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SUB-COMMITTEE ON SOVIET ECONOMIC POLICY

REVIEW OF THE ECONOMIC SITUATION IN HUNGARY

Report of the meeting held on 30th October, 1969

In compliance with the decision of the Sub-Committee(1) the Economic Directorate has prepared the attached draft record of the meeting held on 30th October, 1969 to review the economic situation of Hungary. This draft is being forwarded to participants at the meeting.

2. Addressees who might wish to suggest further amendments are requested to forward them to the International Staff before 31st December, 1969.

(Signed) Y. LAULAN

OTAN/NATO,
Brussels, 39.

(1) AC/89-R/114.

RECORD OF THE EXAMINING SESSION ON THE ECONOMIC SITUATION OF HUNGARY HELD ON 30TH OCTOBER, 1969

The CHAIRMAN welcomed the following experts:

Dr. CZYBULKA, Ministry of Economy, Bonn
Miss EVANS, Ministry of Defence, London
Mr. GOODHEW, Ministry of Defence, London
Mr. WILGIS, Economic Officer, United States Embassy, Budapest.

2. He recalled that two examining sessions had been devoted to the economic development of Hungary in May 1965 and in June 1967. The discussion during the present meeting would be based on an introductory note prepared by the United Kingdom Delegation (AC/89-WP/280). He invited this country's Expert to open the debate.

3. Miss EVANS forwarded to the Sub-Committee some written amendments by her Authorities on their own paper. She then made the following statement:

"Since the last examining session held on Hungary, over two years ago now (June 1967), the much discussed new economic mechanism has been introduced and, after some 18 months' operation, a sufficient interval has elapsed to enable some assessment to be made of the results achieved so far. Because of the overwhelming importance of the reforms for the future development of the Hungarian economy, it was decided to make these the starting point for our study, and it is, therefore, against the background of the reforms that the present draft report on Hungary is submitted for consideration.

Although Hungary is not alone in introducing reforms of the economic mechanism, she has gone further than any other East European country (apart from Yugoslavia) in terms of practical application. At all stages of preparation she has, as far as we know, been careful to consult with her partners in CMEA, particularly the Soviet Union, and keep them informed of current progress. Her approach to various problems is pragmatic, and she has not hesitated to make adjustments where necessary.

The reforms in Hungary, as elsewhere in Eastern Europe are designed to improve the efficiency of the economic system and are, therefore, central to any discussion of the economy. The economic system is more flexible now, but the reforms do not represent a return to capitalism as is sometimes suggested in the Western press. Though the Hungarian reform programme is probably the most radical amongst those of the CMEA countries, it retains at least one thing in common with these more conservative approaches, namely, the need to retain strong overall central direction and control of the economy.

The success achieved so far indicates the Hungarians' awareness of the problems involved and the need for balance, particularly between the State and the enterprises and between management and staff. This contrasts strongly with the Czechoslovak experience where, partly due to political factors too much freedom was allowed to enterprise management and to workers.

It is against this background that one should consider the present economic situation in Hungary. Problems do exist, for example growth has slowed down, there is an excessive demand for investment, and productivity is rising less rapidly than incomes. Undoubtedly inflationary pressures do exist in the economy but the significant factor is that the reforms have not of themselves created these but rather have brought them out into the open. The Hungarians themselves readily admit that it will be many years before it can be said the reforms have succeeded, and that additional changes will be necessary, but at least they can see better now where these changes need to be made.

As regards foreign trade, the changes introduced in the methods of trading are fairly far-reaching. Detailed and compulsory targets have been replaced by a system of economic incentives such as tax concessions, subsidies and levies, foreign exchange arrangements and credit facilities - all designed to promote effective foreign trade operations, and above all, to make enterprises more export-orientated. The granting of direct trading rights to certain foreign trade and producer enterprises is intended to put the responsibility for "profitable" exporting squarely on the shoulders of enterprise managers. Protection for certain sectors of industry initially is ensured by customs tariffs, whilst compulsory deposits and licencing schemes are being used extensively to control excessive imports. All these measures contrast sharply with the rigid bilateral trading procedures operating in Hungary's trade with her Communist partners. And this is one of the points we should like to pursue in the discussion - namely, how far it will be possible for Hungary to develop a free-market sector of foreign trade alongside the existing dominant sector of intra-bloc trade. So far, there has been no lessening of general State control over foreign trade - the volume and direction being influenced through State allocations of foreign exchange, fixing of exchange rates and authorisation of direct trading rights with foreign firms.

As to the impact of the economic regulators on foreign trade so far, although progress last year was in some respects disappointing, results this year have been encouraging, with a particularly high increase in trade with Western countries (exports up 28% and imports 17%). This will certainly have a beneficial effect on Hungary's foreign exchange and balance of payments position.

This leads on to Hungary's relations with the West, and more particularly the industrially developed countries. The record of Hungarian co-operation with the West, in various forms, is impressive. The examples given in the Appendix to this report are just a few selected as representative of the differing types of co-operation deals. Hungary is anxious to develop these links, and the expansion in East-West trade which will result could be considerable. It would be interesting to hear other delegations' views on this.

Along with these increasing economic links with the West, Hungary has been pressing for closer co-operation within CMEA, more especially in long-term joint investment planning, and currency convertibility. The latter is a problem of particular concern to Hungary with her high degree of foreign trade dependence. However, we do not foresee much progress in this field for some time to come. Hungary is heavily committed to her bloc trading partners, and is about to negotiate long-term trade agreements with them for the next 5-year period. We do not believe there will be any basic change in the present distribution of foreign trade, although a more dynamic growth in exports can be expected as a result of the various new economic methods being introduced in foreign trade."

4. The CHAIRMAN emphasised that, although a small country with a population of only 10 million inhabitants, Hungary was characterised by very original features from a triple point of view: there economic reforms had first been conceived, they had been implemented with perseverance and had brought about some favourable effects; it was a traditionally agricultural country which had achieved succes in industrialisation; it was a country very much dependent on foreign trade. He suggested that the main lines of internal economic development (paragraphs 14-39) might be examined before the discussion passed on to the foreign trade of Hungary (paragraphs 40-73).

5. Mr. WILGIS fully agreed with most of the points made in the basic paper as well as in the introductory remarks. He drew attention to the importance of reforms and to the consultations on their main principles which had been very active in COMECON. He also agreed with the conclusion that the reforms would in no way imply an alteration of the present distribution of foreign trade. The West would have an occasion to examine the general features of Hungary's external economic relations with respect to her application for full membership of GATT. As regards co-operation agreements, he considered the emphasis which the Hungarians placed on them as a substitute to the reliance on Western credits. He wished to make a few comments on the economic situation in Hungary: it was a very small country with 10.3 million people living on 93,000 sq.km, which offered a very limited market. With the exception of bauxite it had very few raw materials and this had an influence on its industrial base as it pointed to concentration on those industries

which included a great content of labour and processing and to specialisation; this also caused a very heavy commitment on foreign trade. The traditional value of agricultural production continued to be very important, and self-sufficiency in this field ensured Hungary a certain economic strength; agricultural exports contributed to ease the balance of payments position. Hungary was basically a Western - and not a Slavonic - country; this orientation toward the West was most striking in the cultural field, but it could also be found in industry and in the preference given to French and Germen equipment. The economic link with the Soviet Union was very natural since the USSR provided raw materials and markets to Hungary. He concluded by underlining the importance of the reforms to the present economic situation; the first three years were to be a trial period; the Hungarians hoped to be able to go further in this way during the next five-year plan. There was no doubt that the reforms had created some problems which were detailed in the United Kingdom Note, but they had succeeded in not upsetting the whole economy.

6. Mr. CZYBULKA expressed his appreciation of the United Kingdom Note, the length of which was completely justified by the importance of Hungarian reform, the more sophisticated in all the COMECON countries. He had no comments on paragraphs 14-40; as regards foreign trade, he added that imports of raw materials per capita in 1968 were estimated by official Hungarian sources at 53 roubles for Hungary, as against 32 roubles for Bulgaria, 25 roubles for Poland, 20 roubles for Rumania and 9 roubles for the Soviet Union.

I. INTERNAL ECONOMIC DEVELOPMENT

7. The PORTUGUESE REPRESENTATIVE wondered why Hungarian economic reforms had not aroused the displeasure of the Soviet Union.

8. Miss EVANS explained that they had been very carefully thought out and implemented in consultation with the USSR and that they had been carried out in the context of a stable régime without entailing any lessening of the Party control, which had not been the case in Czechoslovakia.

9. Mr. GOODHEW added that in the latter country the Soviets had not objected to the reform programme itself, but they could not allow any reduction in the Party control.

10. Mr. CZYBULKA was of the opinion that the reforms in Czechoslovakia as well as the ideas and concepts of Ota Sik contained some syndicalist element, which the Soviet Union traditionally feared.

11. The ITALIAN REPRESENTATIVE wished to hear the views of the Experts on the degree of autonomy actually granted to managers and on the flexibility of prices and their relation to costs.

12. Miss EVANS replied that it was difficult to find evidence as to what freedom had been given to managers; the only indicator would be the success achieved in expanding their exports to the West.

13. Mr. GOODHEW added that the enterprise managers did have a certain freedom in the stocks and production policy but they were strongly influenced by central authorities through financial regulations. The repartition of funds between investment and consumption as well as the granting of bank credits were governed by the State; budgetary investments were still a very important factor and enterprises had to comply with them. Considerable confusion had arisen since the allocation of materials was no more centralised.

14. The CHAIRMAN remarked that under the new system obligatory export targets were replaced by various incentives which gave the enterprises a certain margin of autonomy.

15. The FRENCH REPRESENTATIVE would be interested by more details on the financial rôle of the State and on its monetary policy.

16. Mr. GOODHEW said that the government's rôle in the investment policy was a major factor in the direction of the economy. Enterprises were only permitted to renew assets and extent production facilities provided that this did not exceed a certain limit (a 25% increase in the output of the branch or product group concerned). Credits were entirely governed by the State. There were free prices in Hungary but these only represented a very small percentage and there was an indication that between now and 1970 the share of fixed and maximum prices would be reduced; only some fixed prices might become maximum prices. This restricted competition between firms.

17. Mr. WILGIS added that the managers were still under the control of their respective ministries but they had achieved a certain degree of independence as no plan targets were imposed on individual enterprises. The 1969 budget figures did not reflect a great decrease of Government subsidies to enterprises. However, he had heard from Government sources that these had been reduced by 30%. There had been evidence in 1968 and 1969 that the Government had encountered some difficulties in directing the investments of enterprises as the latter tended to spend more on construction than on machinery (which was reflected by the rising prices of building materials). The Government would not influence the employment policy sufficiently; regulations in force were stimulating increases rather than decreases in employment, thereby creating an undesirable competition on the labour market. With respect to inflation, he admitted that a

considerable price rise had taken place last year on the free market; in April prices had increased by 32% over the previous year. But this was a very unimportant indicator as it concerned a very small share of the total market. He agreed that the Government played a key rôle by controlling investments and supplies. The regulating effect of interest rate had not yet developed in Hungary; the Authorities had relied exclusively on their selective credit policy. This in turn had caused an outstanding phenomenon: the power which the National Bank had assumed in the economy was unequalled by any bank in the West.

18. The CHAIRMAN noted that under the economic reforms profitability had become the main success indicator. On the other hand, managers were still appointed by the Government. He asked what would happen if an enterprise made no profit.

19. Mr. GOODHEW explained that an outside accounting organization would look at the finances of such an enterprise, see if there was any internal mismanagement, in which case the managers would be replaced and the finances reorganized. If an inefficient enterprise was not essential to the economy, in theory it should go bankrupt. He mentioned two examples of small firms having been closed down; but it would seem very unlikely that the Government would be prepared to admit the closure of a big firm.

20. The UNITED STATES REPRESENTATIVE added that under the new economic mechanism it was quite possible for strategic enterprises to operate continually at a deficit and to be subsidised.

21. The CHAIRMAN asked if the general principle in foreign trade was the establishment of credit limits and the authorititive distribution of credits and determination of interest rates.

22. Miss EVANS explained that, as regards foreign exchange credits, each application had to be carefully examined by the Foreign Trade Bank and Ministry before being authorised. With respect to credit limits, an enterprise was allowed foreign exchange credits to the extent where it was able to receive foreign exchange through exports; it was entitled to get a certain percentage of these earnings for imports. Apart from this credits were very strictly controlled.

23. The UNITED STATES REPRESENTATIVE added that foreign trade associations also received credits for the purchase of food for export on the domestic market.

24. The CHAIRMAN asked to what extent banks were independent of the State. He recalled that in Western countries there was a duality between the financial power, exercised by the Ministry of Finance, and the monetary power, vested in the National Bank. He asked whether the State Bank was allowed a certain autonomy or whether it was submitted to the Government's decisions; he also wished to know whether ordinary banks were independent vis-à-vis the Central Bank.

25. Mr. GOODHEW stated that the Hungarian National Bank had to adhere to the Government's orders on credit priorities. For smaller investments it was free, under the control of the Government, to use its own discretion. He added that Hungary had a modern bank system, but the Central Bank regulated all the others. The idea of managerial and bankers' independence might develop sometime in the future, but not in the near future.

26. The CHAIRMAN observed that in paragraph 75 of the basic note bankers had been mentioned as one of the pressure groups, which might indicate a certain degree of autonomy. He asked the United Kingdom Delegation to submit detailed information on the structure of the banking system.

27. Mr. WILGIS replied that there was not much information available on this subject. The National Bank had been owned by stockholders (until last year there had been foreigners among them), but this did not decrease the identification with the Government. The Investment Bank was a sub-branch of it. The Savings Banks' deposits reached 33 milliard forints which could be used for private building purposes; this high amount revealed a shortage of quality goods available for purchases. There was another bank, specialised in compensation, co-operation and co-ordination, which was placed under the joint direction of the National Bank, the Foreign Trade Bank and the Ministry of Finance.

28. The NETHERLANDS REPRESENTATIVE added that according to information received from Budapest by his Authorities, besides bank credits and budgetary reserves for bigger projects, other branches of industry had created some kind of development funds from which enterprises could obtain the money they needed for investment.

29. Mr. CZYLBULKA referred to paragraph 2 of Annex I to the United Kingdom Note, stating that enterprises now made their own plans independently and it was a function of the respective ministries to ensure that the plans of enterprises within their jurisdiction were within the framework of state economic policy. He asked how ministries carried out their function and what means of action were at the disposal of the administration to ensure coherence between enterprises' plans and central plans.

30. Mr. GOODHEW indicated that the manager worked out his own plan which was not provisional as it had been in the past. If it diverged from social interest it could be modified by the Ministry. The Government used financial regulations to make sure that plans were in agreement with their wishes.

31. The CHAIRMAN emphasised that, as reforms were implemented and inflationary pressure could be felt, some monetary mechanisms became apparent even in a socialist economy and it would be interesting to analyse how they worked. He then invited experts to give some indications on budgetary problems.

32. Mr. GOODHEW said that due to lack of information it was difficult to give a breakdown of budgetary expenditure. The total revenue had risen from 137,000 million forints in 1968 to 155,000 million in 1969. The State investments through budget accounts represented 60% of total investment. There was a certain degree of decentralisation through local councils for the distribution of budgetary funds, of funds for education, health, etc.

33. Mr. WILGIS found it interesting to notice that in 1968 and again in 1969 for the first time the Government had run a deficit budget; special efforts would be made to stop this trend in the near future. With respect to the budgetary procedure, the budget was worked out in ministries then submitted to the Budget Committee of the Parliament; the parliamentary debate was very perfunctory which had caused some criticism in the press recently and assurance had been given by the Minister of Finance that the discussions would be longer and more detailed.

34. The CHAIRMAN asked how this deficit was to be financed; would the Central Bank advance funds thereby causing an increase of the circulating media and a pressure on prices?

35. The TURKISH REPRESENTATIVE said that in 1968 the deficit had amounted to 1,400 milliard forints (i.e. 1% of the total revenue), but it had been met from the surplus of the 1967 budget.

36. The CHAIRMAN then passed on to the question of prices and asked for further information on the three categories of prices existing in Hungary.

37. Mr. GOODHEW explained that the Government feared a rise in consumer prices; therefore, for 50% of goods in retail trade there were fixed or maximum prices. The official retail price index was based on some selected prices giving consequently a wrong impression of the real trend.

38. The ITALIAN REPRESENTATIVE wondered to what extent costs of production could be taken into consideration when fixing prices.

39. Mr. GOODHEW admitted that this was the point where most reforms fell down in Eastern Europe. The Hungarians considered this as a very long-term problem: to rationalise their price system would need another 10 to 15 years. For the moment they were trying to rationalise wholesale prices on the basis of so-called "world market prices", as they assumed that Western prices were more realistic than their own.

40. Mr. WILGIS added that imported raw materials were priced domestically in accordance with their foreign exchange prices. Before the reform, the turnover tax had been used to divorce production costs from retail prices; its rôle was now considerably reduced. The Hungarian Authorities used to subsidise the sale of some articles which were basic for the standard of living, such as bread and milk.

41. Mr. GOODHEW added that the turnover tax had been transferred from the producer enterprise to the consumer and had become a sales tax.

42. The CHAIRMAN asked for some comments on the statement made in paragraph 30 of the United Kingdom Note, that the costs of rearing animals were still generally above selling prices.

43. Mr. GOODHEW said that this feature was common to agriculture in many countries and explained subsidies. Since cattle was an important earner of foreign exchange, greater subsidies had to be granted to this sector. In the future, very likely higher consumer prices would apply to these goods and that would make them more profitable.

44. The CHAIRMAN asked whether black market existed for consumer goods in Hungary.

45. Mr. WILGIS thought that black market was less significant in Hungary than in most Communist countries. The co-operatives and their members had the right to sell directly in Budapest; this was a supplementary source of earnings which was not black market. On the other hand, the best part of Hungarian production was assigned to export; a certain percentage of this could be held back and purchased on a favouritism basis.

46. The GREEK REPRESENTATIVE wondered how the support of the bankers could be a reason for supposing that the reforms stood a very good chance of success, as stated in paragraph 77.

47. Miss EVANS explained that Hungarian reforms, as distinct from the Czechoslovak ones, had been thought out with the participation of finance experts; the programme had originally been co-ordinated by the Ministry of Finance. Bankers seemed able to advise on the practical implications of the reforms.

48. Mr. GOODHEW added that there had been a change from an industrial to a financial system of planning; the banks were far more concerned with the planning activity than before.

49. The NETHERLANDS REPRESENTATIVE asked for more details on the tendency to specialisation in Hungary.

50. Mr. WILGIS pointed out that contrary to the Poles, the Hungarians wished to reform not only one sector but the whole economy. As regards the tendency to specialisation within COMECON, he observed that they were more interested than other countries in concluding specialisation agreements.

51. As an illustration of specialisation, Mr. GOODHEW mentioned the success achieved in the production of buses (Ikarus) and of machine-tool equipment.

52. The FRENCH REPRESENTATIVE raised questions relating to employment in all the three sectors of the economy.

53. The CHAIRMAN underlined the difference between "unemployment" (in French "chômage") and "underemployment" as referred to in the United Kingdom Note (in French "mal-emploi"), characterised by an apparent full employment together with an inadequate utilisation of labour.

54. Mr. GOODHEW explained that the problem in agriculture was the difficulty to guarantee adequate job opportunities; it should be solved in the future. In industry, the 4% limit on basic wage increases imposed by the Government in 1968 had helped to maintain full employment but had aggravated improper employment. As wages were to be counted as production costs, enterprises had tended to employ unnecessary administrative staff. He hoped that some changes would be brought to the present regulations which would encourage the managers to make a better choice between capital and labour. With respect to the service sector, up to now it had been neglected and absorbed a small percentage of labour.

55. Mr. WILGIS added that according to statistics more up-to-date than those quoted in the United Kingdom paper, employment had risen by 4% this year (as against 3% last year) and productivity had decreased by 2%.

56. Mr. GOODHEW drew attention to the development of ancillary activities in agriculture to fight underemployment. In reply to a question by the Italian Representative, he said that under the new labour code, the employee had a right to work where he wished and to change his job without being obliged to have a permit, and the employer had the right to dismiss him.

57. The GERMAN REPRESENTATIVE emphasised that the number of pensioners was rising and that the expenses for pensions would develop to be a burden for the Hungarian State.

58. The CHAIRMAN invited the Experts to furnish further details on questions relating to population, such as the birth rate, the structure by sex and by age groups etc.

59. Mr. GOODHEW replied that births had been increasing in the past few years and the rate was improving slightly. It was true that there were many pensioners, but Hungary claimed that there had been a reduction in the number of dependents on the working population. In the last few years the ratio of pensioners to active population had been declining.

60. Mr. WILGIS confirmed that the birth rate had risen slightly in 1968 which was attributable to the children's allowance. On the other hand, there was a high suicide rate. The present situation was rather exceptional as children born in the fifties, when abortions were forbidden for a few years, were now entering the labour market.

61. The CHAIRMAN asked for comments on the housing problem mentioned in paragraph 37 of the basic document.

62. Mr. GOODHEW said that the housing shortage was very serious; no improvement was foreseeable in the immediate future.

63. Mr. WILGIS added that this situation was attributable to the lack of investment and the shortage of construction mat materials. The régime had recognised it and had started building "housing factories" providing prefabricated units. In this connection everyone had expected a reform in housing. The State let apartments at such a low rent that it could not afford to maintain them. A new decree had recently been promulgated authorising the transfer of small apartment houses to private ownership and in fact obliging the tenant to buy the property. There was much favouritism in the allocation of housing. Large apartments still existed but were shared by several people= young people were building co-operative apartments.

64. The CHAIRMAN drew attention to the 17% increase of personal savings which had occurred in 1968 and asked some questions on the criteria used to measure this and the ratio savings to investments.

65. Mr. GOODHEW explained that personal savings were measured on the basis of deposits in savings banks; this was a population's saving fund used for private purposes such as building a house or buying a car. Personal savings represented at present about one-third of total investment.

66. The UNITED STATES REPRESENTATIVE said that the increase of personal savings was attributable to late inflationary tensions and the dissatisfaction of the consumers at the quality and range of goods offered, but it was also the sign of a kind of pressure on the régime for allocating a larger share of national income to the population welfare.

II. FOREIGN TRADE

67. The UNITED STATES REPRESENTATIVE referred to paragraph 2 of the basic document, where Hungary was said to be more dependent on foreign trade than any other East European country. He pointed out that Bulgaria was in a similar position as regards foreign trade, with exports representing about 20% of GNP.

68. In reply to questions raised by several Experts Miss EVANS indicated that, in the note submitted by her Delegation, GNP figures were based on US estimates, foreign trade was estimated in value at current prices and at the official commercial rate of exchange. When her Authorities had tried to estimate the balance of payments, certain discrepancies had appeared between Western and Eastern figures; for the purpose of internal consistency, only Hungarian trade statistics had been used throughout the basic document (except for Iceland and Portugal), imports being reported c.i.f. and exports f.o.b. The GNP figures were given at the domestic purchasing power rate.

69. Mr. WILGIS said that GNP figures contained in this paper compared well with the United States estimates, although they certainly did not reflect the standard of living in the East as they would have done in the West. Hungarian economists evaluated their net material product per year at $ 670, which did not coincide with Western estimates. As regards foreign trade, he did not see much discrepancy between US and UK figures.

70. The CHAIRMAN observed that the evaluation of foreign trade in terms of GNP was rather difficult, as the units used were different. He wondered whether some cross-checking could be made of Hungarian statistics on the basis of data available in the West.

71. Miss EVANS said that this had been done in an exercise on the balance of payments; discrepancies in trade figures finally narrowed down to one or two countries but it was very difficult to reconcile these data: Hungarians recorded their imports in c.i.f.; moreover, they sometimes included in the imports of large installations part of the technical know-how or the patented elements.

72. The FRENCH REPRESENTATIVE concluded that a confrontation between Experts on these different methods of evaluation should take place as soon as possible.

73. The CHAIRMAN agreed that such a confrontation should be organised. As soon as the United States Delegation had provided the documentation which it had promised some time ago, a special session would be devoted to the different methods of evaluating GNP as well as foreign trade. With respect to the latter, by comparing the amount of credits granted by the West and the volume of goods consequently exchanged, it should be possible to calculate an implicit commercial value of the forint. He then asked the Experts to express their views on the price conditions in trade relations within COMECON.

74. Miss EVANS said that virtually the intra-bloc trade was carried out at world market prices although it was recorded in roubles or in the various currencies of the countries concerned. In fact, there was no discrepancy between Hungarian relations with the East and with the West as regards their statistical value.

75. Mr. WILGIS explained that there existed four values of the forint: the official rate - 11.74 forints to one dollar - which was used strictly for statistical purposes and also for repaying some loans to the West; the so-called tourist rate (or non-commercial rate) - 30 forints to one dollar - established when the reform had been inaugurated in January 1968, which replaced the old tourist rate of 24 forints to one dollar, plus the State payment rate close to 30 forints to one dollar; then the two commercial values for the forint - 40 forints to 1 rouble and 60 forints to 1 dollar; basically the trade with the West was carried out on the basis of this 60 forints to one dollar rate.

76. The CHAIRMAN expressed doubts as to the validity of certain evaluations made under these conditions. It seemed that trade relations between Hungary and the Soviet Union were based on a common monetary unit which was itself founded on world prices. The advantage derived by one or the other partner from their trade relations depended on the exchange rate used.

77. The UNITED STATES REPRESENTATIVE thought that the realism of the exchange rate of the transferable rouble was entirely dependent upon how close the price system in Communist countries was related to world market prices.

78. The CANADIAN REPRESENTATIVE asked what was the balance of advantage in trade between the USSR and Hungary; which one was exploiting the other?

79. Mr. WILGIS replied that there existed many studies showing that the USSR exploited Hungary and many studies showing the opposite. He had the personal feeling that Hungary had not suffered, at least for the last ten years, from her trading relations with the Soviet Union. However, Hungarian officials had reported that trade within COMECON was carried out at artificially low prices; to offset them, Hungary had a customs turnover tax applied against imports from other Communist countries, instead of the normal tariff.

80. Mr. CZYLBULKA stated that world market prices really existed only for raw materials; the importance of bargaining for other equipment should not be underestimated. Often the prices for Hungarian equipment were too low and those for raw materials too high; this was the case in all East European countries.

81. Miss EVANS added that Hungarians also fixed their prices for a long period of time; this was another element of uncertainty from which the Soviet Union might gain one year and lose another. This fluctuating factor made calculations extremely difficult, and the term "exploitation" seemed slightly out of context here.

82. Mr. WILGIS explained that when the Hungarians had established the commercial values for the forint they had done so on the basis of foreign trade figures for 1966. Some officials had told him that they were going to publish these calculations in the near future.

83. The CHAIRMAN remarked that this problem was of special interest to NATO as the dependence of Hungary upon the Soviet Union was affected by the trade relations within the Socialist World. He then passed on to the industrial co-operation which represented a new development in the external economic relations, not only within COMECON but also between East and West. As it had been previously said by the United States Expert industrial co-operation had been imagined as a substitute to the reliance on credits. He had been surprised, when reading the United Kingdom Note, by the paradoxical structure of trade relations between Hungary and Eastern countries, and especially the USSR, as it reminded him of trade relations between a developed and underdeveloped country: a large share of Hungarian exports to the USSR consisted of manufactured products whereas imports from the USSR included half-finished products and even raw materials.

84. Miss EVANS added that this highlighted Hungary's deficiency in raw materials which explained the pattern of her trade with the USSR.

85. Mr. GOODHEW said that the Soviet Union represented an enormous market for the lower quality consumer goods which the Hungarians could not export to the West.

86. Mr. WILGIS wished to make some minor observations on the United Kingdom Paper. In paragraph 51, stressing the importance of exports of foodstuffs and industrial consumer goods to the West, he would like to add textiles, although they could be considered as included in consumer goods. In paragraph 53, with respect to the increase of capacity of the Friendship Pipeline through Czechoslovakia, he thought that this expansion concerned the second pipeline which would be built directly from the USSR to Hungary. In paragraph 55, it would be useful to mention the two commercial values of the forint (40 forints to 1 rouble and 60 forints to 1 dollar) and also to add a sentence to indicate that the tariff was not applied against other COMECON countries. He agreed that the drop in Western imports in 1968 suggested that the new measures devised to control hard currency expenditure were operating effectively, as said in paragraph 58; however, the large rise in imports from the West,

which had taken place in 1969, should be taken into account. In paragraph 61, he would underline the statement's emphasis that the distribution of Hungarian trade was not likely to change very much under the reform. If trade with the Soviet Union were to drop, the Hungarian reform would be seriously threatened and criticisms would be voiced from the Soviet side. As regards paragraph 65, if the Hungarian view on economic integration came very close to that held in Poland, it should be noted that the Poles had not supported the Hungarians to the extent anticipated.

87. Passing on to industrial co-operation with the West, he thought that another type of agreement should be mentioned in paragraph 70: the Hungarians were becoming imperialist or at least capitalist and they did own some factories in foreign lands. They had established a factory in Lebanon for the production of cheese, and another in Ceylon for the production of light bulbs which was an extension of credits granted to this country. In Algeria too they owned a firm. This was rather distinct from the other types of co-operation agreements since it involved capital investment in a foreign country; the Hungarians were quite worried at this aspect of their reform as the Soviets might accuse them of exploiting underdeveloped countries. It was also stated in paragraph 70(x) that Hungary had not permitted any form of direct investment in her economy with the sole exception of the Hilton and Intercontinental Hotels. He would not call that direct investment. The Hilton deal had strictly been a purchase of a franchise. In the case of the Intercontinental Hotel, a Swiss company had lent a hard currency loan of $4 million to the Foreign Trade Bank, which was to be used as part of the latter's resources; the Foreign Trade Bank in turn had made a loan in forints to the Hungarian company building the hotel which would own and control its management completely. The Intercontinental Hotel would have to comply with certain quality standards put down by the Intercontinental chain and the Swiss company would receive a percentage of the gross dollar income of the hotel; it had been stipulated in the contract that 90% of the hotel's income would be in dollars. He asked whether the United Kingdom Delegation had any indication that direct investment would be permitted in the future.

88. Miss EVANS explained that the authors of the note had been a little unsure about this hotel scheme; they had been rather misled by press statements suggesting that repayments would be in hard currency and out of the profit from the hotel. They were probably wrong in regarding this as a direct investment but it was the only example they could find, and they had no further evidence to suggest that Hungary would accept it in the future. She thought that the Hungarians would certainly not admit direct investment in the Western sense, implying a certain repatriation of profits; this would go against their whole thinking at the moment. In fact, although direct investment was allowed in Yugoslavia for example, they were worried at the probable effects of such a policy.

89. The CHAIRMAN stressed that industrial co-operation with the West seemed to be a refined form of barter, whereby Western know-how and equipment were paid for by means of goods or services. He wondered whether this could be regarded as a kind of panacea against the shortage of foreign currency. Perhaps this industrial co-operation would bring other drawbacks from the point of view of the quality of products and of the rigidity it introduced in East/West trade relations. Did it not create a certain interdependence between Hungary and Western economies, which might present political disadvantages in the future?

90. The UNITED STATES REPRESENTATIVE stated his Authorities' views on this subject: co-operation agreements, specifically those which directly provided for joint sales to third countries, clearly would be helpful in raising the competitiveness of Hungarian products. However, it was by no means certain that enough of the agreements could be concluded to sustain the increases in hard currency exports. Moreover, these arrangements that provided merely for capital equipment, even if they did enable high quality goods to be produced, still left the basic problem of getting into and staying in Western markets. Often this would require selling at near or below cost prices and there was always the danger that a rapid pace of technological change in the West would leave Hungary clinging to the fringes of Western markets. In short, the task of becoming competitive required more than contacts with the West; it required domestic technical and design innovations, marketing know-how, etc., were required.

91. The CHAIRMAN wondered whether the products manufactured under these co-operation agreements would be saleable on Western markets; some doubts could be raised in this respect. He asked if the United Kingdom Expert could provide further clarification on this question.

92. Miss EVANS stated that, as regards the general question of the quality of products, many guarantees had been included in these agreements. With respect to marketing, in arrangements concerning the joint assembly or production with marketing in third countries, the Western partner still had a say in designating the markets where the products would be sold. She mentioned the example of an agreement concluded with Krupp for the manufacture of machine-tools; the products were of a very high quality and were sold all over the world. Similarly, Rumanian made gearboxes for some Renault cars had proved quite up to standard and even better than the French ones. In these two cases, there was no need to question the actual quality of the product.

93. The GREEK REPRESENTATIVE asked if there had been cases of patent infringements and what protection the Western firms had at their disposal against having their products copied in a Communist country.

94. Mr. WILGIS replied that a new patent law had been passed and approved by the Hungarian Parliament earlier this year which tended to introduce the principles of the reform in the patent field. Private ownership of patents was reorganised; the State was entitled to buy a new patent but if it did not exercise its right private individuals and companies could exploit it. On the general question of co-operation with the West in the field of patents, Western firms did have recourse to Hungarian courts and specifically to an arbitration court established under the authority of the Hungarian Chamber of Commerce. The basic position of Western firms in this respect was the commercial position of the Hungarian companies. In this connection, while in the United States patents were given on the basis of a product, in Hungary they were issued on the basis of a process. A very important question was whether Hungary was obliged, under the terms of its treaties with other Communist countries, to pass on to them technoligical knowledge acquired from the West. The Hungarians claimed that this was not the case but that Western firms believed them to do so and therefore had overcharged them for patents for years.

95. Miss EVANS thought it relevant to mention in this connection the recent agreement between Hungary and the USSR on the exchange of technical information for a fee rather than free of charge as had been the case previously; this seemed to be an interesting development.

96. Mr. CZYBULKA believed that the best protection against misuse of Western patents was the fact that rebuilding any Western equipment required a very long time.

97. The CHAIRMAN asked whether the Hungarians had decided to resort to various agreements on industrial co-operation rather than to other forms of economic relations with the West.

98. Miss EVANS stated that they had blamed themselves for having rather neglected this sphere in the past. Progress had so far been too slow and they intended to develop it. However, she would not say that this particular type of co-operation took precedence over others.

99. The CHAIRMAN thought that it was difficult to assess the advantages and disadvantages of such a formula. However, certain types of agreements implying a division of labour between Eastern and Western firms might lead to wasteful expenditures as transportation costs were extremely high. On the other hand, in the case of agreements on assembly in Hungary of products from components supplied from abroad, the added value was extremely limited and the question might arise whether the Hungarians resorted to them only as a first step towards manufacturing the basic components of the product themselves.

100. Miss EVANS thought that their motives in promoting this type of agreement were perhaps a little mixed, but if they were able to sell products into foreign currency they would regard it as worth-while. She did not consider this as a first step towards something else; presumably they did derive some profit from taking part in this kind of agreement. Quite recently it had been reported that a deal was imminent for an Hungarian electrical firm to assemble Philips components, which indicated that they were still pushing on with this type of agreement.

101. Mr. GOODHEW believed that this was a method for getting into Western markets, a result which they otherwise might not be able to achieve.

102. Mr. WILGIS shared the opinion of the United Kingdom Experts as regards the basic rationale behind all these agreements. He added that perhaps one way for the Hungarians to save dollars was to work out an arrangement whereby they would have to buy only a certain percentage from the West; the reason why they could assemble products in Hungary for export to the West was based on the low cost of labour in that country.

103. The NETHERLANDS REPRESENTATIVE mentioned the Fiat-Volga automobile programme, under which agreements had been concluded for the manufacture in Hungary of some 14 sorts of components. Were the Hungarians trying to create a production capacity that might enable them to sell on Western markets?

104. Mr. WILGIS pointed out that Fiat now exported to Hungary a certain number of cars (8,000 a year or so) while Hungary supplied the Fiat Company in Italy with various components. It also provided various parts to Ford in England and to Renault; these were essentially barter agreements.

105. Miss EVANS added that they did see an advantage in this type of agreement: if they could make components for Western firms, with the proceeds of their sales they would be able to import for their own use.

106. The FRENCH REPRESENTATIVE observed that the information provided by the United Kingdom Delegation with respect to industrial co-operation was derived from newspaper and magazine articles and could therefore be questioned. He wondered whether estimates were available of the total turnover of exchanges resulting from these agreements.

107. Miss EVANS said that it was extremely difficult to isolate the particular return on this type of agreement; in some cases it was too soon to do so. As regards the sources used, it was very rarely possible to see the actual terms of the contracts and one had to rely on press statements.

108. Mr. CZYBULKA recalled that in 1968, according to official data, Hungary had concluded 28 agreements on industrial co-operation. On the basis of figures for that year, it had been estimated that from 1970 the volume of exchanges deriving from these agreements might represent a maximum of 4.5% of total exports. One should not be over-optimistic, however, for the future prospects as some doubts were now voiced regarding this kind of co-operation and the managers were not too convinced that it would allow them to make profits.

109. The CANADIAN REPRESENTATIVE asked whether East European countries would ever be able to offer interesting products to the West and whether there was any scope for a substantial East/West trade in the future; it seemed that co-operation in the economic sphere was doomed to remain limited in the foreseeable future.

110. Miss EVANS said that there was another type of co-operation which had not been mentioned in the report. Quite recently an extremely large dealing was under consideration for Hungary to invest in Canadian potash. Its scope seemed enormous and some of its aspects were extremely interesting as it included the provision by Hungary not only of design and mining equipment but also of labour.

111. Mr. WILGIS added that this dealing was apparently not going through due to political considerations in Canada: the stumbling block has been the problem of importing large amounts of Hungarian labour and of paying them at Hungarian wage levels to develop these potash mines in Canada.

112. As regards co-operation agreements on a barter basis, the GERMAN REPRESENTATIVE pointed out that when a Western country imported goods from the East it very often re-exported them to developing countries whose standards were not so high. This operation derived from the necessity for Hungary, as well as other Communist countries, to balance exports and imports; therefore, the condition for exporting to Hungary was to buy in return some commodities. In this case, the export price to Hungary should be high enough to cover the possible losses incurred in re-exporting. This way of bargaining was not a German invention; the first example had been that of the Soviet Union which had had to take Egyptian cotton in return for her exports and had re-exported it to third countries where Egypt could no more sell her own cotton.

113. Mr. WILGIS observed that this operation was a feature of barter trade rather than of co-operation agreements. Returning to the general question of co-operation agreements, he agreed with the comments made by his Authorities but he was not so pessimistic about the future. Part of the Hungarian industry was almost competitive with the West and by selective purchasing of licences and other forms of co-operation it would be fully competitive one day. Moreover, there was an important short-term advantage in these co-operation agreements to Hungary since they generally included a heavy entry price

for the Western firm. Shell was a good example of this: it had permission to establish 10 gas stations and 4 garages in Hungary for a price close to $½ million, which was very high. Siemens was also in the process of paying an entry fee since it was supplying about $1 million of X-ray equipment to Hungary.

114. The UNITED STATES REPRESENTATIVE said that the obligation on the part of Western firms often to import useless or needless commodities in exchange for their exports had given rise to the phenomenon of switch dealers, who bought these commodities at a substantial discount and then resold them to a third country, perhaps getting some other commodity in exchange and so on.

115. The FRENCH REPRESENTATIVE remarked that, from reading the developments devoted to co-operation agreements in the United Kingdom Note, one had the imporession that the initiative came from the Hungarian side. However, he wondered whether an effort was not being made by rival Western countries to force their way into the Hungarian market being ready to accept certain sacrifices, especially to import Eastern products.

116. Miss EVANS remarked that two years ago a trade mission of the United Kingdom Chamber of Commerce had been invited to Hungary; they had visited the country, had been informed of the Hungarian plan and economic reforms and had been taken into the confidence of Hungarian economists and trade officials. After their return an Hungarian mission had duly visited the United Kingdom. Very shortly afterwards, Hungary had applied for a loan for its aluminium industry; this would seem to be a direct result of that visit, but in general it was difficult to determine who had taken the initiative.

117. Mr. WILGIS said a few words on his personel experience in Budapest as an economic officer at his Embassy. Western businessmen on commercial trips were very often proposed a co-operative venture by the Hungarians; sometimes it was nothing more than a barter deal but, if the Western company had some technology which Hungary needed, the co-operative venture took over some aspects above the barter relationship. This was the typical way that most of these agreements were arrived at.

118. The CHAIRMAN suggested that it might be interesting to make investigations among Western firms which had concluded co-operation agreements with enterprises in Hungary as well as in other Communist countries, of their motives for prospecting these markets and of the advantage derived from such agreements.

CONCLUSION

119. The CHAIRMAN stressed that, in spite of her limited size and her relative political stability, Hungary was a very interesting country; she seemed to be a pilot economy in certain fields, such as economic reform and foreign trade. In this respect she should not be underestimated since in a few years Western economies might well have to reckon with Hungary as a trading partner.

120. He then thanked the participants in the meeting, particularly the United Kingdom Delegation for the Note submitted. As in previous meetings, it was decided that the Economic Directorate would prepare a summary record of the meeting as well as a synthesised report of all available information for the use of the Committee of Economic Advisers, and perhaps of the Council.