Recent Developments in Hungary

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Mr. Chairman, ladies and gentlemen. If we had not had the coffee break, I would have kept my remarks very short, agreeing with all the points in Governor Crow's paper that are applicable to Hungary. I feel that the Hungarian experience confirms his conclusions. But now that I am not under the pressure of an imminent coffee break, my comments will be a bit longer.

I will start with what Governor Crow started with, the issue of tying the exchange rate to a basket of currencies or to the currency of a dominant trading partner. Anchoring monetary policy to a fixed exchange rate is, I think, a good idea in the long run for most of us with small and open economies. But I agree with him that, in the transitional period toward a market economy, such an approach is not applicable. One of the most important reasons is that in the transitional phase, monetary policy is considerably less effective in controlling aggregate demand than it is in market economies. For one thing, banking systems are usually underdeveloped. For another, as Mr. Gaspari hinted at, financial discipline is generally weak at the enterprise level.

These two factors reduce the effectiveness of monetary policy. When policy is tightened, enterprises do not adjust their spending behavior. They continue to buy from and sell to each other, even if payment does not take place. Payment arrears—that is, involuntary credit—are accumulated among enterprises, and these increasing payment arrears keep demand artificially high despite the tight monetary policy. Because of the artificially high demand, in turn, prices continue to climb, and eventually the exchange rate must be adjusted to avoid appreciation of the real exchange rate.

I believe Governor Crow makes a reference to this point in his paper, arguing that in such economies one cannot anchor monetary policy to the quantity of money or credit. For that matter, neither can one anchor policy to a fixed exchange rate, for the same reason. What we can do in such a situation, and here I agree once again with Governor Crow, is to follow an approach which he calls "eclectic," and I would call "pragmatic." Under the present circumstances in Hungary, that means to watch the evolution of the current account and adjust monetary policy if the current account does not move as desired.

Why focus on the current account rather than inflation? First, achieving the current account target is a top priority in Hungary. Second, our recent experience suggests that monetary policy in Hungary has been much more effective in helping to shape the current account than in containing inflation. As an example, I would point to the import-liberalization program that we initiated two years ago. Beginning in January 1989, enterprises have no longer been required to apply for a prior import license on a set of imported goods that accounted for about 40 percent of total imports in 1989, and for more than 70 percent this year, and the intention is to increase the share of liberalized imports to somewhere between 80 and 90 percent next year. Liberalization here means, as I have just said, the absence of any licensing procedure—in fact, it is de facto convertibility for the largest of current account transactions, trade.

At the same time, there has been sustained improvement in the trade balance: in 1987 we had a trade deficit exceeding $300 million, but last year we had a surplus of about $550 million, and this year the surplus will probably be around $1 billion or more (for total exports of about $7 billion). Most analysts attribute this improvement, to a very large extent, to an appropriately tight monetary policy, supplemented from time to time by moderate devaluations.

However, Hungarian monetary policy has been much less effective in containing inflation. From year to year, almost irrespective of how tight monetary policy has been, inflation has turned out to be very close to what one would expect by just adding up cost-push factors. Fortunately, that situation is slowly changing. Over the course of this year, we have observed a strengthening in financial discipline at the enterprise level—sellers are not delivering to, and are initiating bankruptcy proceedings against, enterprises that are unable to make normal payment. Indeed, enterprises are accumulating money balances to avoid insolvency. This firming of the demand for money at the enterprise level has already enabled us to avoid disturbingly large devaluations and to improve the outlook for our current account this year.

I think the main reason for this change in the behavior at the enterprise level is the political change. With government bailouts now a thing of the past, enterprises now take much more seriously the need to be solvent at each moment and the need to subordinate other decisions to maintain liquidity. I used to say half jokingly that for a macroeconomist and a central banker, the largest benefit of the recent political change is that it has made market-based instruments of economic policy more efficient because they have become more credible. If this is so, and if it continues, I hope we will achieve a breakthrough in the efficiency of monetary policy in controlling inflation. But that is still down the road. I think that for the foreseeable future we will have to remain very pragmatic in our monetary policy. So I think it would be wise to maintain maximum rigidity in determination, but maximum flexibility in implementation.