a large deficit developed. In response, the number and value of eligible investments were severely limited, and an increasing number of products were included in the so-called framework management (fuels and products made of them, rolling stock, etc.). Return to equilibrium was successful in 1972 and 1973: rise in the inventory declined, the number of projects in the course of construction barely increased, exports increased in 1972–1973 by taking advantage of the favourable western economy, and by 1973 a positive balance had been achieved. It was in this period that regulatory reversal took place, with the 50 largest industrial companies designated in 1973 with the intention of being “given special attention” by central management.

By 1970, there had been significant differences in wage levels (compared to those paid in 1968) between the various groups of companies, and thus from 1971, the correlation between profit levels and the possibility of wage increases was loosened. At the same time, improvement in profitability was rewarded with a greater opportunity for wage increases, based on a central decision made in May 1973 to increase wages for large industrial workers, which meant an 8 per cent increase in industrial wages and a 6 per cent increase in construction industrial wages. Transition to a five-day working week was completed in the period under review.

In the period following the change of regulators in 1971, there was a usual shift towards income that could be used by the corporate sector, to the detriment of the central budget. In RUB terms, exports rose sharply after 1970, and a significant positive balance developed in 1972–1973, which persisted even in 1974. In order to increase RUB imports, preferential loans were granted to companies that purchased equipment imported from this market. Exchange rates did not change. In 1972–1973, the economy was favourable in Western Europe, which could be successfully exploited by Hungarian companies. In 1973, for example, the volume of exports increased by 21 per cent to western markets.

### *1974–1978*

The period between 1974 and 1978 started with a massive external shock. After the Arab–Israeli war, world oil prices soared, followed by rising raw material prices. The

Hungarian economy suffered 20 per cent deterioration in its convertible foreign trade, which raised the import account by USD 300 million per annum. Nevertheless, economic policy did not change domestic prices, which was only possible in 1974 by the provision of HUF 40 billion import subsidies.

Belated, it was not until 1975–1976 that economic policy responded. On the one hand, the prices of numerous raw materials and fuels were adjusted to the import prices of the prevailing capitalist markets, i.e. they were raised, and on the other hand, withdrawals were reduced due to rising production costs. Due to the external imbalance, more restrained production targets were set for 1975–1976, hoping that they could significantly improve the balance during this time. This objective was only met in the first year. The 1976 plan, adopted in December 1975, was once again aimed at higher growth rates.

The number of CAPEX projects increased excessively in 1977–1978 after the 1975 dormant period, the inventory of unfinished projects also increased, and construction was delayed. Inventories also rose sharply. After a temporary improvement, by 1978 a large foreign trade liability had developed, and huge loans had to be taken out from capitalist banks to finance the deficits. Although GDP growth appears to be stable at 5-6 per cent p.a. according to the data released by the Central Statistical Office, actually, growth halted in 1974, because there had been a significant deterioration in the terms of trade, which “offset” the larger share of GDP growth in that year. It was clear that much more drastic restraints would have to be taken than usual. As from 1976 onwards, neither low inflation nor significant annual real wage increases were treated as absolute taboos. This was suggested by the fact that in May 1976 there was an official price increase in the market of meat and dairy products.

Deterioration in the exchange rate took place in the first two years (1974–1975) in trade with the capitalist countries, and then from 1976 also in trade with COMECON member states. The economic policy “protected” the Hungarian economy from higher external inflation by appreciating the HUF against capitalist currencies during major changes in producer prices, but sometimes also against the RUB. In 1978, the Soviet Union granted a loan of RUB 850 million to enable Hungary to pay higher energy and raw material prices, and Hungary repaid the loan by transporting goods. For this reason, RUB exports were rapidly raised, and Hungary achieved a positive foreign trade balance for several years. Increase in this export was also helped by the new capacities of the development programmes.

From the mid-1970's, MNB operated a successful loan facility (with an amount of HUF 45 billion at the time of its announcement) to finance developments that increased exports. This increased net exports by USD 1 billion annually within a few years (Doros, 1980).

#### *1979–1984*

In this period, three drastic series of actions were taken. Firstly, projects were severely curtailed; secondly, there was a massive increase in retail prices; and on the thirdly, a

fixed foreign exchange management was adopted. Retail price increases resulted in a two-year decline in real wages. The volume of CAPEX projects declined every year after 1980, with the investment rate falling from 33 per cent in 1979 to 24 per cent. Public housing construction was curbed. With the adoption of a fixed foreign exchange management, the large-scale accumulation of inventories could be prevented in the corporate sector. In addition, the government announced energy and material saving programmes, and provided state support for these purposes. The result of the period was improvement in the foreign trade balance through subdued imports, and decrease in specific energy consumption. From 1979, the launch of new public projects was restricted. Corporate resources were tapped by raising mandatory reserve funds, thus cutting profits from 15 to 25 per cent of profits, and reducing incentives for development resources. From 1980, a new price regime was adopted, which adjusted domestic prices to export prices. The significantly increased prices thus differed considerably from both lower import prices, and domestic purchase prices, and these differences were fully paid into the budget.

Industrial production increased by only 1-3 per cent per annum, and even declined in one year. The budget deficit gradually decreased from 6-7 per cent to 2 per cent (relative to GDP). The 1980 introduction of the secure income-generating difference between domestic production prices and COMECON purchase prices played a major role in this, as they provided secure income. In 1980, some of the previous subsidies provided to encourage convertible exports were renamed as refund on the difference between the domestic production prices and COMECON purchase prices, and the Hungarian party also had GATT approve this change.

Retail consumer prices were raised by about 16 per cent in the summer of 1979. In the years that followed, no more than the maintenance of real wage levels was announced, not an increase. Real incomes increased somewhat after 1981, as social benefits kept widening (increase in the number of pensioners, family allowances, etc.). In numerous areas, wage mass regulation had been possible since the second half of the 1970's.<sup>11</sup> This is because the number of employees was declining due to demographic reasons.

From 1981, companies were only allowed to access materials and machines procured from a market of a convertible FCY if they were granted an import permit under a considerably stricter system supervised by the Ministry of Foreign Trade. The most important consideration was the contribution a company could make to exports to convertible FCY markets.

In 1981, the Soviet Union reduced the annually supplied amount of mineral oil by one and a half million tons. This created a crisis situation for the energy-intensive Hungarian heavy industry. In this situation, the government announced an energy saving programme, and the energy used by industry noticeably decreased within a few years. On the other hand, energy-related projects were made at full blast in the early 1980's with the aim of strengthening the domestic energy base. Due to subdued imports, the export performance led to improvement in convertible FCY foreign trade in the first half of the 1980's. The Hungarian-Soviet meat and grain trade scheme also played an important role in this, as it was settled in USD. From the beginning of the

1980's, in the case of grain and meat above the previous supply level, the Soviet Union paid in USD, or more precisely, supplied mineral oil at world market prices.

In order to curb the inflation caused by transition to the new price regime, the method of HUF revaluation was still applied, and nevertheless, the overall increase in producer prices in 1981–1982 was still 22 per cent. The collection of the difference between domestic production prices and COMECON purchase prices provided an opportunity to reduce corporate withdrawals, which was also necessary because the increased costs reduced the disposable income, while the asset allocation contribution and the payroll tax were abolished. In 1981–1984, the government also used the means of blocking certain funds and withdrawing money of companies to prevent them from having too many resources for investment. In this period, the construction of state-owned houses to let was significantly reduced, and private construction schemes were already used in a great extent when the previously launched construction projects were resumed. From 1983 onwards, the construction of single-family houses increased significantly because high-volume soft loans and social policy support became available to couples building single-family homes (up to then, these were only available for housing estate-type construction).

Lending was thus used as a tool to curb CAPEX projects after 1979. On the one hand, lenders were instructed not to provide credit for new projects, the only exception being developments that increased quickly implemented exports in convertible FCY. On the other hand, as the lender (MNB as the monolithic bank) sought to commit the free development resources of companies, the main instrument for this was the so-called working fund replenishment. If the company had money in its development fund, the bank began to look at how it financed its fixed inventory. If one of the causes for the surplus was that the company's income was higher than indicated in the previous bank loan application, the central bank said, in many cases, that this should be spent on prepaying the working capital loan.

From 1984, new corporate forms were adopted and corporate councils were established at most state-owned companies. From 1981, in addition to the constraints of wage regulation, a minor easing was made in the form of a new option, the establishment of small businesses called "corporate economic work communities". This was used relatively widely by companies. Over earnings expenses this had the advantage that such expenses could be accounted for as costs to firms. The possibility of such settlement ceased in January 1988, leading to the mass liquidation of corporate economic work communities.

#### *1985–1990*

In December 1984, the government announced an economy boosting programme beginning in 1985. The 4 per cent aggregate increase in real wages realised in the first two years (1985–1986) contributed to falling out of equilibrium. Unlike in the previous recovery period, CAPEX projects played only a minor role in this cycle. In the aggregate of 1986 and 1987, the total volume of investment projects increased by

10 per cent, which was well below the 29 per cent rate recorded in 1970–1971 and the 18 per cent recorded in 1977–1978. During the period, the investment rate averaged 21 per cent (well below the level of the previous decade.) In those two years, i.e. in 1985–1986, imports increased by 13 per cent, lagging behind increase in exports. Overall, the industry increased its production by 7 per cent during the period.

A new regulatory system was put in place in 1985, with the key element being the unified interest fund, and its spending was regulated by targeted taxes imposed on each use (accumulation tax and earnings tax). Wage regulation rates were set in a way that more profitable companies had a significant earning potential. In 1985, average earnings rose sharply, by 8.4 per cent on nominal terms, increasing real wages. In 1986, this was repeated: increase in earnings became relatively high (compared to the plan).

Although there was some recorded GDP growth in the first two years, this was offset by the loss in the terms of trade. In 1985, the external conditions of business activity were not favourable either: on the one hand, there was a significant drought, and on the other hand, referring to the 1985 Chernobyl disaster, Western buyers were only willing to buy Hungarian food at lower than usual prices, and moreover, an unusually cold winter required additional imports of USD 300 million. In 1985, the balance of foreign trade in convertible FCY deteriorated by USD 500 million, and in 1986 by another USD 300 million.

In 1985, the companies spent their rising resources<sup>12</sup> on raising wages and on investments, and so the balance of foreign trade in convertible FCY was once again negative for the first time since 1981. As distributable GDP did not rise, deficit was recorded not only in the external position but also domestically, and this caused the budget deficit to soar. One of the main reasons behind the higher-than-expected 1985 budget deficit was declining revenues obtained from the difference between domestic production prices and COMECON purchase prices, due to changes in RUB exchange rates, and other lower-than-expected profits of financial institutions, which led to lower corporate income taxes.

In the autumn of 1986, the HUF was depreciated by 8 per cent, which was interesting because at that time a special technique was used to prevent domestic prices from automatically rising due to the export tracking system. Then, in the spring of 1987, it was officially announced that the previous system of export tracking had been abolished and replaced by market prices. Thus, the next 8 per cent devaluation at that time raised producer prices by about 4 percentage points, under the two-year spill-over effect.

Due to the failure of the economy boosting attempt, by 1987 the priority had already been to improve the balance. The annual plan envisaged a modest increase of 2 per cent in output, which would maintain internal consumption at a level and improve the balance to zero on a convertible FCY basis. Production did increase, but both main elements in internal consumption (household consumption, investment) also increased at a similar rate, by 2 per cent. Although foreign trade liabilities decreased, they did not disappear. If we look for the reasons for falling short of targets, we can point to higher-

than-expected profit growth, early household purchases due to the 1988 tax reform, and weaker-than-expected export capacity. Although real wages fell by 1 per cent in 1987, real incomes remained flat overall, due to pensions and other cash social security benefits and consumer prices, which had both increased by 9.3 per cent.

In 1987, significant revenue was realised from inbound tourism. The balance of trade in convertible FCY showed a surplus of USD 370 million (and trade in RUB had a surplus of RUB 300 million). The RUB-denominated foreign trade balance also showed a surplus, which was used to repay the debt owed in this relation. The headline deficit was smaller than expected, as the revenue earned on the difference between domestic production prices and COMECON purchase prices showed a significant surplus of HUF 15 billion, but increase in the amount of subsidies provided to companies (HUF 7 billion) lagged behind.

In 1987–1989, non-RUB-denominated exports achieved significant success, taking advantage of the then strong Western European economy of the day. The USD-denominated Hungarian foreign trade deficit decreased from 470 million in 1986 to USD 320 million in 1987; then in 1988 there was an export surplus of nearly USD 500 million, and in 1989 the positive balance showed a surplus of around USD 600 million. However, the impact of the favourable results was deteriorated by shopping tourism after the introduction of the world passport at the end of 1987, and the usual surplus of the sector's balance in convertible FCY changed to liabilities in 1988. In RUB terms, the balance of exports and imports showed liabilities.<sup>13</sup>

From January 1987, the banking system became two-tier, with three commercial banks separated from MNB. In the first year, they had a relative abundance of liquidity. However, in 1988 MNB announced a credit reduction, continuously pumping significant amounts of income from the banking sector, which was one of the main reasons for the high lending rates. About 15 per cent of the deposits had to be placed with the central bank, which did not pay any interest on them. In contrast, from mid-1987 onwards, banks were required to pay interest rates of at least 15 per cent and, from mid-1988, over 20 per cent to depositors. At that time, all this cost commercial banks HUF 40-50 billion per annum, which is about 2 per cent of GDP, representing a considerable value.

The tax reform took place in 1988, and included the introduction of two new types of tax: PIT and VAT. Producer prices fell by 3 per cent as a result of the changeover. Prices of energy- and raw material-intensive products hardly changed, while producer prices in manufacturing did not fall. The prices of more labour-intensive services rose significantly. Mandatory gross wages provided coverage to enable companies to pay PIT on the earnings of their employees and thus avoid reducing the nominal value of net wages for anyone. Rise in consumer prices accompanying the tax reform also contributed to decline in real wages, which totalled 7 per cent over 3 years.

The tax reform provided an opportunity for the reallocation of the main income holders' incomes. In addition to replacing corporate taxes by new taxes, the basic goal was to reduce corporate profits by 40 per cent, in which case the degree of state centralisation could be reduced. Thus, less of the unit income had to be paid to the

budget and a higher ratio could be retained by firms. Although the quantified goals were not fully achieved, it can be said that the new situation brought significantly different conditions. The ratio of taxes collected from the corporate sector to GDP fell by almost a third in 3 years: from 38 per cent in 1987 to 26 per cent in 1990. Decrease was mainly due to the discontinued taxes.

On the expenditure side, subsidies to the corporate sector declined significantly. Government expenditure to GDP fell from 65 per cent in 1987 to 61 per cent in 1990. One of the important elements in this process was reduction in price subsidies by 8.2 per cent of GDP in 1987, but by 4.1 per cent, only half of the latter, by 1990. The elimination of price subsidies was usually followed by a proportional increase in prices, which the consumer either paid or did not, but the point is that none of them applied to the budget for price subsidisation (and if they did, they were rejected). The tax reform also rearranged public finances: as most of the PIT was collected by local councils, the central budget significantly reduced its support to the council sector. The inflation process also rearranged expenditures: on the one hand, public interest subsidies paid by the state tripled between 1987 and 1990 due to rising deposit rates, and on the other hand, the state earned substantial income tax revenues from 1988 due to high interest income from commercial banks. The impact of the change in economic policy was also felt in expenditures. Price subsidies declined and the real value of public project spending dropped. Due to the introduction of PIT and VAT, the reported amount of taxes increased already as a result of this accounting method.<sup>14</sup>

In addition, there was a technical change between the various sectors in public finances. An exchange of tasks took place between the budget and the social security fund in the spring of 1990. The state took over the financing of family allowances, but transferred the financing of healthcare expenses to the social security fund, together with the coverage collected from contributions.

In addition to devaluations, the fact that it was possible to raise earnings, up to a limit, free of taxes played a major role in the rise in the inflation rate after 1988. This limit amounted to half the annual increase in the ratio of "value added to number of employees" indicator,<sup>15</sup> i.e. if the value added per employee of the company increased by 20 per cent per annum, then in the case of a 10 per cent wage increase, the company did not have any additional burden. As competitors rarely encountered resistance on the demand side, a wide range of companies took advantage of the inflationary price increases that triggered increase in the company's value added and thus a higher level of earnings. In the two to three years after 1985, Hungary's external debt, expressed in USD, almost doubled due to the massive exchange rate loss on the debt portfolio.

Between 1988 and 1990, the number of employees decreased by 2 per cent per annum. Projects were on the decline, especially after 1990, with an investment rate of only around 20 per cent. By 1990, stagnant industrial production had turned into decline. In 1990, the current account showed a slight surplus, because the so-called NEO (net errors and omissions) line included a surplus of USD 700 million (the value of the currency converted by the population without permission appeared under this NEO number).

In mid-1988, the government came forward with a package including liberalisation intended to play a major role. This was the so-called version A economic policy.

## CONCLUSIONS

In the 1970's and 1980's, the budget deficit and the current account deficit moved closely together in Hungary. The drastic upset in the balance in the second half of the 1970's was no accident. Household consumption, which amounted to 60 per cent of internal consumption, community spending and rapid home construction were treated as taboos by the management at the time, and were not allowed to be significantly affected by restraints. Domestic consumption was reduced half-heartedly also in other areas: the 1976 cut in CAPEX projects was followed by a two-year rapid rise, and the 1976 lower real-wage growth was also followed by faster growth.<sup>16</sup> In addition, in many cases, measures were taken to boost the economy, such as increasing the number of CAPEX projects, especially in the framework of central development programmes, but also in other corporate areas. On the other hand, up to 1980, no substantial changes had been made in the then relatively liberal corporate import management system. Such a policy resulted in a high foreign trade deficit, and the "balancing item" was borrowing from abroad.

The answer to the "hen or egg" question asked at the beginning of this article may be that the cyclical surge in CAPEX projects was the common reason behind increase in foreign trade and budget deficits. Pick-up in CAPEX projects and increase in production required additional imports. On the other hand, project financing also increased the budget deficit. In the next period of the cycle, imports could be reduced by curbing projects, which allowed decline in budget expenditures. In foreign trade, the balance improved faster, while improving the budgetary position took longer.

## NOTES

- <sup>1</sup> For seven years, see the Detailed Data of the Ministry of Finance about budget implementation 1971, 1976, 1984, 1987.
- <sup>2</sup> This is why neither the extent of the so-called primary deficit underlying the deficit of a given year nor the size of the deficit due to financial items can be analysed.
- <sup>3</sup> The Hungarian government frequently provided loans to developing countries.
- <sup>4</sup> At that time this resulted in real interest rates at 6-8 per cent.
- <sup>5</sup> Differential producer sales tax. For example, in the case of mineral oil, the RUB price converted into HUF was significantly lower than the domestic price set at the world market price, and the difference between the two was withdrawn in the form of this tax.
- <sup>6</sup> After 1981, all budget accounts were calculated gross. For the sake of comparability, the Central Statistical Office provided two data for the year 1980.
- <sup>7</sup> Detailed Data of the Ministry of Finance for budget implementation 1971, 1974, 1987.
- <sup>8</sup> In addition, the debt increased with each HUF devaluation after 1984.
- <sup>9</sup> For example, if exports increased by 10 per cent and imports decreased by 10 per cent, the former required expenditure in an amount of about 0.4-0.6 per cent of GDP, customs revenues, etc. and the amount missing was about 0.4% of GDP, i.e. this resulted in a combined worsening of the budget deficit



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by nearly 1 percentage point. To this was added the effect of the following year(s), but in the second and third years improvement in foreign trade was generally more modest.

- <sup>10</sup> According to Károly Lóránt, 60 per cent of the imported goods were materials and parts for the direct purpose of production. Having risen before the 1970's, the import demand of the industry no longer changed significantly after 1970, in relation to any of the two currencies.
- <sup>11</sup> Up to that date, the regulation of average wages had been the general practice, partly to prevent companies from laying off workers in masses.
- <sup>12</sup> In 1985, corporate profits did not grow exponentially. However, income centralisation had declined as the corporate tax rate had dropped to 35 per cent.
- <sup>13</sup> Expenditure was HUF 40 billion, compared to the HUF 20 billion budget revenue in 1988, especially in the case of food. On the other side, however, the annual revenue realised on the difference between domestic production prices and the COMECON purchase prices was around HUF 60 billion for items imported for RUB.
- <sup>14</sup> For example, VAT had to be paid on CAPEX projects financed by the state or by the local council, and for this purpose, VAT had to be allocated as an expense in the budget.
- <sup>15</sup> Above this level, however, wage increase was included in the income tax base.
- <sup>16</sup> The country permanently lost 20 per cent of its GDP in its external relations completely for nothing.

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