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### "CONVERTIBILITY" OF THE HUNGARIAN FORINT: A MEANINGFUL OPTION?

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**Summary:** The proposal to make the Hungarian forint convertible has attracted considerable attention in the Western press in recent years. In this paper, we attempt to evaluate the likelihood that Hungary will actually achieve this goal in the foreseeable future. We suggest that a currency can only be regarded as convertible if the country issuing it has a domestic market economy, and if that country's policy-makers do not make use of extensive administrative regulations to control the conversion of the currency into other currencies. We argue that Hungarian use of administrative regulations of both domestic economic activity and international economic transactions are such as to render the forint currently inconvertible.

Policy statements by Hungarian authorities over the last decade have consistently raised the possibility of a "partially convertible forint," with the implication that the existing regulatory system would be either substantially modified or dismantled. An examination of the more recent statements of Hungarian authorities on this subject, however, indicates that the Hungarians plan to retain the system controlling international transfers of goods and financial assets. These same statements indicate that the Hungarian authorities plan to issue a new currency, convertible on demand into Western currencies; this new currency will be used only in trade transactions with the West. We argue that this would not "make the forint convertible" in any meaningful sense. Indeed, the currency used in domestic transactions will remain inconvertible. The new currency will only be convertible in a very limited sense and is unlikely to have a direct impact on economic decision-making in Hungary. To the extent that the new currency might be used as an instrument for attracting hard currency credits, and to the extent that it bolsters the image that Hungarian economic policy-makers "do things differently," this move might produce some indirect pay-offs for the Hungarian economy.

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Over the last two decades various monetary authorities in Eastern Europe, particularly in Czechoslovakia, Hungary, and Poland, have stated that an important goal of international monetary policy in their respective countries was to achieve convertibility of their domestic currency. Moreover, under the terms of its membership in the IMF, Romania has formally committed itself to the goal of making the leu convertible. It is, therefore, appropriate to assess the meaning and likelihood of currency convertibility in Eastern Europe.

For various reasons, it is possible to dismiss for the foreseeable future Czechoslovak, Polish, and Romanian aspirations to convertibility. Since the Soviet invasion of Czechoslovakia in 1968 it is evident that the Czechoslovak monetary authorities have themselves rejected the possibility of unilaterally seeking to make the Czechoslovak koruna convertible. In Poland, although a number of economists have reasserted that Poland should aim to make the zloty convertible, it is evident that this goal will be a function both of the restoration of economic equilibrium within Poland and of the fate of recently proposed economic reform programs. The uncertainty surrounding the future prospects of the Polish economy makes it impossible to predict the likelihood of an eventually convertible zloty. It is clear, however, that this goal can only be a long-term one.

While the Romanian authorities are formally committed to the goal of achieving a convertible leu, it is evident that since joining the IMF they have made little headway (if any) in seeing that this commitment is fulfilled. Indeed, of all the currencies in Eastern Europe, the leu is perhaps the least likely to become convertible.

One cannot, however, lightly dismiss Hungarian aspirations toward the convertibility of the forint. Since the introduction of the New Economic Mechanism in 1968 the Hungarian monetary authorities have consistently maintained that they intended to make the forint convertible. Since 1968, moreover, Hungary has pursued an exchange rate policy that is considerably different from that of other CMEA countries. Indeed, this exchange rate policy, together with a recently renewed commitment to a market-oriented reform program, has led to renewed speculation that Hungary will be the first CMEA country to make its currency convertible.

Hungarian monetary authorities have fueled this speculation by repeatedly stating that Hungary intends to make the forint "partially convertible" in the near future. The most recent officially published pronouncement to this effect was made in January 1981 by Janos Fekete, a Deputy Director of the Hungarian National Bank, when he stated that he hoped that the Hungarian forint would be made convertible in 1982. (1)

Given such statements, it might be useful to evaluate the likelihood that Hungary will be successful in achieving its goals.

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(1) Hajdu-Bihari Naplo, 7 January 1981.

Before doing this, however, it is important to consider both the meaning of the term "convertibility" and the degree to which the East European currencies currently exhibit the characteristics necessary for convertibility.

#### What Does "Convertibility" Mean?

East European monetary authorities have rarely provided any indication of what they mean by the term when they have stated their ambitions to achieve a convertible currency. This is rather unfortunate, for the complexity of the subject is not conveyed in frequently casual statements of aspiration. In order to facilitate an understanding of the issues involved, it is important that the terms commonly used in discussions of convertibility of CMEA currencies be clearly defined.

A currency is usually defined as being convertible if, and only if, the holders of that currency are able freely to convert that currency into goods and into other currencies. In order further to clarify the subject, economic theorists divide this definition into two conceptually distinct notions. They define a currency as exhibiting goods convertibility if holders of that currency are able freely to convert that currency into goods, while the currency exhibits financial convertibility if holders of that currency are able freely to convert that currency into other currencies. Given these definitions, economists generally hold that a currency exhibits pure convertibility only if that currency simultaneously exhibits both goods and financial convertibility. In order to satisfy these requirements, the country issuing the currency must facilitate its free flow, so that any individual or institution can acquire the currency, exchange it for a foreign currency, or transfer it abroad without administrative restrictions. Moreover, this definition requires that the country issuing the currency forgo the use of policies designed to limit free trade (*i.e.*, quotas, licenses, excessive tariffs, and other, nontariff barriers, including official trade agreements).

It is evident that no country in the world issues a currency that fully satisfies the requirements of this definition. But if one were to conceptualize a scale ranging from pure convertibility to pure inconvertibility, economists would generally accept that the major Western currencies tend toward pure convertibility, while the CMEA countries tend toward pure inconvertibility; most currencies issued by the developing countries exhibit a degree of convertibility, thus falling somewhere toward the middle of the scale. To understand why economists reach these conclusions, it is useful to consider further the meaning of the terms goods and financial convertibility.

First, it is evident that a currency will only exhibit goods convertibility if the country issuing that currency has a domestic market economy open to international trade; only then will all economic agents be able to obtain goods in exchange for currency. In an economy characterized by command central planning, this condition can never be fully satisfied, since in such an economy money



does not, by definition, exercise a command over all goods. Thus, in a centrally planned economy, enterprises obtain goods because they have been allocated those goods by the central plan; the availability of money does not influence the enterprises' access to goods.

Secondly, if a currency is to exhibit financial convertibility, the country issuing the currency must, in practice, use only market mechanisms (i.e., only use policies that affect exchange rates and/or import and export prices) to regulate the demand for other currencies by holders of that currency. The existence of administrative regulations limiting the ability of holders of the currency to convert it into other currencies would thus imply that the currency is financially inconvertible.

From the discussion so far, it should be apparent that it is not really appropriate to ask whether a currency is likely to "become convertible." To the degree that, in the real world, all currencies exhibit both elements of convertibility and of inconvertibility, it is more appropriate to ask whether a currency is likely to become more convertible. In terms of the conceptual scale suggested above, there is no clear dividing line between a currency that is convertible and one that is inconvertible. Thus, one can only evaluate where an individual currency lies on the convertibility/inconvertibility scale, and whether a country is likely to implement changes that will move its position on this scale. The remainder of this paper is devoted to answering these questions as far as Hungary is concerned.

#### Where Does the Forint Lie on the Convertibility/Inconvertibility Scale?

In order to gauge the position of the forint on the conceptual scale ranging from pure convertibility to pure inconvertibility, it is useful to divide our discussion according to the effect of existing administrative regulations on Hungary's international economic transactions. In accordance with the institutional structure of Hungary's international trade, we will consider separately the impact of these regulations on individuals and on enterprises engaged in foreign trade. We will also consider separately the effect of existing regulations on Hungary's trade with other countries, and contrast the regulations applying to trade with the CMEA countries with those applying to trade with non-CMEA countries.

As far as individuals are concerned, holders of the Hungarian forint generally enjoy a degree of goods convertibility. Thus, despite evident imperfections in domestic markets for consumer goods, Hungarian residents are generally free to use forint to purchase those consumer goods available on the domestic market. Individuals are not free to use forint to purchase producer goods. As elsewhere in Eastern Europe, the Hungarian authorities maintain the right to determine the institutional framework for goods production.

In practice, this means that a high proportion of goods production takes place in state or cooperative enterprises. Although there has been a recent trend toward a liberalization of the rules controlling the private sector, it is quite apparent that the state intends to continue to regulate the terms and conditions of private sector activity. In general, therefore, Hungarian residents are only able to use their forint to acquire consumer goods and services, thus limiting the goods convertibility of the forint.

Nonresident individual holders of the forint (*i.e.*, usually tourists or visitors) are confronted with administrative regulations which limit the volume of consumer goods that can be taken out of the country. While the explicit terms and conditions of these regulations vary from time to time, they take the form of lists describing the goods subject to export prohibitions or which individuals can take out only in limited quantities. These regulations are generally designed to preserve domestic supplies of consumer goods (and of artifacts connected with the national culture) for domestic consumers. Formally, such regulations apply equally to all individuals (including Hungarian citizens); they make no distinction between residents of CMEA countries and residents of non-CMEA countries. In practice, however, such regulations (especially those applying to consumer goods) tend to discriminate against both Hungarians and residents of other CMEA countries, since they: a. stop tourists from other CMEA countries from purchasing and taking home goods that are in short supply in their own country; and b. stop Hungarians from purchasing goods in Hungary, taking them to another CMEA country, and exchanging them for goods in short supply at home. These regulations tend further to limit the goods convertibility of the forint. Moreover, given the deficiencies of markets for consumer goods in Hungary (and the even greater deficiencies of those in other CMEA countries), it is difficult to envisage the removal of these regulations in the near future.

Individual holders of forint also face regulations which constrict their ability to use those forint to buy and sell other currencies. As far as holders of "convertible" currencies issued by non-CMEA countries are concerned, they are generally free to use these holdings to purchase an unlimited amount of Hungarian forint for tourist purposes. They can generally reconvert unused holdings of forint back into Western currency, although a number of regulations place limitations on such transactions. First, Hungary has imposed regulations making it illegal for anybody to import and export more than a nominal amount of forint. Secondly, Hungarian regulations generally limit reconversions of forint into Western currency to amounts that were initially exchanged with the Hungarian National Bank or its agents; these regulations are designed to stop Western tourists from taking advantage of potentially profitable arbitrage between official and black market exchange rates. (2)

- (2) In the absence of control, arbitrage would take the following form: Western tourists could exchange hard currency for forint on the black market, take the forint to a Hungarian bank, and obtain a greater quantity of hard currency than they started with.

The regulations described above generally duplicate those imposed in other CMEA countries. With the exception of Bulgaria, Hungary is the only CMEA country that does not impose minimum exchange regulations (which require Western tourists and visitors officially to exchange some minimum amount of Western currency for domestic currency for every day they stay in the country). In a sense, then, it might be argued that Western tourists enjoy a marginally greater financial convertibility from the forint and the Bulgarian lev than they do from other CMEA countries.

In contrast to residents of Western countries who can generally freely acquire foreign currencies for tourist purposes, citizens of CMEA countries are confronted by a set of regulations that strictly limit their ability to convert their holdings of domestic currency into those of other countries. While Hungarian regulations in this area tend to be among the most liberal in the region, they are still sufficiently restrictive to make it extremely difficult for Hungarian citizens to satisfy their demand for other currencies through official channels.

In order to purchase Western convertible currencies officially, the Hungarian citizen must ordinarily obtain a tourist visa entitling him to travel to the West. If he is granted a visa, the tourist can then apply to purchase a limited quantity of Western currency from the National Bank. The visa thus acts as a regulator of the domestic tourist demand for hard currency; a tourist cannot obtain this visa at will. Those who can demonstrate that they have an independent source of hard currency (e.g., those with friends or relatives living in the West who will undertake to finance the planned trip, or those who have a legitimate hard currency income) can generally obtain a visa more readily than those who must rely on the National Bank for a hard currency allocation.

Individual CMEA countries exercise varying degrees of control over the issuing of visas and hard currency allocations to citizens wishing to travel to the West. Hungary, together with Poland and (even) Czechoslovakia, has regularized this control by publishing regulations that normally permit citizens to apply every three years for a tourist visa to travel to the West. On obtaining a visa, they are usually allowed to purchase a limited quantity of hard currency (3); the limit varies according to the proposed length of the trip, the type of trip (less for package tours, more for private tourism), and according to the supply of hard currency available to the tourist from other sources (friends, relatives, etc.), but generally does not exceed 200 to 300 US dollars. (4) Normally, Hungarians, Poles, and Czechoslovaks can obtain a visa more frequently if they can demonstrate that they have a legitimate, independent source of hard currency which is sufficient to cover all their expenses:

- (3) Although Poland has recently announced that, due to a chronic shortage of hard currency, it will discontinue the practice of selling tourists hard currency.
- (4) See Hungarian Situation Report/5, Radio Free Europe Research, 25 March 1981, Item 4, for a more detailed description of the current provisions in Hungary.



In the other countries of the region, travel to the West is regarded as a reward, not a right; and so in Bulgaria, the GDR, Romania, and the Soviet Union hard currency sales to tourists are more closely linked to political than to economic criteria.

A Hungarian resident wishing to travel as a tourist to another CMEA country usually must follow the same procedure as that outlined above for travel to the West, the essential difference being that he can travel more frequently to other CMEA countries and generally the limits on the acquisition of CMEA consumer currencies are more liberal than those applying to the acquisition of Western currencies. Hungarian tourists wishing to travel to Yugoslavia are generally faced with tighter currency restrictions than those applying to tourists traveling to CMEA member countries; but at the same time, these are more liberal than those applying to tourists going to Western countries.

Hungarian enterprises, like their counterparts in other CMEA countries, face strict controls which effectively render the forint inconvertible (both in the goods and financial senses). As far as the domestic transactions of enterprises are concerned, enterprises formally enjoy the goods convertibility of the forint: nominally, Hungarian enterprise managers make their production decisions according to market data, using profitability as the criterion for determining their output mix and their choice of inputs. It is difficult, however, to find evidence that the practice of enterprise decision-making fully supports this theory. Rather, it would seem that Hungarian enterprise managers are subject to a complex system of central interference, based partly on financial regulation (the "economic regulators") and partly on administrative fiat. As a result, it would seem that Hungarian enterprise managers enjoy: a. somewhat more goods convertibility from the holdings of currency than do their counterparts elsewhere in Eastern Europe, but b. significantly less goods convertibility than enjoyed by enterprise managers in the West.

Enterprise decision-making concerning foreign trade transactions are heavily influenced by the fact that approximately half of Hungary's trade is conducted with CMEA countries. With the exception of the relatively small proportion of intra-CMEA (above plan) trade contracted at world market prices and settled for in Western currencies, Hungary's trade with other CMEA countries is conducted through the annual bilateral trade agreements. As these trade agreements are binding on the Hungarian government, individual Hungarian enterprises can be presented with a fait accompli to accept delivery of certain imports from other CMEA countries and/or to deliver certain exports to these countries. While it may or may not be profitable for individual enterprises to undertake such activities, it is clear that the profitability of such transactions is not in question: the plan determines the intrabloc flow of goods, and so long as existing intrabloc trading procedures continue, Hungarian enterprises will be faced with imperatives, forcing them to deliver, and accept delivery of, goods without regard to profitability. As far as intrabloc transactions is concerned, the forint (and all other CMEA currencies) exhibits goods inconvertibility.

Moreover, the forint (again like other East European currencies) is also financially inconvertible in intrabloc trade transactions. Hungarian trade with other CMEA countries is negotiated and settled in a special inconvertible currency, the "Transferable Ruble" (TR). (5)

When he undertakes transactions with Western enterprises or individuals, the Hungarian enterprise manager faces a system rather different from that confronting enterprise managers in other CMEA countries. Rather than being confronted with planned import and/or export quotas, the Hungarian enterprise can undertake contracts either directly with the Western trader or with a Hungarian foreign trade organization.

In order to import goods from the West, Hungarian enterprises need to obtain an import license; upon obtaining this license, the enterprise usually can obtain a Western currency allocation to pay for the goods. As a result, the availability of import licenses is the determinant of enterprise import transactions. It is difficult to determine the criteria used by Hungarian authorities when allocating such licenses, but it is reasonable to assume that licenses are more (or less) readily available when balance of payments constraints are less (or more) severe.

Hungarian enterprises are actively encouraged to obtain export sales with Western enterprises, although it is reasonable to assume that intra-CMEA trade agreements place limitations on goods convertibility: so long as approximately one half of Hungarian trade is conducted with CMEA countries, it is unlikely that Western traders will be able freely to acquire the goods of their choice. Moreover, the authorities' desire to ensure an adequate supply of consumer goods probably results in administrative regulation of exports (through export licensing) even if exports would be more profitable than domestic sales.

Finally, the denomination of Hungarian trade transactions with the West in Western currencies obviates the need for the financial convertibility of the forint. Indeed, it is possible that, as far as Hungary's Western trade partners are concerned, the existing system of settlement in "hard" currencies is probably preferable to a system involving a "convertible" forint, since the intercession of the forint would subject them to the extra risks of exchange rate adjustments to the forint.

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- (5) In theoretical terms, a currency is transferable when it exhibits goods inconvertibility but has some controlled financial convertibility. It is doubtful whether the TR is actually transferable. The TR is transferable in the sense that, e.g., a Czechoslovak trade deficit with the GDR, and an equal GDR deficit with the Soviet Union can be canceled by Czechoslovakia depositing the sum with the International Bank for Economic Cooperation in Moscow (the bank which issues the TR) to the benefit of the Soviet Union. But this only occurs within the CMEA and then only for CMEA currencies. Since the goal of CMEA countries is to balance bilateral trade according to annual trade agreements, clearing balances (which indicate a need for currency transfers) only arise through the violation of trade plans and are usually not settled through currency transfers but through an equal (but opposite) planned clearing balance in the following year.



The situation described above is largely a reflection of the fact that the domestic and international planning procedures employed in all CMEA countries are incompatible with currency convertibility. In order to support these procedures, a complex administrative structure has been developed in Hungary in the post-war period to regulate trade and payments both with other CMEA countries and with non-CMEA countries. This regulatory system has been somewhat modified since the introduction of the New Economic Mechanism in 1968, and it has been these changes that have provided the basis for the speculation that the forint might "become convertible."

It is, however, evident that, despite these modifications, the Hungarian government currently employs wide-ranging administrative regulations that place significant restraints on the convertibility of the forint, both in the goods and financial senses. Indeed, given these regulations, it is not unreasonable to conclude that, on the conceptual scale of convertibility suggested in the previous section, the Hungarian forint is approaching the inconvertible end of the scale.

#### Prospects for a Convertible Forint

For at least a decade, Hungarian financial authorities have maintained that Hungary intends, as a long-term goal, to make the forint convertible. Despite repeated official policy statements to this effect, there remains some confusion as to what practical significance could be attached to such a policy goal. Part of the confusion is attributable to a tendency to simplify an essentially complex subject into oversimplified alternatives: will the Hungarian forint become convertible or not? We have argued above that it is more appropriate to examine the question of convertibility in terms of a conceptual scale ranging from the (theoretical) extreme of pure convertibility to the other (theoretical) extreme of pure in-convertibility. We have also argued that the complex administrative system employed in Hungary to regulate international goods and financial flows has resulted in the forint tending toward the extreme of pure inconvertibility.

What changes do the Hungarian authorities plan to make to this regulatory system in order to make the forint relatively more convertible? Perhaps the most authoritative recent statement on this subject has been that made by the Deputy President of the Hungarian National Bank, Janos Fekete, and as such it is worth quoting in detail:

In the further development of our foreign exchange system, I regard the implementation of the forint's convertibility to be a realistic objective that is reconcilable with the planned socialist economy; in these circumstances, we would retain the system of import and export licenses, but for the so-called current payments

(goods, transport, insurance, etc.), we would assure the convertibility of the forint, while for capital movements and the satisfaction of the population's needs, we would maintain foreign exchange limitations consistent with our foreign exchange situation and the changes thereto. (6)

It is thus apparent that the Hungarian financial authorities are not planning the wholesale removal of the administrative regulations controlling international goods and financial flows. The statement quoted above would suggest that, on the contrary, this system will remain largely intact. Indeed, the anticipated changes will affect only current account transactions with Western traders, i.e., those transactions already conducted in (Western) convertible currencies.

The implication of the above quotation is that Hungary would discontinue the practice of negotiating trade contracts in Western currency but would instead denominate transactions in a newly issued currency that we shall call the "convertible forint"; the Hungarian government would undertake to convert Western traders' holdings of this currency into a Western convertible currency on demand. Individual Hungarians would be unable to hold the "convertible forint" and would be confronted by the same set of regulations described above. Moreover, Hungarian enterprises would continue to be subject to existing import and export licensing procedures, so they could not obtain the "convertible forint" (and hence Western convertible currencies) at will. Indeed, as far as domestic individuals and institutions are concerned, current regulations would remain unchanged by the envisaged initiative, and their holdings of forint would remain inconvertible.

The terms of the Hungarian proposal indicate that the "convertible forint" will exhibit neither goods nor financial convertibility -- or, at least, not in the way in which Western currencies are acknowledged to exhibit these characteristics. Goods convertibility will be limited by the fact that the (Western) holders of the "convertible forint" would only be able to convert the currency into Hungarian goods after the approval of the export licensing authorities. Financial convertibility will be limited by the fact that the government would not undertake to convert the new currency into the TR or into the currencies of the CMEA countries.

Given that this limited initiative is unlikely to have any direct influence on domestic economic activity, what is the purpose of the proposed initiative? (7)

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- (6) Janos Fekete "The Crisis of the Capitalist Monetary System and Our Economic Policy," Tarsadalmi Szemle, Vol. 35, No. 2, 1980, p. 44.
- (7) See also Paul Marer, "Exchange Rates and Convertibility in Hungary's New Economic Mechanism," in Joint Economic Committee, US Congress East European Economic Assessment Part 1, 1980, pp. 525-548.

According to Fekete, a "convertible forint would be tangible proof of the Hungarian economy's stability and continued growth and it would enhance [Hungary's] international standing and credit rating. It would be feasible economically to attract foreign capital to convertible forint accounts." (8)

Despite this colorful evaluation, it is not clear how changing the rules regulating current account transactions with the West constitutes proof of the performance of the Hungarian economy, particularly given the fact that such transactions are already negotiated and settled in (Western) convertible currencies. Moreover, it is not clear how, say, a deterioration in the performance of the Hungarian economy would prejudice the implementation of this proposal. It is thus evident that the proposed move is closely connected with Hungary's demand for hard currency credits. First, it would confirm the reputation that Hungary "does things differently," an image that Hungary actively seeks to encourage. Secondly, and more tangibly, it may provide a new source of Western credits, since Western holdings of the "convertible forint" would constitute an effective credit. But then credits could also be obtained merely by offering favorable interest rates to holders of Western currencies who deposit them with the Hungarian National Bank -- it is immaterial whether these are denominated in dollars or "convertible forint."

Why would Western traders wish to hold the "convertible forint?" One authority (9) has suggested that traders might be encouraged to hold the convertible forint if they were offered more favorable interest rates than those available elsewhere; this may be complemented by favorable tax concessions. Traders would, however, need to measure any potential returns from holding the "convertible forint" against: a. new transaction costs from being forced to convert Western currencies into the "convertible forint"; and b. the risk that the Hungarian authorities might devalue the "convertible forint" against major Western currencies.

Against the potential benefits of obtaining a new source of credit, the Hungarians will be forced to hold larger reserves of Western currencies, in order to ensure the ready conversion of the "convertible forint" on demand. This, together with the potential need to offer an interest rate premium in order to attract Western traders to hold the "convertible forint," may reduce the economic benefits from the scheme. However, the fact that the Hungarian authorities plan to issue a "convertible forint" rather than allowing Western traders, say, to deposit dollar denominated funds at favorable interest rates with the Hungarian National Bank indicates that the proposed system might have been designed primarily with its public relations impact in mind, *i.e.*, with economic considerations taking second place.

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(8) Janos Fekete, op. cit.

(9) Marer, op. cit.



Whatever the motivations for this proposed initiative, it is clear that implementation will not result in the convertibility of the forint in the sense that the term has been defined above. The implementation of a policy to create a degree of financial convertibility for the forint in a certain set of transactions may have a significant (and anticipated) public relations impact. It will not, however, lead to any fundamental change in the system of administrative regulation of Hungary's international trade, a change that would be necessary if the forint were to satisfy the conditions for goods and financial convertibility set out above. In the terms of our conceptual scale of convertibility, the implementation of Fekete's proposals could be taken to indicate a movement toward the pure convertibility end of the scale, but the forint would still more closely resemble the currencies of its CMEA neighbors than those (convertible) currencies of the West.

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