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OECD ECONOMIC SURVEYS

HUNGARY

1995

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Publié également en français.

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BASIC STATISTICS OF THE REPUBLIC OF HUNGARY 1994

THE LAND

Area (sq. km)	93 036
Arable land (sq. km)	47 144

THE PEOPLE

Population (thousands, end-year)	10 245
Urban population (percentage of total)	63
Rural population (percentage of total)	37
Projected population decrease (1990 = 100, percentage)	
2000	2
2020	9
2040	18-23
Employment (thousands, end-year)	4 002.3
Unemployment rate (percentage, end-year)	9.7
Rate of activity of population aged 15-74 (percentage)	57.0
Private farms (thousands)	1 201

Population of major cities, (thousands):	
Budapest	1 930
Debrecen	210
Miskolc	180
Employment by sector (percentage of total):	
Agriculture, forestry and fishing	8.9
Industry (mining, manufacture, electricity, water and gas)	28.0
Construction	5.4
Services	57.7

THE PARLIAMENT

Parliament	386 seats
Number of policital parties (elections of May 1994)	35 (6 in the Parliament)
Share of seats held by governing coalition	72%

PRODUCTION

GDP (billion forints, current prices)	4 330
GDP per capita (US$, official exchange rate)	4 000
Consumption (private, percentage of GDP)	73.7
Gross fixed capital formation (percentage of GDP)	19.6

PUBLIC FINANCE

State budget deficit (percentage of GDP)	5.5
General government revenues (percentage of GDP)	53.7
Total consolidated public debt (percentage of GDP)	83.3

FOREIGN TRADE AND FINANCE

Exports of goods and services (percentage of GDP)	28.7
Imports of goods and services (percentage of GDP)	35.5
International reserves (months of imports)	5.6
Total gross external debt (billion US$)	28.5
Total gross external debt (percentage of GDP)	69.2

THE CURRENCY

Monetary unit	Forint
Currency units per US$:	
Year average, 1994	105.13
April 1995	120.24

This Survey was prepared by the OECD Secretariat in the context of the Partners in Transition programme.

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Its contents were discussed in a Partners in Transition meeting of the Economic and Development Review Committee on 12 June 1995.

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This Survey is published on the responsability of the Secretary-General of OECD.

Introduction

The course of economic developments during the two years 1993 and 1994 covered by this review was importantly shaped by two partially conflicting pressures. On the one hand, it was necessary to carry forward the complex tasks of financially restructuring the banking and enterprise sectors of the economy --a process that was given a decisive push in 1992 with the implementation of a tough bankruptcy law and measures obliging banks to deal with their non-performing loans. On the other hand, it was clear that ''reform fatigue'' had become widely prevalent in the Hungarian population after several years of declining output and rising unemployment; pressures therefore mounted to find ways of lowering the perceived adjustment costs of the transition. These conflicting pressures gave rise to a certain amount of ambiguity and incoherence in the implementation of structural policies: programmes designed to improve financial discipline were modified in practice via *ad hoc* government interventions when they threatened to cause too much pain. While privatisation remained an important objective, in practice the rate of privatisation slowed as debates about processes and priorities intensified, and the government's role in the economy was in some ways reinforced by establishing a state holding company. Pressures to reduce the costs of transition also revealed themselves in rapidly increasing budget deficits – as what society expected from the government ran increasingly ahead of what it was willing to pay for. Finally, the pressures revealed themselves in the growing priority given to achieving a turnaround in the economy by more expansionary macroeconomic policies.

In early 1992, stabilisation in Hungary appeared to be bearing fruit although GDP was still declining: inflation had declined from a peak of 40 per cent in June 1991 to around 20 per cent in July 1992, the current account was in surplus, and net foreign debt was declining. These positive developments prompted an easing of monetary policy, while the budget deficit was permitted to increase by about

4 percentage points. Increasing demand and a weak supply response led to a rapid deterioration of the current account in the second half of 1992 and early 1993, which, at the time of the previous Economic Review in early 1993, appeared to be temporary.

Rapidly rising domestic demand fuelled by a decline in household saving and high bank liquidity led to a further deterioration of the current account in 1993. Foreign debt – already high by international standards – increased and in the course of the year inflation picked up. The supply response of the economy remained insufficient with GDP declining by a further 1 per cent, although operating losses declined and production started to recover toward the end of the year. External shocks and drought partially contributed to weak production but other factors also played a role. The strictures of the bankruptcy law were in practice eased with respect to a number of large enterprises and their debt was partly taken over by the budget. Bank recapitalisation got underway but restructuring along commercial lines remained slow. Public debt increased rapidly as a result of bank recapitalisation and measures to aid enterprises, establishing a significant fiscal liability for future years in the form of debt service. In view of the worsening current account, monetary policy was tightened in the course of the year, while the budget deficit, which had threatened to deteriorate, was held to around 5.5 per cent, an improvement in comparison with 1992.

Developments in 1994 were mixed, but on the whole the macroeconomic situation was not sustainable. Despite a tightening of monetary policy throughout the year, domestic demand – driven to some extent by infrastructure investment – remained buoyant and the current account deficit increased further to $3.9 billion, or 9.5 per cent of GDP. Non-debt creating inflows of around $1.1 billion financed only part of this deficit, the remainder being covered to a great extent by bank and corporate borrowing. The supply responsiveness of the economy improved with GDP likely to have grown by some 2.0-2.5 per cent. Operating losses by the enterprise sector fell sharply although the dualistic nature of the economy – where losses are concentrated in a number of large firms – has persisted. Bank recapitalisation was essentially completed and a broad programme to deal with non-performing bank loans was initiated. The budget deficit, despite some measures to contain it, increased and – excluding privatisation – is likely to have reached 9 per cent of GDP. Without policy corrections there was a real danger

that a debt trap could develop as rising interest payments came into conflict with pressures to maintain high levels of social expenditures.

Under these difficult conditions the new government, which took office in July 1994, formulated an economic strategy for 1995 which had as its principal objective to reduce the current account deficit by around a half. Certain measures to achieve this objective were initially identified in the 1995 budget bill presented in October of 1994, though it was only in March 1995 that a decisive action plan for macroeconomic policies and structural reforms was presented. A fundamental element of the strategy is a tight wages policy intended to reduce consumption and imports, while at the same time reducing pressures on the budget and lowering public consumption. Improved cost competitiveness via reduced real wages is to be supported by further structural reforms: the government announced its intention to accelerate privatisation and to end direct and indirect support of unviable enterprises. The fiscal stance is planned to tighten by around 3 percentage points of GDP, reducing the general budget deficit to 6 per cent. An ambitious target for privatisation revenues was set which, if fully achieved, would lower budget financing requirements by a further 3 percentage points. Supporting the 1995 budget, and the March 1995 supplementary budget, are a number of proposals to reform the social security system and the state administration, though clearly these constitute only the initial steps in what must be a multi-year reform programme. Monetary policy is programmed to remain tight, since March 1995 operating within the framework of a crawling peg exchange rate system: for the year as a whole, the forint will be devalued by 29 per cent.

This survey, the third for Hungary within the framework of the Partners in Transition Programme, analyses the complex set of issues confronting stabilisation policy in the short term, and beyond that by structural measures which will encourage growth and competitiveness. Chapter I reviews recent economic developments and outlines the issues which policy needs to address. These include the danger of a debt trap arising from the interaction of a high debt/GDP ratio and a real rate of interest in excess of the growth rate of the economy, and the need to deal both with excess absorption and with structural deficiencies that impair international competitiveness.

Fiscal and monetary policy issues are the subject of Chapter II. In view of the high and rising level of government debt, a substantial fiscal adjustment is needed to obtain a significant primary budget surplus as soon as possible. This

will require important microeconomic policy measures in both the social welfare system and in the operation of the public sector. The options which are available to achieve fiscal consolidation, while at the same time promoting growth, are discussed. The analysis of monetary policy focuses on the important restrictions which have been placed on the conduct of policy by the need to finance the budget and from the interest insensitivity of important areas of expenditure. The policy choices facing the authorities in dealing with the current account deficit are considered. To a great extent the current account and the budget have been financed through high interest rates, encouraging foreign borrowing by domestic residents. The limits of such a policy choice are highlighted.

The current account problem confronting Hungary has often been considered a question of an inappropriate exchange rate. But in an economy where supply flexibility still appears to be limited by the ongoing transition process, other factors – including importantly the level of aggregate demand – also have to be considered. Chapter III reviews various measures of international competitiveness and seeks to weigh the relative importance of different factors in explaining trade performance. Chapter IV considers the framework conditions that will shape the dynamism and responsiveness of aggregate supply over the medium term – including financial discipline, privatisation and the efficiency of financial intermediation.

The report's assessment and recommendations are presented in Chapter V. Annexes discuss debt dynamics, the development of corporate profitability, the relative importance of factors influencing the trade balance, and income distribution.

I. Growth with widening imbalances: macroeconomic developments in 1993-1994

Overview

The first few years of the transition in Hungary were characterised by marked declines in income and output, accompanied by improving inflation performance and a strengthening external balance. Several indicators point to a resumption of output growth getting under way in mid-1993, and this led in 1994 to the first recorded annual increase in GDP since 1989. In both 1993 and 1994 domestic demand grew strongly: in 1993 the ending of inventory de-stocking and consumption led the way. Consumption continued to increase in 1994, but fixed investment – broadly defined – became the leading source of growth. Directly and indirectly, the government budget underpinned the recovery of domestic demand, though data deficiencies make it difficult sometimes to trace the channels of influence. In any event, the large budget deficit that had emerged in 1992 grew larger still by 1994. Inflation stopped falling and began to rise again in the course of 1994. In both 1993 and 1994 domestic demand exceeded slowly expanding domestic supply by about 7 per cent, giving rise to a sharp deterioration in the current account.

In view of the large current account and budget deficits it became necessary in early 1995 to question whether growth had been established on a sustainable basis. Some observers – particularly inside Hungary – assessed the overall economic situation as promising and therefore proposed only a rather cautious policy correction. This chapter concludes that although there were a number of positive developments, the situation at the end of 1994 was indeed serious, with the budget deficit widening rapidly and the economy threatening to enter a debt trap, so that strong corrective measures were called for.

The recovery of demand and output

The recovery of demand was consumption-led to a considerable extent

Gross industrial production grew in both 1993 and 1994 (by 4 and 9 per cent respectively), the turnaround having come about the middle of 1993 (Figure 1). GDP, however, still declined in 1993 for the year as a whole by an estimated 0.8 per cent due to apparent weakness in services and in agriculture – the latter adversely affected by climatic factors that were partly reversed subsequently (Table 1). Preliminary estimates suggest that in 1994 GDP grew by around 2 per cent.

Domestic demand grew by around 7 per cent in 1993 and by a further 8 per cent or so in 1994 (Table 2). This strong demand growth was led by the recovery

Table 1. **Sources of GDP**[1]

	Structure of GDP 1991	1992	1993	1994	Structure of GDP 1994
		% growth in volume			
Agriculture and forestry	7.9	–16.6	–6.7		
Mining	3.3	–63.2	–44.1	5.9	34.6
Manufacturing	19.8	1.6	6.3		
Electricity, gas, heat and water	3.6	–0.7	10.2		
Construction	5.0	1.9	–6.4	17.0	5.6
Trade, repair, maintenance	12.3	–18.0	–4.9	–4.5	9.4
Accomodation services and catering	1.9	–4.3	–6.9	–5.6	1.7
Transportation, telecommunications	8.5	–4.3	–5.1	–1.6	7.7
Financial services	4.1	–14.5	14.7	3.0	4.2
Real estate, leasing	9.4	3.9	3.9		
State administration, mandatory social security	5.9	3.7	1.4		
Education	4.4	3.5	0.4	0.9	28.8
Health and welfare	3.8	4.0	2.0		
Other communal services	2.4	31.0	–3.8		
Sectors total	92.3	..	..	..	92.0
Undivided fee of financial intermediation	–4.3	–25.3	6.6	6.6	–3.7
GDP (at producer prices)	88.0	–4.0	0.1	2.6	88.3
Balance of product taxes	12.0	4.3	–6.7	–2.0	11.7
GDP (at market prices)	100.0	–3.0	–0.8	2.0	100.0

1. The national acounts have been corrected by the CSO so as to exclude the acquisition of MIG aircraft in 1993 in return for the partial forgiveness of debt owed by the Russian Federation.

Source: Central Statistical Office and Ministry of Finance.

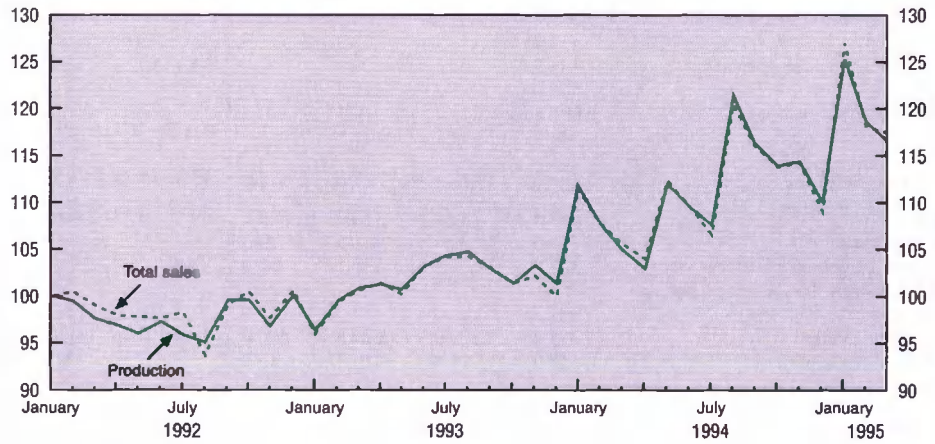
Table 2. **Uses of GDP**

	1992	1993	Contribution percentage points[1]	1994	Contribution percentage points
	% growth in volume			% growth in volume	
Final consumption	0.8	1.7	1.3	0.7	0.6
Household consumption[2]	–0.1	1.5	1.0	1.3	1.0
Government consumption[3]	6.4	3.1	0.4	–2.7	–0.3
Fixed capital investment	–2.7	1.7	0.4	11.5	2.5
Change in inventories (HUF bn)	–107.8	22.5		59.1	
Total domestic demand	–3.6	7.0		4.5	
Exports	2.1	–10.1	–3.5	13.3	3.8
Imports	0.2	12.6	–4.4	17.9	–6.4
GDP	–3.0	–0.8		2.0	

1. Growth rates weighted by share of GDP in previous year.
2. Including health, education and other social services provided in kind.
3. Collective consumption only excluding MIGs.
Source: Central Statistical Office and Ministry of Finance.

in inventory accumulation and by personal consumption, and these factors appear to have been sustained into 1994. Household consumption contributed about one percentage point to the change in GDP[1] in both years. Despite large and growing budget deficits the contribution of collective consumption[2] to demand growth

Figure 1. **INDUSTRIAL PRODUCTION**[1]
1992 January = 100



1. Seasonally adjusted.
Source: Hungarian Central Statistics Office.

was relatively small for the two years taken together (positive in 1993, negative in 1994).

The relatively constant contribution of household consumption to growth over the review period masked substantial underlying, and offsetting, swings in income growth and the household savings rate (Table 3). In 1993 real wages and

Table 3. **Sources of household income and savings**

	HUF billions, current prices % of disposable income in brackets				Volume (previous year = 100)			
	1992	1993	1994	1995[1]	1992	1993	1994	1995[1]
Adjusted disposable income	2 507.8 (100)	2 905.4 (100)	3 590.0 (100)	4 255.0 (100)	95.5	95.0	103.8	92.7
of which:								
Total primary income	2 201.6 (87.8)	2 621.3 (90.4)	3 173.1 (88.5)	3 806.0 (89.4)	98.4	97.1	101.7	93.8
of which:								
Wages and salaries	1 166.0 (46.7)	1 362.9 (47.1)	1 654.8	1 870.0 (43.9)	91.9	95.4	102.2	87.9
Mixed income[2]	498.2 (19.9)	565.0 (19.4)	722.0 (20.1)	1 009.0 (23.7)	111.9	92.5	107.6	108.8
Total transfers received	848.9 (34.1)	941.8 (32.6)	1 080.0 (30.6)					
of which:								
Social security benefits	414.3 (16.6)	491.1 (17.0)	584.5 (16.2)		103.2	96.8	100.2	
of which: Pensions	305.5 (12.2)	367.1 (12.7)	444.1 (12.2)					
Social assistance benefits	148.8 (6.0)	188.3 (6.2)	209.9 (5.9)		84.1	103.3	93.8	
Total contributions paid	–1 007.8 (–40.3)	–1 211.2 (–41.9)	–1 340.0 (–37.5)					
Total consumption	2 144.8	2 632.1	3 188.8	3 813.0	99.9	101.5	101.8	93.6
Savings	368.1	282.4	418.8	442.0	89.9	60.5	146.6	85.2
Savings rate	14.6	9.7	11.6	10.3				
Balance of capital transfers[3]	27.8	31.9	86.1	61.0	25.6	93.6	227.2	55.1
Profit from exchange rate valuation changes	7.7	24.8	37.9	87.0	32.2	262.8	124.2	178.6
Adjusted savings	398.6	329.9	527.8	590.0	67.9	67.6	134.7	111.8
Adjusted savings rate	15.9	11.3	14.7	13.9				

1. Ministry of Finance estimates for 1995.
2. Mixed income includes income from self-employment, non-market agricultural incomes, and entrepreneurial incomes.
3. Composed of cancelling of government housing loans and change in market value of household holdings of compensation vouchers, including new issues.

Source: Central Statistical Office.

total disposable income fell by 6.5 and 5.0 per cent respectively, so that consumption growth was driven by a decline in the household savings rate, from 14.6 to 9.7 per cent.[3] As was noted in the previous Economic Survey savings rates in 1991/92 were abnormally high by recent standards; this was attributed to high real deposit rates, an attempt to rebuild savings balances after the government's mortgage reform programme,[4] and precautionary savings in the face of rising unemployment and high levels of inflation. By mid-1993 unemployment had peaked, *ex post* inflation was possibly much lower than anticipated, and real deposit rates were falling. In 1994 higher real wages and incomes permitted continued consumption growth and a recovery in the savings rate: *ex post* real interest rates rose and households became the recipients of large capital transfers in the form of compensation vouchers and exchange rate gains. The increase in nominal savings in the first half of 1995 was nearly identical to that of a year earlier, indicating a substantial decline in real savings and possibly the savings rate.

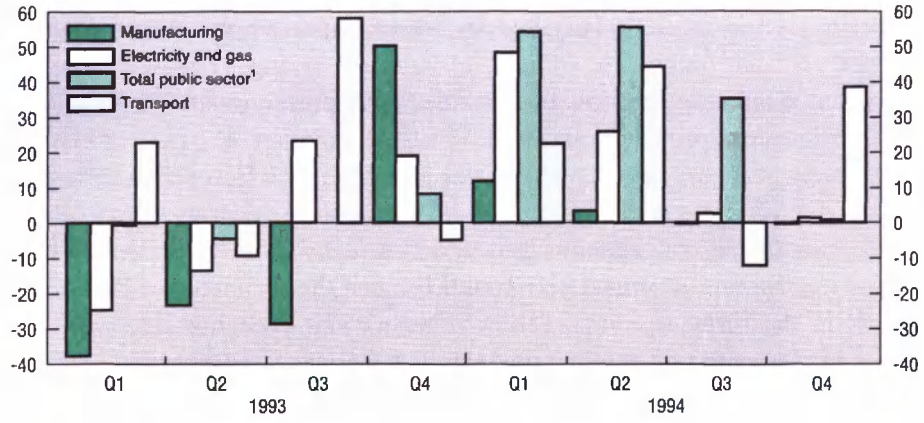
Investment accelerated in 1994, but net exports were a drag on growth

Based on monthly figures, investment recovered from mid-1993 but was nearly unchanged for the year as a whole. 1994 national accounts estimates point to investment growth of 11.5 per cent, spread across all sectors, and particularly strong in infrastructure projects conducted by various levels of government and public utilities (Figure 2). Investment by public utilities and parastatals in transportation, electricity and gas accounted for about one-third of total investment in 1993 and such investment was even more important in 1994, led by major projects such as the Vienna-Budapest highway. Direct public sector investment was concentrated in infrastructure projects like water treatment and sanitation. The timing of public investment appeared to be in part conditioned by electoral considerations: central and local government expenditures were particularly large before their respective elections in May and December 1994.

Industrial investment was stagnant, and what did occur appears to have been largely realised through imports of capital goods by firms with foreign participation or ownership. Manufacturing investment fell by 13 per cent in volume terms in 1993 and only recovered by an estimated 2 per cent in 1994. Credits for enterprise investment remained expensive and difficult to obtain except for the

Figure 2. **AN INFRASTRUCTURE BASED RECOVERY OF INVESTMENT**

% change over same period previous year



1. Total public sector includes public administration, education, health and social work, and community services.
Source: Hungarian Central Statistics Office.

best borrowers; thus investment was largely financed by retained earnings or by foreign borrowing.[5] The importance of foreign ownership shows up in a breakdown of investment by type of ownership and composition: over half of enterprise investment was undertaken by firms with some foreign participation,[6] and imported machinery and equipment accounted for about two-thirds of investment expenditures of this type. Overall, more than half of total investment was in construction.

Net exports made a negative contribution to growth in both 1993 and 1994, though this decreased in 1994 as exports recovered from their 1993 trough. Considering exports and imports separately, exports are expected to have made a positive contribution to GDP growth in 1994 of 3.8 percentage points, an impressive turnaround from 1993 when there was a negative contribution of 3.5 percentage points.[7] Most of the decline in exports in 1993, and much of the subsequent rebound in 1994 was in the still-dominant traditional sectors of food and agricultural products, clothing,[8] basic metals and chemicals – together theses sectors account for about half of total exports. While exports by many newer

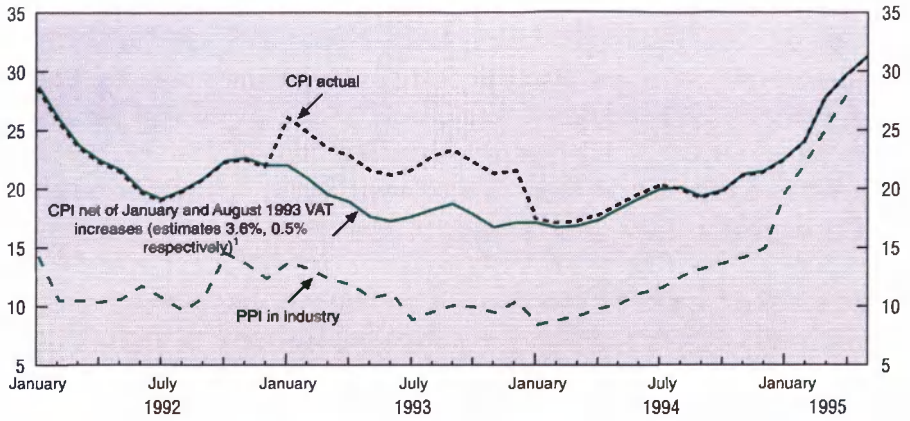
sectors grew rapidly in 1994 – plastics, electrical machinery, radio, television and communications equipment – their small size limited their impact on aggregate exports (see Tables 23-25 in Chapter III).

Imports accelerated steadily from already high growth rates in 1992. On a national accounts basis (and excluding MIG aircraft) they rose by 12.6 and 17.9 per cent in 1993 and 1994, respectively (Table 2), so that the negative contribution of imports to GDP growth increased from –4.4 to –6.4 percentage points. While a negative factor in an accounting sense, it would be an error to view this surge in imports as necessarily problematic. Consumer goods imports account for only one-fifth of the total: industrial supplies and investment goods together account for about 60 per cent of total imports, and an even higher share of the increase in imports in both years. Such imports serve to improve product quality and weaken dependency on a narrow domestic supply base, making a positive contribution to Hungary's continuing transformation and integration into the world economy. The challenge is to assure sufficient export growth to make import growth sustainable.

Price and wage increases have accelerated

Consumer and producer price inflation (over the preceding 12 months) declined gradually throughout 1993 despite the VAT increase in January 1993, but in 1994 this trend was reversed (Figure 3). The recovery of inflation in 1994 was partly accounted for by policy measures: the authorities increased excise taxes (gas, petrol, alcohol and tobacco) though energy price increases were delayed until January 1995 when they rose by some 39 per cent. At the same time agricultural tariffs and other protective measures, in conjunction with the contraction in agricultural supply, served to push up food prices strongly. An accelerating rate of devaluation may also have contributed to the rise in inflation (see Chapter II) given the apparently quick pass-through of exchange rate changes into prices: producer prices for exports increased rapidly over the period and prices for domestic sales rose more or less in line with them. Inflationary pressures strenthened in the first half of 1995 following large increases in administratively-controlled energy prices and a 9 per cent devaluation in March,[9] with the CPI and PPI increasing at annual rates of around 30 and 24 per cent respectively.

Figure 3. **INFLATION**
% change over previous 12 months



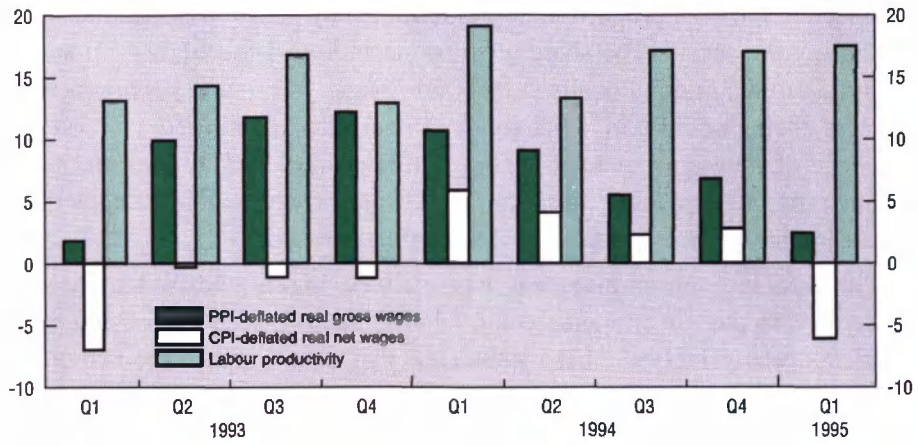
1. Administered price changes are estimated to have contributed 2 percentage points to inflation in both January and March 1995.

Source: Hungarian Central Statistics Office, estimates by OECD Secretariat.

Gross wages in the enterprise sector have grown steadily – by 25.1 per cent and 23.4 per cent in 1993 and 1994, respectively – and this has translated into an increase of real producer wages in manufacturing by over 10 per cent in both years (Figure 4). A marked feature of the experience in Hungary has been a significantly higher rate of inflation as measured by consumer price than by producer prices,[10] so that real wage developments were quite different from the perspective of consumers/workers: wages net of social security contributions and personal tax increased by much less than gross wages in 1993, resulting in a decline of the consumer real wage. This situation was reversed in 1994 when, following a change in the tax codes, net wages grew strongly and the consumer real wages increased by some 7 per cent. In both years labour productivity increased – split about equally between increasing output and declining employment – so that despite the strong rise in real producer wages, the share of wage costs in total enterprise costs has fallen. In the first quarter of 1995 real consumer wages fell by some 7.5 per cent as wage increases did not keep up with accelerating inflation.

Figure 4. **REAL WAGES AND LABOUR PRODUCTIVITY IN MANUFACTURING**

% change over same period previous year



Source: Hungarian Central Statistics Office.

In the public sector, which accounts for about a quarter of the employed workforce, the implementation of new laws concerning civil servants resulted in an increase in their wages about 3.6 percentage points greater than the average in the enterprise sector in 1994. However, wages in the public sector remain substantially below those for comparable positions in the private sector, particularly for managerial positions, and are scheduled to decline by double-digit levels in 1995.

Unemployment has fallen

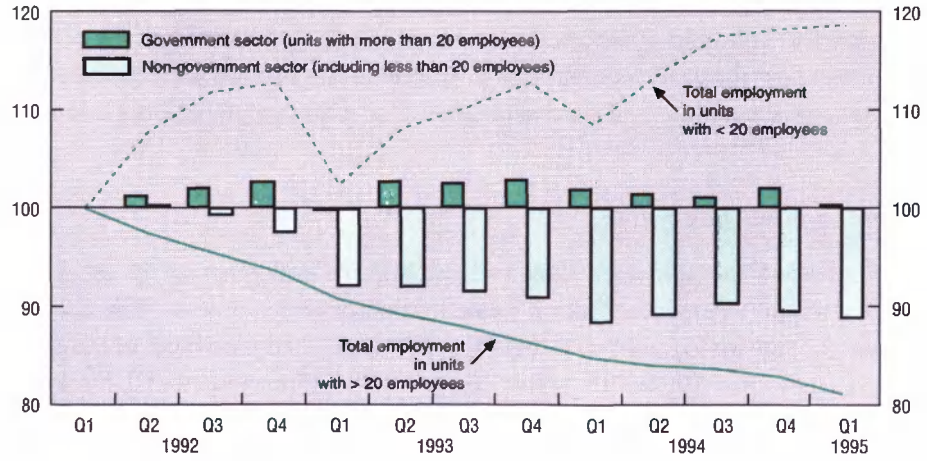
Registered unemployment has declined significantly since early 1993. Registered unemployment reached its peak in February 1993 with 705 thousand persons (an unemployment rate of 13.6 per cent) and declined continuously through December 1994[11] for a total drop of 185 thousand, to 10.4 per cent. Labour force survey data indicate that 70 per cent of the inflow into unemployment in 1994 came from new layoffs. Early 1995 witnessed an abrupt upsurge in unemployment to 11.4 per cent, about half of which was due to the annual re-

basing of estimates of the labour force, but by May the rate had fallen to slightly below the December level.

Two major labour market problems – the high share of long-term unemployment and the high proportion of youth unemployment – continued to worsen over the review period. The share of those unemployed for more than one year – according to the internationally comparable labour force survey – has increased from less than one-fifth in 1992 to over two-fifths at the end of 1994. The persistence of long-term unemployment is further burdened by two overlapping problems: the large regional disparities in unemployment and the extremely high share of unemployment among the Roma ethnic group.

The structure of employment has evolved in an unexpected direction: employment in the government sector,[12] but excluding state-owned enterprises, expanded strongly in 1993 at the same time that it declined in the non-government sector by some 8 per cent (Figure 5). Employment in the government sector declined somewhat in the course of 1994 but the gains made in the previous year were not reversed. More in line with expectations, employment fell strongly in

Figure 5. **CHANGING STRUCTURE OF EMPLOYMENT**
1992 Q1 = 100



Source: Hungarian Central Statistics Office.

units with over 20 employees and increased in smaller units by some 65 000 between 1992 and 1994. From the perspective of productive sectors, the share of agriculture in employment declined by 3 percentage points, to 7 per cent, with all the gain accounted for by the government sector; as the shares of other sectors did not change significantly.

Enterprise profitability has improved

On the supply side of the economy there has been slow but steady improvement in overall enterprise profitability, but there is still some way to go to reach a satisfactory situation. Full profit data is only available up to 1993, but preliminary estimates by the Ministry of Finance show that overall pre-tax profits of non-financial enterprises finally became positive in 1994 – reaching HUF 40 billion, up from HUF -179 billion in 1992. A strata of profitable private and foreign owned firms has continued to develop and the share of state-owned firms in economic activity has declined further. Despite the overall fall in exports in 1993, the profitability and efficiency of the exporting base appears to have improved, and this probably continued in 1994 thereby contributing to the strong recovery of exports.[13]

Tax return data for 1993 indicate that operating profits recovered significantly in that year. This was in part related to improved factor utilisation. Employment was reduced by 10 per cent in non-financial enterprises, contributing to an improvement in labour productivity of 15 per cent, and there also appears to have been some improvement in raw material usage. Although total expenditures on labour and raw materials grew by 15.2 and 18.2 per cent respectively, sales rose by 19.2 per cent. Offsetting what appears to be a positive trend, part of the improvement in operating profits was attributable to increased subsidies (HUF 27 billion or 0.4 per cent of sales) and lower depreciation allowances.

After-tax profits improved by more than operating profits, largely through debt forgiveness (see Chapter IV for details). It is hard to give an estimate of cost reduction due to debt forgiveness since a great deal of debt was in any case not being serviced by the companies. However, in 1993 interest paid by enterprises declined by HUF 17 billion. Unpaid taxes increased substantially in 1993 and further in 1994, helping to sustain large loss-makers; a substantial portion of the increase in both years is attributable to the accumulation of penalty interest.

The improvement in overall profitability reflects both higher profit by profitable firms and declining losses by unprofitable ones. Nonetheless, losses by unprofitable firms, while declining, remain large and are highly concentrated. The overall level declined by 20 per cent in 1993, and probably further in 1994.[14] The number of firms with losses exceeding HUF 100 million fell from 603 in 1992 to 541 in 1993,[15] but these firms still accounted for three fifths of the total losses incurred by non-financial enterprises, and for 15 per cent of enterprise employment. Within this group, 24 firms – 11 of which are classified as majority state-owned – had losses greater than HUF 1 billion, accounting for 19 per cent of corporate losses in 1993.[16]

The bankruptcy law which came into operation in 1992 only marginally affected the largest loss-making firms. Some large state-owned firms were saved by the government acquiring their debt, while for others bank debt was rolled-over (see Chapter IV).[17] In the case of joint ventures, where losses may largely reflect start-up costs, finance from the parent company was probably important in ensuring that the enterprise was not obliged to petition for bankruptcy.

Table 4. **Structure and performance of non-financial enterprises**

Per cent

	1992			1993		
	Domestic private	Joint venture	State owned	Domestic private	Joint venture	State owned
Growth of						
Per capita nominal wages and related costs				18.1	35.4	31.1
Labour productivity (gross output)				15.9	18.3	3.1
Employment				–6.3	17.8	–22.9
Unit labour costs				1.9	14.5	27.1
Unit labour costs in dollars				–12.5	–1.8	9.1
Share of						
Total exports	24.4	37.0	38.7	24.7	49.0	26.3
Total sales of non-financial sector	34.0	23.5	42.5	35.7	31.6	32.7
Total employment of non-financial sector	39.4	14.8	45.7	41.2	19.5	39.3
Ratio of						
Pre-tax profits to sales	–2.62	–2.27	–4.75	–0.03	–0.76	–2.83
Exports to sales	10.1	22.2	12.8	9.2	20.6	10.7

Source: Calculations by the Secretariat based on data from enterprise tax records provided by the Ministry of Finance. For details, see Annex II.

Within the enterprise sector, behaviour and performance is strongly related to ownership status: whether the firm is domestically privately owned, is a joint venture with foreign participation, or is state-owned.[18] Labour productivity increased by 16 and 18 per cent respectively in private and joint venture firms in 1993 but in state-owned firms by a mere 3 per cent (Table 4). Substantial increases in total wage costs in both joint ventures and state-owned enterprises (above 30 per cent) resulted in a significant increase in the unit labour costs of the latter by 27 per cent, far above the overall increase in output prices of 15 per cent; in joint venture firms unit labour cost increased by 14 per cent. For domestic private firms the nominal wage bill increased by very much less;[19] and in combination with high labour productivity growth, unit labour costs only increased by around 2 per cent.

Increased macroeconomic imbalances

Accompanying the recovery of demand has been a rapid widening of the current account deficit to nearly $4 billion by the end of 1994 – 9.5 per cent of GDP – and a large budget deficit approximating 9 per cent of GDP. The policy questions raised by these imbalances relate above all to their likely sustainability, and beyond that to how the imbalances are linked and to the nature of the response which is required.

A large current account deficit

The current account deteriorated by nearly 9 per cent of GDP between 1992 and 1993 (Table 5). This decline was quite unexpected at the time, occurring after three years of current account surpluses, and in the face of a continued decline in Hungarian GDP. The external accounts deteriorated further in 1994 despite rapid growth in Hungary's export markets, the reversal of several adverse supply shocks, and a substantial tightening of monetary policy. The decline would have been worse if not for favourable movements in Hungary's terms-of-trade, which improved by 2.3 per cent in both years.[20]

Almost all of the increase in the current account deficit in both years occurred in the trade balance. According to balance of payments data, there was a steady deterioration in the trade balance over the course of 1992 with a very large

Table 5. **Balance of payments**

US$ millions

	1990	1991	1992	1993	1994
Exports	6 346	9 258	10 028	8 094	7 613
Imports	5 998	9 069	10 076	11 340	11 248
Balance of trade	348	189	–48	–3 247	–3 635
Freight and shipment, net	–164	–80	–116	–106	–176
Travel					
Receipts	818	1 006	1 231	1 181	1 428
Expenditures	473	446	641	739	925
Balance	345	560	590	442	503
Government expenditures, net	17	63	78	–17	–12
Investment income					
Income	230	297	420	456	661
Expenditures	1 644	1 628	1 636	1 586	1 947
Balance	–1 414	–1 331	–1 216	–1 130	–1 286
Direct investment income, net	–24	–32	–45	–56	–117
Unrequited transfers, net	727	860	859	732	909
Services, net	302	67	103	–104	–55
Labour and property income, net	18	–20	9	–6	–43
Other current payments, net	–28	–9	110	38	1
Current account balance	127	267	324	–3 455	–3 911
Long-term capital	204	3 070	432	5 632	2 295
Assets, net	–76	–57	–145	237	36
Liabilities, net (– increase)	–31	1 668	–894	3 066	1 161
Inflow	2 516	4 077	2 204	6 388	5 429
Outflow	2 547	2 409	3 098	3 322	4 267
Direct investment, net	311	1 459	1 471	2 350	1 100
In Hungary, net	311	1 459	1 471	2 339	1 146
Abroad, net	..	..	..	11	–49
Basic balance	331	3 337	756	2 177	–1 616
Short-term capital	–893	–617	5	459	960
Assets	–324	141	–152	–165	189
Liabilities	–569	–758	157	624	771
Overall balance	–562	2 720	761	2 635	–656
Reserves	562	–2 720	–761	–2 635	656

Source: National Bank of Hungary.

drop in the fourth quarter. By the end of the first quarter of 1993 exports had fallen by 28 per cent compared with the same quarter a year earlier,[21] and the current account deficit was running at an annual rate of $2.8 billion. Exports then stabilised for the rest of 1993, but showed a further decline of nearly $500 million in 1994. With imports growing strongly in 1993 and remaining at high levels in 1994, the current account deficit reached $3.4 billion in 1993, $3.9 billion in 1994, and $1.4 billion for the first quarter of 1995.

While the customs figures show a similar overall deterioration on an annual basis, the timing is very different. There was little deterioration of the trade balance during 1992; rather the sharp drop in the trade balance did not occur until the first half of 1993. Exports recovered strongly in 1994, increasing by over 18 per cent in contrast to the decline on a payments basis. The pattern of imports on a custom's basis was also quite different: they increased steadily over the entire 1992/1994 period, with an acceleration in 1994.

There are a number of reasons for discrepancies between the two methods of measuring the trade balance,[22] one of which is unregistered capital outflow. There is substantial anecdotal evidence that a number of companies fail to fully repatriate export earnings, and that many small entrepreneurs maintain bank accounts abroad. Supporting evidence for capital outflow is provided by looking at shifting leads and lags of payments around exchange rate devaluations. In 1993-1994 there were five major exchange rate devaluations; in all but one case the trade deficit on a payments basis was larger than the unadjusted customs deficit in the period 4-6 weeks before the devaluation, and this discrepancy was mostly reversed in the month following devaluation as the leads and lags were presumably unwound. Statistical analysis also indicates that there is a strong correlation between the level of domestic real deposit rates and the difference between payments and adjusted customs figures, indicating that relative rates of return may have been a factor[23] as would be expected if the gap reflects hidden capital outflows. Table 6 provides a very crude estimate of the magnitude of such flows, which might have averaged close to $1 billion over the two years.[24]

Table 6. **Reconciling measures of trade flows**

US$ millions

	1992	1993	1994
Balance of trade (customs basis)	–361	–3 623	–3 853
Less balance of non-payments activities	+718	+1 568[1]	+989
Balance of trade on comparable basis (net customs data)	+356	–2 055	–2 864
Balance of trade on BOP basis	–48	–3 246	–3 635
Difference	404	1 192	771

1. Includes imports of MIG aircrafts from Russia as part of a debt settlement agreement.
Source: National Bank of Hungary, Balance of Payments Statistics.

The non-trade component of the current account has weakened steadily since 1992, going from a surplus of $372 million in 1992 to a deficit of $275 million in 1994. The individual items are relatively small – only tourism, unrequited transfers and interest payments are of any significance.[25] Net tourism receipts experienced a slight dip in 1993, but over the last few years have been generating a relatively steady surplus of around $500 million as growing expenditures have been matched by increased receipts. Taken together with unrequited transfers, which may in fact largely reflect unrecorded export earnings,[26] the positive balance on these items still remained large enough to cover a substantial, if declining, share of Hungary's large net interest payments in 1994.

Despite rising net foreign debt, net interest payments increased only marginally between 1992 and 1994. Gross interest payments increased by around $360 million in 1994 but this is less than would be predicted on the basis of rising world interest rates. Indeed, the implicit average interest rate (net payments over the stock of net debt) fell steadily from 8.7 per cent in 1992 to 7.2 per cent in 1994.[27] At current levels of net foreign debt, each percentage point increase in world interest rates (or spreads) raises net debt payments by some $190 million, or two per cent of exports.

Financed by increased external debt

In 1993/1994 Hungary was able to finance a large proportion of the current account deficit through foreign direct investment[28] (FDI) and foreign borrowing by both enterprises and commercial banks. In 1993 all of the current account was financed by these two methods, in large part because FDI was unusually high at $2.3 billion due to the $880 million inflow from the partial privatisation of the telecommunications company, MATAV. Enterprises emerged as substantial external borrowers for the first time, generating net capital inflows of $725 million. The NBH provided no net financing of the current account, despite very large borrowing, as all of this went toward debt repayment or into reserves to cover future amortisation; the government itself borrowed about $212 million.

Foreign direct investment and private capital flows were not sufficient to finance the current account deficit in 1994, and the NBH was forced to increase its net foreign borrowing. Without the added inflows from large privatisations, and a slowdown in the overall privatisation process, FDI fell to $1.1 billion in 1994, even lower than the 1991/92 levels. Enterprise and commercial bank

foreign borrowing continued to increase but did not fully offset the fall in FDI (Table 7). Given the $456 million increase in the current account deficit, the decline in net capital inflows required an increase in NBH net borrowing of $1.6 billion. Total net foreign debt increased over the two year period by $5.6 billion to $18.9 billion, with increased official net debt accounting for 37.5 per cent of the total rise.[29]

Significantly higher debt levels and the poor trade performance led to higher debt service ratios. Debt service indicators deteriorated sharply in 1993 and this continued in 1994 (Table 8), a reversal in the improvement in the debt indicators achieved in 1990/1992.[30] Between 1992 and 1994 the debt service to export ratio rose from 31.2 to 48.7 per cent – nearly the same level as had prevailed in 1990.[31] On the other hand, foreign exchange reserves at the end of 1994 were comfortable at $6.8 billion or 7.2 months of imports.

Despite the higher debt levels, Hungary's debt management strategy has reduced Hungary's vulnerability to a possible crisis in investor confidence. Most Hungarian foreign borrowing over the review period has been in the form of medium-term bonds (mostly 5-10 years maturity), so that the share of short-term borrowing in total debt has fallen by over half during the last five years.[32] Hungarian bond issues have been largely placed with small investors[33] so that there is little secondary market trading.[34] Borrowing continues to be well-diversi-

Table 7. **Foreign debt and assets**

US$ billions at current exchange rates

	1992[1]			1993			1994		
	Gross foreign debt	Gross foreign assets	Net foreign debt	Gross foreign debt	Gross foreign assets	Net foreign debt	Gross foreign debt	Gross foreign assets	Net foreign debt
National bank	16.1	4.4	11.7	18.3	6.8	11.5	20.2	7.1	13.1
Government	1.6	0.1	1.5	2.0	0.2	1.8	2.3	0.2	2.1
Enterprises	1.9	2.1	–0.2	2.4	1.3	1.1	3.7	1.3	2.4
Commercial banks	1.8	1.5	0.3	1.8	1.3	0.5	2.4	1.0	1.3
Total	21.4	8.1	13.3	24.6	9.6	15.0	28.5	9.6	18.9

1. Data for 1992 are based on a new methodology and are not consistent with Table 8.
Source: National Bank of Hungary.

Table 8. **Debt service indicators (BOP basis)**

	1990	1991	1992	1993	1994
	(US$ millions)				
Gross foreign debt	21 270	22 658	21 438	24 560	28 521
Net foreign debt	15 938	14 555	13 052	14 927	18 935
Reserves (RES)	1 166	4 017	4 381	6 736	6 769
Reserves net[1]	–1 775	1 840	2 095	4 731	4 372
GDP	32 893	31 238	36 503	38 282	41 268
Imports	5 998	9 069	10 076	11 340	11 248
Exports of goods and services (XGS)	8 466	11 621	13 332	10 898	10 674
Total debt service[2]	4 191	4 037	4 733	4 908	6 214
Interest expenditures	1 644	1 628	1 635	1 586	1 947
Interest net	–1 414	–1 331	–1 216	–1 130	–1 286
Prepayments		296	568	699	1 016
	(in per cent)				
Gross foreign debt/GDP	64.7	72.5	58.7	64.2	69.1
Net foreign debt/GDP	48.5	46.6	35.8	39.0	45.9
Total debt service/GDP	12.6	12.0	11.4	11.0	12.6
Gross foreign debt/XGS	251.2	195.0	160.8	225.4	267.2
Total debt service/XGS	49.0	32.2	31.2	38.6	48.7
Interest expenditures/XGS	19.4	14.0	12.3	14.6	18.2
Interest net/XGS	–16.7	–11.5	–9.1	–10.4	–12.0
Import coverage indicator (months) (RES)	2.3	5.3	5.2	7.1	7.2
Memorandum: Customs data[3]					
Exports of goods and services[4] (XGS2)	..	12 335	14 009	11 711	13 762
Gross foreign debt/XGS2	..	183.7	153.0	209.7	207.2
Total debt service/XGS2	..	30.3	29.7	35.9	37.8

1. Reserves less short term liabilities.
2. Principal repayments on medium- and long-term debt, net of prepayments, and interest payments.
3. Debt service ratios are normally calculated using balance of payments data. However because of the wide discrepancy between Hungarian customs and payments data, payments data may understate the export potential of the economy. Customs data are provided for comparison purposes.
4. (XGS2) Exports of goods on gross custom basis and exports of services on BOP basis.

Source: National Bank of Hungary.

fied across currencies, with US. dollars, Deutschmarks and Japanese yen each accounting for about one-quarter of debt, and the Hungarian authorities have been active in making placements in smaller markets, as well as in hedging risks related to exchange rate movements among the major currencies.

Managing future debt payments will be easier as the National Bank has successfully smoothed-out the repayment schedule. At the end of 1992 Hungary faced a substantial surge in principal repayments in 1995 and 1996 (Table 9). The authorities were able to take advantage of favourable market conditions in

Table 9. **Principal repayments on convertible currency external debt**

US$ millions, at end of March 1993 exchange rates

As of	1992	1993	1994	1995	1996	1997	1998	1999	2000	Later	Total
12/92	3 098 (actual)	2 253	2 183	3 074	3 512	2 095	1 979	1 657	676	2 094	19 523
12/93		3 322[1] (actual)	2 717	3 339	3 455	2 350	2 955	2 484	2 294	3 363	22 957
9/94			4 241[1] (actual)	3 202	3 228	2 710	2 965	3 191	2 504	5 105	23 788
12/94				3 549	3 329	2 915	3 019	3 330	2 560	5 792	24 665

1. Actual payments were well above scheduled because of, in order of importance: *a)* Large prepayments by the NBH; *b)* increased private borrowing, for which repayment begins immediately; and *c)* exchange-rate movements.

Source: National Bank of Hungary, Statistics Department.

1993/1994 to make early repayments and to build-up foreign exchange reserves ahead of this payment bulge, while at the same time increasing average maturities. Repayments over the period 1995-2000 average around $3.1 billion per annum as of September 1994, but strong medium-term non-official borrowing in the fourth quarter has since increased scheduled repayments slightly for the period 1995 to 1997.

The consolidated budget deficit grew rapidly

To obtain a clear picture of macroeconomic developments since 1992, it is necessary to consider the evolution of the consolidated public sector including the National Bank of Hungary. The reasons include the important fiscal responsibilities of the National Bank of Hungary with respect to servicing sovereign foreign debt and the extensive web of extra-budgetary funds and local governments which characterise the economy. Unfortunately, the information systems which are needed to track intra-government transactions are poorly developed so that the available consolidated accounts must be treated with care and as an indicator of tendencies rather than clear cut outcomes. This is particularly so with respect to levels of expenditures and revenues: according to one estimate,[35] aggregate expenditures and revenues might be overstated by as much as 6 per cent of GDP.

Between 1991 and 1994 the nominal consolidated budget deficit (excluding privatisation revenues) deteriorated from 2.1 to 9.8 per cent of GDP. This move

occurred in two large jumps in 1992 and 1994, as there was a small improvement in 1993, though proper accounting of interest payments would probably show a steady deterioration over the entire period.[36]

Within this overall deterioration, the primary balance of the central budget improved slightly (Table 10). Real non-interest expenditures fell steadily over the review period after a substantial increase in 1992. Expenditure reductions were registered in nearly all categories (see Chapter II for details), with wages being the least effected and real social transfers declining sharply. Reflecting these developments in the central budget, the share of general government expenditures in GDP declined from the extremely high level of around 60 per cent in 1992 to around 57 per cent in 1993/1994, though these estimates should be treated with caution. The decline in real consolidated expenditures was slightly exceeded in both years by a reduction in real revenues, with the fall in non-tax revenues being particularly marked.

The small improvement in the primary balance of the central budget was more than offset by rising interest payments and the growing deficits of the social funds and local governments. Consolidated interest payments have grown rapidly, driven by the growth of foreign debt service, the increased domestic debt burden arising from bank recapitalisation including the purchase of non-performing loans, and rising domestic interest rates beginning in mid-1993. Between 1992 and 1994 total interest payments increased by 1.5 percentage points of GDP.[37] Taken together the deficits of the pension and health funds and of local government increased by over one percentage point of GDP.

Assessing the impact of the public sector on demand and the savings-investment balance requires looking at different measures. From the national accounts or final demand perspective, government consumption made a slight contribution to the growth of final demand taking 1993 and 1994 together (Table 2). Public consumption is not the only way in which government spending shows up on the national accounts: changes in the government balance sheet, specifically the issuance of compensation vouchers, affected household wealth and therefore indirectly stimulated household consumption. Furthermore 1993 and 1994 witnessed very strong growth in public investment, broadly defined; much of this investment was financed off-budget, and appears in the national accounts as part of gross capital formation.

Table 10. **Consolidated budget of the public sector**

HUF billions

	1991	1992	1993	1994	1995[1]
Central budget					
Revenue (excl. privatisation)[2]			1 041.0[3]	1 356.8	1 605.5
Non-interest expenditures[2]			1 051.8	1 395.3	1 453.4
Primary balance		–23.0	–10.8	–38.5	152.1
Per cent of GDP		–0.8	–0.3	–0.9	2.8
Balance of[4]					
Social security funds	–9.3	–17.3	–30.1	–34.5	0.0
Extra-budgetary funds	4.3	–1.4	11.1	–7.6	–23.9
Local government			–8.8	–41.7	–5.5
Total	–5.0	–18.7	–27.8	–83.8	–29.4
Less receipts from privatisation agencies[5]				30.0	13.0
Overall primary balance		–41.7	–38.6	–152.3	109.7
Per cent of GDP		–1.4	–1.1	–3.5	2.0
Consolidated interest					
Domestic securities		64.8	53.3	146.0	
Less net domestic income of NBH		19.5	16.8	16.2	
Total domestic		45.3	36.5	129.8	
Foreign net debt		95.1	115.6	143.3	
Total interest[6]		140.4	152.1	273.1	500.2
Per cent of GDP		4.8	4.3	6.3	9.1
Consolidated deficit[6]		182.1	190.7	425.4	390.5
Per cent of GDP	2.1	6.2	5.4	9.8	7.1
Debt amortisation			27.0	85.0	164.0
Privatisation revenues[7]		19.3	21.5	59.0	150.0
Public sector borrowing requirement (excl. foreign debt)		162.8	196.2	403.6	332.3
Per cent of GDP		5.5	5.5	9.4	6.0
Memorandum items:					
Borrowing by the HSHC				16	13

1. Including March supplementary package.
2. The figures for 1994 and 1995 include own incomes of central budgetary units of HUF 287 billion and HUF 207 billion respectively. They are not comparable with previous years.
3. Including an unknown volume of privatisation revenues.
4. Assumes no interest payments.
5. In 1994, comprises HUF 16.0 billion loan raised by the HSHC and paid to various funds plus an estimate of other privatisation receipts including HUF 5 billion paid to local councils. For 1995, comprises only a loan for $125 million taken out by the HSHC in the first quarter.
6. 1995 is not consolidated and is only payments by the central budget including those to the NBH.
7. Revenues recorded in the central budget as arising from privatisation.

Source: Ministry of Finance and estimates by the OECD Secretariat.

The fiscal stance also had important effects on national savings. Although gross national savings declined by about two percentage points in 1993 the measured contribution of government saving remained roughly constant at a little over 1 per cent (Table 11). This changed significantly in 1994 when gross saving by the government fell to –1.5 per cent of GDP, largely offsetting the improvement in household and enterprise savings.

Gross public sector debt (domestic and foreign) increased from HUF 1 919.5 billion at the end of 1992 to around HUF 3 624.3 billion at the end of 1994 (Table 12): from 65 to 83 per cent of GDP. High and growing nominal budget deficits, (including interest payments), accounted for about one-third of the increase.[38] Equally important were the large bond issues required to replace unserviceable liabilities from the past, – in particular bonds issued for the recapitalisation of banks and to cover losses from earlier housing loans. The fiscal impact of these bonds will be felt only from 1995 when interest payments will increase by around HUF 100 billion on this account alone.

In sum, the budget exerted a powerful – though hard to quantify precisely – influence on economic performance during the review period. Despite the modest growth of government consumption, public expenditures contributed substantially to sustaining final demand through their effects on household consumption and fixed investment, and the budget deficit absorbed a large share of national savings. This conclusion still applies even if correction is made for inflation and for the fact that interest payments from the central budget are to a great extent directed toward servicing foreign debt. On the other hand, advances were made in 1993 in reducing the role of the budget in resource allocation.

The policy environment at the end of 1994

The policy agenda at the end of 1994 and in the opening months of 1995 was influenced not only by economic performance during the review period – and the resulting imbalances – but also by several other salient features. Before considering economic policy proper in the following chapters, it is useful to outline several features of this policy environment. Three aspects were particularly noteworthy: the international situation, the possibility of a debt trap, and the authorities' overriding concern with competitiveness.

Table 11. **Savings and investment ratios in Hungary[1] and OECD**

Shares of GDP, excluding privatisation revenues

	1988	1989	1990	1991	1992	1993[2]	1994	OECD Europe 1970-79	OECD Europe 1980-89
Gross national saving	25.1	25.0	27.3	17.8	14.4	12.1	13.4	25.6	23.0
Households	6.6	7.9	9.1	15.1	12.5	8.0	9.7	10.2	9.1
Enterprises	10.9	12.0	13.1	–0.4	1.2	2.8	5.2	11.5	12.4
Government	7.6	5.2	5.1	3.1	0.6	1.3	–1.5	3.9	1.6
Capital transfers, net									
Households					0.9	0.9	2.0		
Enterprises					0.7	0.7	–0.7		
Government					–1.7	–1.6	–1.3		
Gross investment	25.3	26.6	25.4	20.4	15.2	19.4	21.5	25.6	22.9
Households	4.9	5.2	3.9	5.4	4.6	5.0	4.9	4.9	4.6
Enterprises	14.3	15.5	18.0	10.7	4.7	9.3	11.0	15.2	14.1
Government	6.2	5.9	3.6	4.3	5.9	5.2	5.6	5.5	4.2
Net-financial balance	–0.2	–1.5	1.9	–2.7	–0.8	–7.4	–8.1	0.0	0.1
Households	1.8	2.7	5.3	9.7	8.9	3.9	6.8	5.2	4.5
Enterprises	–3.4	–3.6	–4.9	–11.2	–2.7	–5.8	–6.6	–3.7	–1.7
Government	1.5	–0.7	1.5	–1.2	–7.0	–5.5	–8.4	–1.5	–2.7

1. Including net capital transfers for 1992-94. Data for these years are on the new SNA basis and are not comparable with previous years.
2. Excluding MIG imports.

Source: Ministry of Finance.

Table 12. **Gross public debt**

End of year stock in HUF billions

	1990	1991	1992	1993	1994
NBH credit to government (net of credit to SDI)	516.9	583.6	568.6	537.9	498.0
NBH credits to the State Development Institute	259.5	253.5	247.0	241.9	235.4
Treasury bonds	13.0	26.2	149.5	319.5	465.1
Treasury bills	10.2	60.0	157.3	220.7	315.1
Subtotal	799.6	923.3	1 122.4	1 320.0	1 513.5
Per cent of GDP	38.3	37.1	38.2	37.3	35.0
Capitalisations	28.1	30.0	159.7	442.5	547.2
of which:					
Treasury bonds to replace housing loans	..	..	83.2	79.4	75.8
Housing fund finance	19.1	19.1	19.0	19.0	19.0
Bank recapitalisation	..	..	..	285.6	332.7
Other capitalisations	9.0	10.9	9.2	10.2	12.3
Bonds to rouble claims			48.3	48.3	48.3
Revaluation bonds					59.1
Other credits					7.9
Total state debt	827.7	953.3	1 282.1	1 762.6	2 068.6
Per cent of GDP	39.6	38.3	43.7	49.8	47.7
Social security deficit bonds	..	..	..	16.0	22.0[1]
Debts of budgetary institutions, extra-budgetary funds, and local governments	27.6	28.6	26.3	29.1	54.4
Total public domestic debt (net of devaluation item)	855.3	981.9	1 308.4	1 807.7	2 145.0
Per cent of GDP	40.9	39.4	44.6	51.1	49.5
Fiscal liability from forint devaluation	519.2	777.9	888.9	1 182.0	1 440.0[2]
Per cent of GDP	24.9	31.2	30.3	33.4	33.3
Total general government domestic debt (including devaluation item)	1 374.5	1 759.8	2 197.3	2 989.7	3 585.0
Per cent of GDP	65.8	70.6	74.9	84.5	82.8
Foreign debt of general government	37.4	118.8	133.9	202.7	241.7
Borrowing of HSHC					16.5
Total government debt	1 411.9	1 878.8	2 331.2	3 192.4	3 843.2
Less: NBH holding of government debt (including devaluation item)	1 300.1	1 622.1	1 841.9	2 1686.8	2 558.3
Plus: gross external debt at NBH	1 148.4	1 418.9	1 430.2	1 934.1	2 339.4[2]
Total consolidated public debt	1 260.2	1 675.6	1 919.5	2 959.7	3 624.3
Per cent of GDP	60.3	67.2	65.4	83.7	83.7
Memorandum items:					
State budget interest expense	81.1	97.6	166.4	170.0	307.0
Per cent of GDP	3.9	3.9	5.7	4.8	7.1
Outstanding contingent liabilities of state budget:	1.5	21.7	41.9	132.7	197.2
SPA					10.0
HSHC					22.0
GDP	2 089.0	2 491.7	2 935.1	3 537.8	4 330.0

1. Does not include HUF 32.4 billions of bonds which were issued on 1 February 1995 to cover the 1994 Social Security deficit.
2. Estimate as of 1st February 1995.

Source: Ministry of Finance.

Both before and certainly after the Mexican crisis in December 1994 questions were raised about the sustainability and desirability of running a current account deficit of over 9 per cent of GDP. At first sight Hungary appeared to be unaffected by the unsettled conditions in world capital markets. Even after the onset of the Mexican crisis, Hungary was able to sell foreign bonds at 232 basis points above LIBOR, while Hungarian banks and firms still had access to capital markets – and indeed reported being approached by investors to accept new loans. Short-term debt was low and the debt management operations of the NBH had smoothed the refinancing requirements for several years to come at around $3.1 billion per annum. At the same time, however, it was also true that some foreign banks had become very cautious about handling Hungarian paper, and that the credit rating agencies, while not downgrading their rating, had placed the situation on watch for deterioration. Moreover, although the planned volume of refinancing was small, it still amounted to about a half of the net official reserves at the end of 1994. Under these conditions Hungary remained dependent on market sentiment – although perhaps less so than some other countries – and it was in this light that the combination of large current account and budget deficits had to be viewed. In this respect the experience of Turkey and Sweden, where the budget situation influenced the possibilities and terms of external financing, is clearly relevant.

With regard to desirability, a number of observers at the end of 1994 viewed the situation as having changed fundamentally for the better:[39] investment had increased and some companies were directly borrowing abroad and thereby did not contribute to worsening the fiscal problem associated with official foreign debt,[40] while ensuring, it could be hoped, the efficient utilisation of the funds. Although all this was true, it represented only part of the situation: in terms of levels rather than changes, the bulk of foreign savings went to financing government dissaving rather than investment. Moreover, borrowing by enterprises and banks abroad represented a financing transaction for the balance of payments – induced by higher domestic rates of interest – and ultimately for the budget rather than an autonomous capital inflow.

During 1994 the authorities became increasingly concerned about the projected growing interest burden of the budget. From a formal perspective, Hungary was probably in a debt trap: the nominal growth rate of GDP was less than the nominal rate of interest so that the ratio of debt to GDP was set to continue

increasing without limit (see Annex I). Less formally, the combination of growth, interest rates, debt and the current primary surplus would likely result in a stabilisation of the debt/GDP and deficit/GDP ratios only at very high levels. To avoid such a situation required a significant fiscal consolidation. While only illustrative, rough estimates suggest that an increase in the primary surplus in the order of 2-3 percentage points of GDP was necessary to achieve stabilisation of the debt/GDP ratio in the long run (Table 13, Scenario I). The illustrative model highlights another key feature of the Hungarian situation constraining policy options: with nearly two thirds of official debt denominated in foreign currency, a sustained devaluation (Table 13, Scenario III) results in a deterioration of the fiscal position and increases, *ceteris paribus*, the primary surplus which is required to stabilise debt/GDP.

The policy priority of fiscal consolidation was potentially lessened by a second consideration: whether and to what extent to monetise the deficit in order to lower the budget's debt and interest burden. This is a complex question which is partly addressed in Annexes I and in Chapter II. Very briefly, the budget deficit has always been monetised to some extent but at a time of a large current account

Table 13. **Debt dynamics: illustrative scenarios**

	Scenario I	Scenario II	Scenario III
	%	%	%
Growth rate of nominal GDP	21.8	21.8	24.5
Level of gross debt (end 1994)	3 500	3 500	3 800[1]
Less foreign assets	800	800	800
Net debt	2 700	2 700	3 000
Ratio of GDP	62	62	55
Interest rates			
– domestic	24.9	26.0	29.5[1]
– foreign	7.5	7.5	7.5
– revaluation effect	16.0	16.0	29.0
Total effective interest rate	24.0	28	34.0
Primary surplus required	1.4	3.8	5.2
Actual primary balance: general government	–2.0	–2.0	3.0
Limit of debt/GDP ratio	none	none	none

Note: Scenario I and II based on end 1994. Scenario III based on the March 1995 supplementary budget.
1. Excluding revaluation of foreign debt and assuming an increase in borrowing by HUF 300 billions.
Source: Calculations by the OECD Secretariat. See Annex I for methodology.

deficit and rising inflation, the need for greater money supply was not convincing.

The single greatest concern voiced by the authorities and the public was the question of competitiveness: there was a widespread sentiment that Hungary had lost international competitiveness, as evidenced not only by the current account deficit but also by Hungary's relatively slow growth rate in comparison to other countries in the region. The numerous policy measures under debate at the time included devaluation, export credits, protection against imports, and the formation of large Hungarian holding companies with the ''capacity to compete''.

The following chapters address these elements of the Hungarian policy problematic.

II. Macroeconomic policies and options

Overview

Macroeconomic performance has been strongly shaped by fiscal and monetary policy. The high level of the fiscal deficit has both contributed directly to the large current account deficit and, over much of the review period, tightly constrained the room for manœuvre of monetary policy because of budget financing requirements. The current account deficit has been viewed as primarily related to the real exchange rate. This led to a reorientation of exchange rate policy away from providing a nominal anchor and towards targeting the real exchange rate, thereby validating high levels of wage and price inflation. Efforts at fiscal consolidation have been comparatively modest to date, and have been hampered by the need to reform the public administration and to cut public sector employment. A significant rebalancing of macroeconomic policy toward a tighter fiscal stance is required: on the revenue side, room remains for widening the tax base and lowering marginal rates; expenditure cuts can be made by modifying the universal focus of many social welfare programmes and curbing widespread abuse. At the same time, the resulting relaxation of constraints on monetary policy could be used to more closely define objectives for exchange rate policy. The March 1995 economic policy package marks a significant step in this direction although it depends to an important extent on maintaining a reduction in real wages for the entire year. Fiscal tightening will only be sustainable if accompanied by medium-term structural reforms of the public sector and fiscal system.

The first section sketches the institutional framework for the implementation of fiscal policy. It outlines the measures taken during the review period to control the budget deficit, including the 1995 budget, the March 1995 policy package and the associated supplementary budget, which was expected to become law in July 1995. The policy issues which have arisen in enhancing revenues and curtailing

expenditures are reviewed and the 1995 measures assessed from this perspective. Controlling the level of wages has been a key element of macroeconomic policy, both in the past and in 1995. Labour market institutions and wage control measures are discussed in the second section. Finally, monetary and exchange rate policy is reviewed from the perspective of both policy objectives and the utilisation of monetary instruments.

Fiscal policy

Institutional context of fiscal policy

The formulation and implementation of fiscal policy is hampered by inadequate and tardy information and control mechanisms as well as by the complex and overlapping sets of central, local and parastatal institutions which characterise government in Hungary. There are 29 off-budget funds which are not yet consolidated and which function under separate acts of Parliament. They are usually financed by earmarked revenues, giving them significant independence from the budgetary process. Budgetary institutions often have independent sources of income – frequently from commercial activities – which are not remitted to a central treasury; until 1995 they were able to purchase government securities and treat the interest income as their own resource. There are two self-governing social insurance funds[41] which, for financial and policy purposes, are ultimately controlled by the Parliament; the Ministry of Finance can comment on their proposed budgets, but must rely on the government's Parliamentary majority to carry policy. Finally there are more than 3 000 local governments with independent borrowing rights but which receive a substantial proportion of their income through tax sharing with the central government. Setting fiscal policy in such a system is complicated,[42] and, as a result, the central budget often has had to carry the burden of short-term adjustment, although for the medium and long-term it is clear that reforms affecting the other institutions of government are of critical importance.

In addition to a complex structure of government, the rules under which each unit operates are fluid, making rational decisions and the maintenance of financial discipline difficult:

- Budget control and financing of the social funds is uncertain. The funds have access to the current account of the central budget and it is difficult to see how financial discipline over them can be maintained in practice. At the same time they do not always bear responsibility for their financial balance. For example, throughout 1994 the deficit of the Health Fund increased steadily reaching some HUF 24 billion by September.[43] This was automatically financed through the Ministry of Finance's current account at the NBH. The main reason for the deficit was that at the time the Fund's budget was prepared, new legislation was expected which would reduce sick leave and medication expenses. The legislative changes were dropped by the government but the fund was neither compensated nor its budget revised.

- When the two self-governing social insurance funds were established a law was passed obliging the government to transfer HUF 300 billion in assets to the funds by the end of 1994 at the latest. In both 1993 and 1994 revenues from these assets were included in the respective budgets, but up till early 1995 only an insignificant volume of assets had been transferred.[44] While there are good reasons for not transferring property, the fact still remains that the government was legally obliged to do so, and overall budgetary planning continued to include this income even though it was fairly clear that it would not be forthcoming. Agreement was reached in March 1995 to transfer only HUF 65 billion, and expenditure and revenue measures were finally put in place to fill the revenue shortfall.

- Local government financing appears poorly designed in relation to its responsibilities, which have been increasing. In addition to tied grants, local governments receive 35 per cent of revenues raised from personal income tax two years previously with no correction for inflation. At the same time their ability to raise local income is effectively constrained by the central government. There have been no controls on local government borrowing, facilitating an unexpected deficit of around HUF 41 billion in 1994 to meet their wide ranging obligations. A cap on debt service – 70 per cent of adjusted own revenues – was passed as part of the March 1995 policy package and took effect on 1 July 1995. Local government expenditures comprised about 18 per cent of GDP in 1994.

– Financial relations between the government and the Central bank are legally defined but in practice are subject to frequent changes. The law governing the NBH established limits on its ability to finance the central government (including purchases of government securities in the primary or secondary markets). The limit was set at 5 per cent of estimated budget revenues in 1993 decreasing to 4 per cent in 1994 and 3 per cent in 1995. The 1994 budget law overrode this provision, setting a fixed requirement of HUF 80 billion. The 1995 budget law re-established the 3 per cent target for 1995, though as a ceiling and not as a fixed commitment for the NBH; subsequently the NBH has permitted the budget to circumvent the rigours of market financing by allowing banks to hold some of their compulsory reserves in the form of special treasury bills. Continuous change in the "rules of the game" risks undermining the demonstration effects of legal constraints on government actions: if the budget law can be used to override the Bank Act almost every year, the effectiveness of the latter in influencing behaviour will be lost.

The structure of general government expenditures is heavily weighted in favour of entitlement spending and wages, making budget control and fiscal consolidation difficult. These categories account for about a half of government expenditure and a third of GDP (Table 14). Expenditures on entitlements are very difficult to control since capping them is hardly possible and legislative changes are often required to alter the entry conditions for programmes. In addition, general government is a major employer in the Hungarian economy, accounting for around a quarter of total employment. Following civil service and public sector reforms in 1993, flexibility to reduce employment levels and redirect workers has been curtailed. Since 1993 budgetary units have been required to compensate excess wage costs by cuts in other expenditures. While welcome as a disciplinary measure to support the budget, it does not address the more fundamental problem of restructuring employment in budgetary units.[45]

A consequence of the complex structure of the government sector and the lack of information systems is that budgets tend to be formulated as increments based on criteria such as the rate of inflation and do not involve a comprehensive review of expenditure priorities.[46] Under normal conditions this would be only a minor problem, but at a time when the government is seeking both to control the deficit and to lower the level of intervention in the economy the lack of a

Table 14. **General government expenditures, 1989-1994**

Shares of GDP

	1989	1990	1991[1]	1992	1993	1994
EXPENDITURES	60.9	57.4	54.7	61.6	57.2	57.5
of which:						
Wages and salaries	8.3	7.6	8.5	8.6	8.6	8.5
Other goods and services	12.2	11.1	8.4	9.1	9.3	11.6
Subsidies	12.1	9.6	6.9	5.6	4.5	3.8
On domestic products	7.1	5.6	4.2	3.0	2.8	2.1
On production	4.9	4.0	2.6	2.6	1.7	1.6
Social benefits in cash	14.4	14.9	16.9	18.4	17.2	15.8
O/w pensions	9.1	9.7	10.5	10.6	10.5	10.3
O/w family allowances[2]	3.1	3.1	3.4	3.2	3.1	2.4
O/w maternity and child care[2]	0.9	0.9	0.9	1.0	0.9	1.0
O/w sickpay	1.2	1.2	1.2	1.0	1.0	0.8
O/w unemployment benefits	0.0	0.8	0.8	1.6	1.3	1.2
Social benefits in kind	5.0	6.6	3.8	5.2	7.1	5.6
Interest payments	2.4	3.0	3.2	6.0	4.7	6.9
Capital expenditures	6.6	4.7	5.6	7.8	5.9	5.4
O/w fixed capital formation	5.9	3.6	4.3	6.1	4.5	4.0
O/w capital transfers	0.6	1.1	1.3	1.7	1.4	1.3
Memorandum item:						
GDP (used for the calculations)[3]			2 476.4	2 885.6	3 502.6	

1. There was a change in methodology for measuring GDP after 1991. The figures before and after 1991 are therefore not comparable.
2. Estimated shares of family allowances, maternity and child care taken from Blue Ribbon Commission report.
3. Differs from Tables 1 and 2 which include the most recent estimates of GDP.

Source: Ministry of Finance.

decision-making mechanism is important. A Committee was established in early 1995 by the government to review the structure and operations of the public sector, but how it will address the question of resource allocation subject to the tight fiscal constraints which exist is not yet clear. In any case, there is a continuing requirement for public administration reform which can only be ensured by institutionalising the process and establishing appropriate information systems.

Maintaining fiscal policy objectives in 1993 and 1994

Despite the rapid deterioration of the central budget deficit in 1991 and 1992, the targets set for fiscal consolidation in 1993 and 1994 were compara-

tively modest. The intention was to reduce the central deficit by a percentage point in 1993, but in 1994 an increase by about a percentage point was planned. During the course of both years the deficit threatened to exceed targets by substantial margins. In the event the outcomes proved better than expected, in part because of the supplementary budgets adopted in July 1993 and September 1994, respectively, but mainly because end-of-year revenues proved much stronger than projected (Table 15).

Table 15. **Central budget[1] targets and outcomes**

HUF billions, shares of projected GDP in brackets

	1992	1993	1994
Revenue[2]			
Budget target		960	1 131
		(28.9)	(26.4)
Supplementary budget		939	1 135
		(28.3)	(26.5)
Outcome	793	1 041	1 191
	(27.0)	(31.4)	(27.6)
Expenditures[2]			
Budget target		1 124	1 380
		(33.9)	(32.2)
Supplementary budget		1 131	1 394
		(34.1)	(32.5)
Outcome	965	1 219	1 430.1
	(32.9)	(34.4)	(33.2)
Central deficit (including privatisation)			
Budget target		–164	–249
		(4.9)	(5.8)
Supplementary budget		–192	–259
		(5.8)	(6.0)
Outcome	–172	–178	–238.7
	(5.9)	(5.0)	(5.0)
Social insurance funds deficit			
Budget target		–37	8
		(1.1)	(0.0)
Supplementary		–37	8
		(1.1)	(0.0)
Outcome	–22	–30	–35
	(0.7)	(1.0)	(1.0)

1. Excluding the social insurance and off budget funds. Measured on GFS basis rather than according to the previous Hungarian practice.
2. Excluding own revenues and expenditures of central budget units.

Source: Ministry of Finance.

Fiscal consolidation in 1993 relied overwhelmingly on measures to increase revenues. The original 1993 central budget envisaged a dual rate VAT system with rates of 8 per cent for consumer staples and 25 per cent on remaining goods, but the bill which finally emerged from discussions in the Interest Reconciliation Council placed the lower rate at 6 per cent and retained important exemptions –characteristic of the Hungarian system.[47] The need for a mid-year fiscal correction was driven by lower than projected VAT revenues and the loss of tax receipts from bank profits occasioned by increased bank provisioning for bad debts. The lower VAT rate was raised from 6 per cent to 10 per cent and excise taxes were tightened. At the same time, however, a one-off compensation payment was paid to lower income groups which accounted for half the expected revenue enhancement for the year.[48] Total expenditures remained as planned because lower than expected interest rates led to savings which compensated for overruns in other programmes.

The planned increase in the central budget deficit for 1994 was accompanied by further measures to enhance revenues since public sector wages were mandated to rise by 24 per cent – an *ex ante* increase in real wages of some 6 per cent. VAT exemptions were reduced and some new taxes were imposed. However, social insurance payments were also made tax deductible for the calculation of personal income tax, offsetting the increased tax burden from tax bracket creep,[49] resulting in net wages growing faster than gross wages throughout 1994. By mid year, after the new government had taken office, a supplementary budget was clearly required. Unlike past occasions, expenditure reductions amounting to around a percentage point of GDP were at first proposed: terminating the longer term commitment to the World Expo; and, more importantly, changing the pension law to avoid a legally-mandated retroactive adjustment of pensions to wage growth for the first eight months of the year, honouring only the last quarter. In the event, the World Expo was cancelled, but the pension change was not approved so that the full 8 per cent retroactive rise went through. Other measures to increase energy prices and to raise the lower VAT rate to 12 per cent were put-off until the 1995 budget. Revenue enhancing measures were confined to increasing some excise taxes and improving the collection of customs duties.

Financing the general government deficit has been a major concern of the authorities since 1992 when the requirement to finance the budget exclusively by the issue of securities was introduced. In early 1993 high household saving and

lower interest rates made financing relatively easy, but this changed in the course of the year. As further explained below, the NBH was placed under increasing pressure to support the bond market and to hold down interest rates – pressures that remained throughout 1994. Concern with the magnitude of debt service and therefore with the level of interest rates is understandable, especially in view of bank recapitalisation and the purchase of non-performing loans by the state, which by the end of 1994 had resulted in the issue of HUF 332 billion in bonds.[50] One primary response of the authorities – apart from urging the NBH to reduce market interest rates by ensuring adequate banking liquidity – has been to start selling debt directly to households. This has included: measures to develop a system of primary dealers – to this end commissions were increased in 1995; tax incentives to households (1994 only);[51] and developing a retail sales network. Through such devices the authorities anticipate significant savings on domestic debt service. While any move to improve financial market efficiency and the intermediation of savings is to be welcomed, the macroeconomic problem of budget dissaving crowding-out private investment will remain.

The 1995 budget and March supplementary measures

The 1995 budget, which was approved by the Parliament in December 1994, aimed to reduce the general government deficit by 2 percentage points including privatisation revenues and, more importantly, to establish a primary surplus of around 3 per cent which would facilitate some reduction of state debt (Table 16). Fundamental to the realisation of these objectives were two assumptions: privatisation receipts amounting to nearly 3 per cent of GDP and a limitation of budget sector wage growth to 8 per cent, implying a substantial reduction of wages in real terms. The budget envisaged a large decrease in real non-interest expenditures: these were planned to rise by some 14 per cent in nominal terms, a contraction in real terms of some 6 per cent. Such a decline was seen as necessary in view of projected weak revenues (low growth of customs revenues due to a slowing of import growth and cuts in tariff rates,[52] and, to a lesser extent, slow growth in wage incomes) and a substantial increase in interest payments by some two percentage points of GDP. The structure of non-interest expenditures was set to change substantially: social expenditures were budgeted to decline only slightly with respect to GDP so that the burden of adjustment was to be borne by the decline in real wages in the public sector.

Table 16. **The 1995 fiscal framework**

	1994[1]	1995 Budget	June supplementary budget and March policy measures
GDP (nominal) bn HUF	4 310	5 140	5 470
Current account ($bn)	3.9	2.5	2.5
Real growth (per cent)	2.0	0.0	0.8
Nominal growth (per cent)	21.8	19.3	26.3
Exchange rate (per cent)	15.6	15-17	29.0
Wage growth budget sector	23.6	8.0	6.0
CPI inflation (annual average) (per cent)	18.8	20-23	28.5
Interest rates			
Bonds	19.3	27.5	
Treasury bills	24.9	29.5	
Central budget			
Revenues	1 426.0	1 631.0	1 789.1
% of GDP	33.0	31.7	32.7
o/w privatisation	31.0	150.0	150.0
% of GDP	0.8	2.9	2.7
GFS expenditures	1 682.0	1 914.0	1 945.1
% of GDP	39.0	37.2	35.6
o/w domestic interest	284.0	454.0	483.6
% of GDP	6.6	8.8	8.8
GFS balance	–256.0	–283.0	–156.0
% of GDP	–5.9	–5.5	–2.9
Primary balance incl. privatisation[2]	–7.5	171.0	302.1
% of GDP	0.0	3.3	5.5
Balance of:			
Social security	–34.5	0.0	0.0[3]
Extrabudgetary funds	–7.6	0.0	–23.9
Local governments	–41.7	0.0	–5.5
General government GFS balance	–339.8	–283.0	–204.7
% of GDP[4]	–7.8	–5.5	–3.7
General government primary balance excl. privatisation	–127.6	21.0	115.7
% of GDP	–2.9	0.4	2.1

1. 1994 actual central budget figures are from the draft bill on the implementation of the budget.
2. Interest payments and privatisation revenues are assumed to affect only the central budget.
3. Social security funds were without an approved budget for 1995 at the time of writing (June 1995). The funds project a deficit of HUF –7.4 billion, while the government's proposal incorporates a balance.
4. GFS basis and cannot be compared with Table 10 which attempts to remove intra-government transactions and to incorporate the transactions of the National Bank of Hungary.

Source: Ministry of Finance.

The projected reduction in the general government deficit from 8 to less than 6 per cent of GDP derived almost entirely from privatisation receipts; some HUF 150 billion were projected from privatisation of the energy utilities, including power generation and gas. Treating these revenues as a financing item rather than

as current revenue shows that the budget deficit would have continued to deteriorate to about 8.5 per cent while the primary balance would have been only around half a per cent. However, there was a second difficulty with the 1995 budget: timing. It was projected that privatisation revenues would be realised only towards the end of the year and that this would place an enormous strain on budget financing – and programme credibility – up until that time. Moreover, the law limiting NBH purchases of budget debt to no more than 3 per cent would have severely constrained budget financing, forcing interest rates possibly higher than projected.[53] For these reasons planning for a supplementary budget began almost immediately.

The 1995 budget in its original state included a number of important changes to taxes discussed below, but from a broad perspective did not change the fiscal system in a fundamental manner. Budget consolidation was based heavily on transient elements which could not be sustained: one-off privatisation proceeds and a marked compression of budget sector salaries.

In March a package of economic measures was announced comprising 21 pieces of legislation together with a supplementary budget. The programme was passed in May and the supplementary budget was due to be approved at the end of June. Taken together they go a long way to addressing fundamental issues which were by-passed in the original 1995 budget. There were two reasons for the additional package of measures. First, both the current account and budget deficits for 1994 were worse than at first expected and, on the basis of unchanged policies, the Minister of Finance stated that the budget deficit in 1995 could reach some 10 per cent of GDP. Second, the over dependence of the 1995 budget on privatisation revenues was widely accepted, reinforcing the commitment to make a real fiscal consolidation of around 3 per cent.

The package of supplementary measures, not including the supplementary budget, aimed to save HUF 170 billion (around 3 per cent of GDP) comprising HUF 70 billion in revenue increases and HUF 100 billion in expenditure cuts. Last minute modifications by the Parliament reduced the projected savings to HUF 160 billion. At the same time, however, it was necessary to alter the basic assumptions of the budget due in part to a pre-announced exchange rate devaluation for the year of 29 per cent (Table 16). Interest payments were accordingly increased by some HUF 30 billion, partly offset by stronger revenues due to higher inflation and devaluation; the projected improvement in the central budget

deficit (excluding privatisation revenues) was HUF 157 billion. In addition, the government proposed a package of measures for the two social funds which would save HUF 26 billion, finally adjusting for the unrealistic expectations of current incomes which might arise from the transfer of property. At the time of writing, the managements of the funds had submitted their own budgets to the Parliament which differed from those proposed by the Ministry of Finance.

The principal fiscal measures in the March package comprise:

- Revenue enhancement

– An import surcharge of 8 per cent until mid-1997 on all imports with the exception of energy and machinery (which will be refundable). The surcharge is expected to earn HUF 50-55 billion. Including exchange rate and other changes, revenue is projected to increase by around HUF 88 billion.
– Excise tax increases, particularly on cars, are projected to raise HUF 4-5 billion.
– Enlarging the contribution base for the health and pension funds to increase revenues by HUF 15 billion in 1995; this will be lower than forecast as Parliament exempted in-kind payments in food from the base.

- Expenditure reduction

– Withdrawal of universal family allowances, maternity pay and leave provisions from July 1 to be replaced by targeted social assistance. The combined net savings were originally expected to be HUF 14 billion in 1995 and HUF 32 billion in 1996 (of which HUF 22 billion is due to family allowances), but will be slightly lower because of amendments added by Parliament maintaining automatic benefits for families with three or more children.
– Wage allocations to central budgetary units are to be cut by a further 3 per cent saving HUF 4 billion. More importantly, in support of the 1995 budget measures the government amended laws on budget sector employment so as to make it easier to reduce and restructure employment including limiting severance pay. The supplementary budget mandates employment reductions in central budget institutions of 15 per cent and has set aside HUF 2 billion for redundancy costs.

– Cost savings in the health system including better control of medicines to save HUF 8 billion in 1995.

The Ministry of Finance estimates that the package of policy measures taken in 1995 will result in savings for the central budget in 1996 of some HUF 230-HUF 270 billion. Nevertheless, viewed overall, a significant proportion of the deficit reduction in 1995 arises from temporary factors: the import surcharge, the freeze on current purchases in nominal terms and the limit on wage rises to 6 per cent. It is probable that wages will have to rise by around the inflation rate in 1996. Fiscal consolidation will thus have to continue in 1996 with new measures. To highlight these issues, the following section briefly reviews some programmes in which additional consolidation measures might be expected.

Enhancing revenues: achievements and outstanding issues

The previous Economic Review pointed to a number of deficiencies in the Hungarian taxation system: enforcement was poor and tax avoidance widespread, the tax base was narrow and tax rates high but effective rates low (Table 17). Other observers have criticised the constant changes and unnecessary complexity of the tax system, unclear incidence of tax, bias against new and small and medium-sized enterprises and high marginal effective tax rates on labour and,

Table 17. **Fiscal indicators**

Per cent

	1991	1992	1993	1994	1995[1]
Enterprise direct taxes/operating surplus	39.4	25.2	18.2	14.2	10.3
Social security contributions/wages and salaries[2]	42.3	45.3	50.2	46.0	45.1
VAT and other excise taxes/actual final consumption	17.6	16.4	16.4	16.4	17.2
Customs duties + dues/import	7.2	10.7	10.7	9.8	11.8
Personal income taxes/disposable income	10.6	10.8	11.9	11.1	10.8
Social benefits in cash/disposable income	27.2	27.6	28.9	27.2	24.5
Cash benefits less income taxes/disposable income	16.6	16.8	17.0	16.1	13.7

1. Including March measures and supplementary budget.
2. Including contributions for unemployment benefits.

Source: Ministry of Finance.

indirectly, on capital.[54] Progress made in addressing these problems appears inadequate, the authorities having to trade-off microeconomic efficiency against the risk of reducing budget revenues.

Tax enforcement

Arrears on taxes and social insurance payments remain a substantial problem. By the end of 1993 tax arrears amounted to HUF 95 billion (2.5 per cent of GDP) of which around HUF 19 billion represented unpaid penalty interest (Table 18). Tax arrears mainly comprise unpaid VAT.

The bulk of arrears are to the social insurance funds. Arrears were estimated at around HUF 136 billion in 1993 – rising to HUF 205 billion in June 1995 – but these figures must be regarded as approximate because the underdeveloped accounting and information systems do no permit an accurate accounting of unpaid enterprise obligations.[55] No break down of arrears by ownership status of companies is available, although it is known that some large state owned firms – especially the railways – are amongst the largest debtors.

The government has attempted to improve tax collection by strengthening fiscal enforcement powers and the 1995 supplementary budget increases the sums devoted to enforcement. The tax authorities and the social funds can now seize assets without going through the courts and have more flexibility to come to agreements with debtors as part of wider arrangements with creditors (see Chapter IV). Tax collectors have been placed on a commission basis and the recovery rate in 1994 is reported to have risen. In July 1994 the government announced a major effort to collect arrears, but this appears to have slowed as it became apparent that drastic action would be necessary against some large enterprises. Nonetheless these actions have resulted in a gradual increase in recovered taxes which now amount to around 1 per cent of GDP. Emphasis has instead been switched to ensuring that enterprises remain current in their tax obligations and the social insurance funds have made commitments to improve recoverability. A bill to forgive past arrears was proposed by the government in 1994 and was supported by the governing boards of the funds, but was later withdrawn from the Parliament. While the prevention of new arrears is important, not too much can be expected by way of recovering past debts: one estimate by the Ministry of Finance places the expected recovery rate at only 20 per cent given that, accord-

Table 18. **Tax and social security arrears**

HUF billions

	1990	1991	1992	1993	1994	1995
Stock of arrears:						
Taxes	33.7	64.2	69.4	95.0[1]	n.a.	n.a.
Social security				135.9	186.7	205.0[2]
Total				230.9		n.a.
Recovery[3]						
by enforcement	4.6	12.0	13.4	27.2		
liquidation	2.7	10.7	10.7	5.0		
compromise at bankruptcy			1.6	4.8		
Total	7.3	22.7	25.7	37.0		
Per cent of tax revenues	0.9	2.8	3.1	3.7		

1. Of which HUF 19 billion represents accrued interest.
2. June 1995.
3. Only refers to taxes not to social security funds.

Source: Ministry of Finance.

ing to estimates by the social funds, the majority of outstanding arrears are to companies under liquidation with little apparent residual value.

Tax evasion remains an important problem though it is difficult to quantify. High nominal rates for taxes and social security contributions create a powerful incentive for evasion, while effective tax inspection and enforcement still remains underdeveloped though improving. Issuing double tax receipts to avoid VAT is a well known practice but should be amenable to spot checking and some high publicity prosecutions. It has become an increasingly common practice for customers at all levels to be offered two prices: with and without VAT. To improve tax collection, the government is developing a joint computer system for the tax and customs office, while a new law is before Parliament which will restrict the number of companies permitted to sell goods subject to excise taxes.

Indirect taxes

Indirect taxes account for around 40 per cent of consolidated tax revenues, high by international standards; VAT and tariff revenues contribute 18 per cent and 8 per cent, respectively. Extensive exemptions, which have plagued the VAT system in Hungary, were reduced in 1993 and are largely set to disappear with the 1995 budget[56] when household energy purchases will no longer be zero-rated.

However, the system is far from optimal: the 25 per cent top rate is a powerful incentive for non-compliance and the difference between the two rates (12 per cent and 25 per cent), while narrower than in the past, might still lead to distorted resource allocation. Tariff revenues are relatively large but are set to decline in line with the Association Agreement with the EC and Hungary's commitments to the WTO.

The 8 per cent import surcharge introduced as part of the March supplementary package was implemented immediately and the WTO notified. From the fiscal perspective two issues arise: the reimbursement for exporters on their imported inputs, and the refund on imported investment goods. Both features will contribute to the administrative complexity of the surcharge, and may result in incomes lower than projected if past experience from other allowances is any guide to go by. Moreover, the longer the tax is in place, the greater will be its distortionary effects: import-competing intermediate products and investment goods are being discriminated against.

Personal tax reforms

The previous Economic Review noted that the personal income tax system was characterised by a wide dispersion of rates, and a large number of exemptions and special treatment for particular types of income. Since then the government has widened the tax base but revenues do not appear to have increased noticeably: revenues comprise about a fifth of total tax receipts while as a proportion of disposable income they have remained rather constant at around 11 per cent, and indeed are projected to decline (Table 17).[57] One reason for the continuity is that during negotiations in the Interest Reconciliation Council the government has often agreed to give some new relief in place of the old one being phased out.

Two important reforms were introduced in 1993 but little progress was made in 1994. In 1993, one third of estimated fringe benefits, amounting to some HUF 65 billion, (around 2 per cent of GDP) became fully taxable and special treatment of intellectual work became less generous. These changes might well have contributed to a short lived increase in the ratio of taxes to disposable income (Table 17). For 1994, a new maximum tax rate of 44 per cent was introduced,[58] and all rates and brackets will be continued in 1995 without indexation. At the same time, social security contributions by employees were made tax

deductible, accounting for a large increase in net wages relative to gross wages, and possibly reversing much of the tax revenue enhancement gained in 1993.

From the perspective of both equity and efficiency important changes have been introduced in the 1995 budget: the extensive tax deduction system has been replaced with tax credits[59] and some costly tax expenditures eliminated. Prior to October 1994 a tax credit of 30 per cent was prescribed on investments up to a limit of 50 per cent of taxes payable. The prescribed investments included Treasury bonds with a maturity of three years or longer and in 1995 will probably cost HUF 11-15 billion in terms of reimbursements. The tax credit covering Treasury bonds was abolished in the 1994 supplementary budget, but has been maintained for a limited range of other investments. In order to encourage savings, interest receipts on both foreign currency and forint bank accounts will also be tax free in 1995 – there was a withholding tax of 10 per cent until November 1994 – while dividends will be subject to a tax of 10 per cent. However, as described below, firms will be taxed at the rate of 23 per cent on distributed dividends.

Despite important reforms to the tax system and bracket creep, personal tax revenues still appear to be sluggish. One reason for this might be the relatively high tax rates (the highest is 44 per cent) which, unlike tax reforms in many other countries, have not been reduced at the same time that the tax base has been broadened. This may have contributed to tax evasion. Tax allowances and credits have also played a role, although without more information it is difficult to make a definitive judgement on this point.[60]

One possible way to increase tax revenues is to widen the tax base. Family and maternity allowances, pensions, and other social transfers are currently not treated as taxable income – as in fact happens in most OECD countries. Given the size of these programmes (Table 17) in relation to disposable incomes, the issue is clearly a very emotive one. In principle, all benefits should be treated as taxable income, to the extent that underlying contributions have been excluded from the tax base so that income is taxed only once. Employee contributions for pensions and health benefits (10 per cent of wages) are now included as taxable income but at the same time receive a 25 per cent tax credit, which removes much of the tax liability. Moreover, the 44 per cent contribution by employers is not treated as household income even though it contributes to households non-taxed income in the future – in most OECD countries the latter is taxed while the

former is not. Most other social assistance income is not taxed, though the targeting of some programmes achieved by the March policy measures will diminish the benefits of such a move. On the other hand, the difficulties of widening the tax base in this manner should not be under-estimated. The social assistance system probably already includes a number of poverty traps – when effective marginal tax rates rise steeply thereby inhibiting economic activity by the recipient – and these might likely become more important with a widened tax base. The capacity to introduce such a wide ranging reform is limited in most countries.

Corporate taxes

Corporate taxes account for around 2 per cent of budget revenues. Given the low level of tax revenue involved, the 1995 budget has introduced a major change in the system replacing the 36 per cent single-stage tax with a two-part tax system: the general corporate tax rate is halved to 18 per cent with a further 23 per cent supplementary tax on dividends. Inter-corporate transfer of dividends are permitted as the higher rate is only to be paid on net dividends. A particular problem has arisen with companies currently enjoying tax holidays or tax relief:[61] the authorities have argued that the tax holiday or reduction applies only to the first part of the tax and not to the tax payable on dividends. While eliminating tax holidays and other distortions are welcome, and indeed were encouraged in the previous OECD survey, this interpretation has been taken, especially by foreign investors, as a breach of prior commitments and as an abrogation of the grandfather clause.[62] These changes have widened the tax base, but the corporate tax system remains distorted with tax relief varying by sector, location and ownership. Despite the upturn in profitability discussed in Chapter I, receipts are likely to remain weak for some time to come as enterprises write-off accumulated or otherwise acquired tax losses.

Payroll taxes

Despite high payroll taxes – the effective payroll tax rate for social security including pensions is 55 per cent[63] – the financial situation of the social funds remains difficult. With the exception of a small decline in the contribution rates to the fund paying unemployment benefits, the situation has remained essentially unchanged over the review period. In the absence of major changes in the expenditure commitments of the funds, revenue enhancing measures will be

required. Under such conditions the only reform which appears viable is a widening of the contribution base through including those fringe benefits not included in the 1993 reform, together with a reduction of the contribution rate:[64] the base is at present confined to wages and wage related costs but firms have been enterprising in minimising this base through paying fringe benefits. Lower contribution rates might also help widen the coverage to include the "grey sector" but herein lies a major policy issue about which judgements differ: is the informal or grey sector financially strong enough to shoulder the burden or might the effective enforcement of the tax contribute to its collapse? The March 1995 package broadened the base to include all fringe benefits except in-kind payments in food, and, most importantly, income from copyrights and other intellectual income.

Curtailing and controlling expenditures

Throughout the review period government expenditures have remained under pressure from social expectations to maintain, if not enhance, Hungary's high level of social spending and transfers which amounts to some 35 per cent of GDP (Table 19). Expenditures came under additional pressure in 1994 from

Table 19. **Composition of public social expenditures in Hungary and selected OECD countries**

Shares of GDP

	Hungary 1992	Germany 1990	Spain 1989	Sweden 1991	USA 1989
Pensions	10.4	9.6	7.9	13.2	5.3
Health[1]	5.3	9.1	6.5	8.8	13.3
Family	3.9	1.3	0.1	1.4	0.4
Housing	2.8	0.2	0.1	0.9	0.4
Unemployment	2.3	2.1	3.1	4.1	0.7
Total	24.7	22.3	16.3	26.4	11.6
Education and culture	7.1	..	..	..	..
Sick pay	1.0	..	..	..	..
Price subsidies	3.1	..	..	..	..
Total	35.9	..	..	..	..

Note: Pensions include old age, disability and survivors. Unemployment includes all active programmes and unemployment compensation. Figures differ from those published in *Social and Labour Market Policies in Hungary*, OECD, Paris 1994, due to more recent data revisions.

1. Refers to 1991 and only to public sector expenditures on health.

Source: Ministry of Finance. *OECD Health Systems: Facts and Trends, 1960-1991*, OECD, Paris, 1994, Volume 1.

public sector wage increases and rising debt service payments. The drive to control and if possible to curtail expenditures has been felt in several areas – social assistance and sick pay, medical costs, and in 1995 in wage costs – but in several other areas controls have been lax (*e.g.* agricultural subsidies). This section briefly reviews some key policy issues and how they have been addressed during the review period.

Pension reform

In line with other countries of the region, the pension system is in urgent need of reform.[65] No overall reform programme has yet been developed in Hungary so that individual measures still lack coherence. During the review period two policy measures have been implemented: complementary private pensions and indexing. A legislative and regulatory framework was put in place for complementary private pensions funds during 1993. A number of funds have now been established, but not surprisingly they are still very small in terms of members and assets. Changes to the personal tax system in the 1995 budget will facilitate their development: a tax credit has been introduced for pension premiums. The complementary private pension funds were conceived as part of a two or three pillar system, possibly including a basic guaranteed minimum pension and a portion based on voluntary contributions. No progress has been made in developing this concept and in freeing the resources which would be necessary for the development of the private and voluntary components through, for example, lowering basic contributions.

In 1992, Parliament introduced formal indexing of pensions to the net average wage. There is general agreement in most countries that pensions should be indexed. However, practices do differ for at least two reasons: first, neither indexing based on changes in consumer prices nor indexing based on average wage movements operate as intended under all circumstances; second, any automatic formula can conflict with a country's capacity to pay, especially as the old age cohort increases. Movements in wages are largely reflected in changes to pension contributions so that the choice of a wage base is logical from this perspective. However, there is no good reason to choose net average wages. More appropriate would have been an indexation related to the overall wage bill. Finally, the indexation of pensions to net average wages does not resolve the

problem of high contribution rates – and might make them worse in the future as growth recovers and real wages rise.

Retirement ages remain low and plans to increase them have been repeatedly postponed. The age of eligibility for a retirement pension is still 60 years for men and 55 years for women. The age of retirement for women was supposed to increase gradually until 2003 when the same age would apply for men and women. Increases were enacted in 1993, with implementation scheduled for 1994, subsequently postponed to January 1995. The 1995 implementation has now been partly suspended: an employer cannot initiate retirement for women at the age of 55, but only at 56, whilst the employee has the right to retire at 55 years.

Two other remaining policy issues in Hungary concern the abuse and misuse of early retirement provisions and disability pensions; taken together they account for a third of the inflow of new pensioners. Particularly abused appears to be the disability pension. The Health Fund has taken some steps to tighten entry conditions into disability pensions. By and large there has been little progress in addressing the key policy issues in these two areas.

Social welfare provisions

- Family allowances

By international standards, family allowances were high amounting to some 4.7 per cent of GDP in 1993. They were less progressive than generally believed because: 1) per capita income is a biased measure of need since it does not correctly adjust for family size; and 2) the distribution of family size by income level is bimodal in Hungary.[66] The replacement of the system from 1 July with a means-tested cash benefit is sound in principle. The new system contains both income and wealth criteria. Allowances are confined to families with: 1) a net per capita income less that HUF 17 000 per month – the average net wage in 1994 was HUF 23 000 per month; 2) property less than HUF 10 million; and 3) a car not exceeding the value of HUF 2 million. Around 80 per cent of families receiving benefits under the old system are still eligible under the new one; the law excepts families with 3 or more children from means-testing. For cost effective targeting a system based on demographic equivalence which incorporates the economy of scale in consumption as family size increases might have been preferable to the Hungarian practice of defining per capita measures by a

simple head count. The asset criteria may prove difficult to implement in practice and may add little to the simple income test. For example, how will property be valued when there might have been few transactions, and how will debt be treated?

- Sick pay

Sick pay is extraordinarily generous in Hungary and as a result payments account for 1 per cent of GDP. As with disability pensions it is also widely abused. The Health Fund has taken some steps to more tightly control misuse by improving the system of follow-up medical tests for people on long duration sick leave (*i.e.* over one year!). The key policy issue has been the number of days of sick leave to be paid by the employer, since this also changes the incentive structure for the employer to more directly control abuses. The government initially proposed to increase the period to 30 days in the 1995 budget, but after long negotiations in the Interest Reconciliation Council it was reduced to 15 days. The March supplementary package set it at 25 days, with the first 5 days subject to the outcome of collective agreements. This amendment was passed by the Parliament over the objections of the funds.

- Medical costs

The Hungarian medical system absorbs a relatively high share of GDP (Table 19), two major factors being high hospital costs and pharmaceutical subsidies. Underlying these high expenditures is the fact that a great deal of treatment has been free, even though gifts from patients to doctors are standard practice. The Health Fund has taken a number of measures to stabilise the situation: doctors have been placed on a capitation payments system, as from 1994 pharmaceutical subsidies have been more tightly controlled and hospital budgets have been more closely monitored. However these changes are only relatively modest and still avoid charging user fees on any appreciable scale. The March supplementary package introduced co-payments for some treatments as well as measures to decrease the number of hospital beds.

Agricultural subsidies

Agricultural subsidies amounted to some HUF 52 billion in 1994 and overran budget estimates by about a third. The cost overrun was most pronounced in the area of export subsidies and was due to the practice of specifying entitlements

on export volumes: there was no control on outlays. As agricultural production and exports rose in 1994 so did total expenditures. The system has been modified in 1995 with the subsidy now specified in terms of values. This will not prevent cost overruns but reduces some of the worst features of the previous system.

Public procurement

Expenditure on goods and services by general government amounted to some 12 per cent of GDP in 1994 so that efficiency gains in purchasing could make an important contribution to both the budget and to efficiency more generally . However, the regulations covering purchases are not transparent and market testing seems more the exception than the rule. A procurement law has been passed by the Parliament with a provision that enterprises with more than 50 per cent local content will enjoy a price preference of 10 per cent. The institutional provisions and enforcement mechanisms were not known at the time of writing.

Assessment

There were a number of indications during the review period that a reduction of the budget deficit from the levels reached in 1992 was appropriate: budget financing difficulties were encountered in 1993, there was a large current account deficit, and interest expenditures were projected to increase substantially in the wake of bank recapitalisation, corporate debt purchases, and cumulating deficits. In addition, the medium term pressures on the budget arising from health and pension commitments were already well known. A number of significant measures, particularly on the revenue side, were taken in 1993 but the central budget remained in a primary deficit. The general budget deficit increased still further in 1994 and up till 1995 budget targets have remained at best only modest, while supplementary measures to achieve these targets have tended to be one-off, failing to fundamentally alter trends in revenues or expenditures.

There were a number of reasons for the limited progress on fiscal consolidation. The conduct of fiscal policy in Hungary is extraordinarily difficult due to the multiplicity of institutions, diffuse decision making powers, and the need for important structural measures to underpin even rather modest fiscal consolidation. All these factors increased pressures on the central budget to assume the bulk of fiscal adjustment and to bring flexibility to fiscal policy when budget targets were slipping – requirements which were almost bound to be disap-

pointed. However, failure to set and to follow through reasonable targets for fiscal consolidation also appear to have arisen from the view that the budget deficit should support growth while the current account was a question for exchange rate policy.

The fiscal policy targets for 1995 – as amended by the March policy package and associated supplementary budget – represent a welcome change in policy direction. The deficit is planned to decline by 2-3 percentage points – which is ambitious by OECD standards – and a start has been made on fundamental reforms of the public sector. Moreover, the underlying assumptions of the budget appear plausible, lending the package credibility. The approval of the package by a substantial parliamentary majority has increased credibility. However, there are two issues which will have to be addressed. First, the fiscal consolidation plan relies to a great extent on substantial wage moderation but has weak policy instruments to achieve this. Second, the proposed reduction of the budget deficit to around 6 per cent of GDP – excluding privatisation – still leaves it well above the level which can be comfortably financed within the constraints of an anti-inflationary monetary policy. Further reductions will be required in 1996 but it is important to consider the prospect that budget sector wages, which will bear the brunt of adjustment in 1995, will recover or cease to decline in 1996. A medium term fiscal consolidation plan is clearly required.

Developing a new approach for wages policy

Hungary had no binding wage controls during the review period. Nevertheless, the economic strategy for 1995 relies to a great extent on significant wage moderation in both the budget and non-budget sectors: real net wages for the economy are projected to fall by 11 per cent. The wage strategy is based on three pillars: budgetary controls in the public administration; the exercise of ownerships rights with respect to majority state-owned firms; and the propagation of these restraints through the non-controlled parts of the economy via normal labour market reactions. With controls directly affecting about a half of wage earners, the effect on the labour market is expected to be significant. The institutional structures to enforce the policy are, however, weak – with the exception of budget units – and market relations are still developing.

Institutional structure

The system of tax based wages policy for the enterprise sector was ended in 1992 and replaced by a multilevel system of collective bargaining: non-binding negotiations at the national level and firm and branch level collective bargaining, including those enterprises owned by the SPA and the HSHC. The framework for the negotiations is set by the Interest Reconciliation Council which establishes guidelines each year covering maximum, minimum and average growth of wage rates. The non-government members of the Interest Reconciliation Council are often not in a position to make binding commitments on behalf of their constituents. The trade union movement comprises seven national federations, undermining co-ordination. Individual unions have on occasion broken away when they have disagreed with commitments by their federation. The nine employers associations reflect all the weaknesses characteristic of an economy in transition: the management of state-owned companies are subject to competing interests; most new private sector employers are not represented; and foreign companies are subject to a different set of expectations on the part of employees.

Decentralised wage bargaining has developed slowly while wage outcomes do not yet appear to be related to economic conditions. Official data, which are incomplete, indicate that in 1994 there were 12 agreements at branch level and 490 firm level agreements, up from 394 in 1993. The latter included many of the larger state-owned enterprises and therefore covered around 30 per cent of the industrial labour force. For the remainder, employment conditions appeared to be determined more informally. A comparison of the national guidelines with the actual wage increases in the enterprise sector shows that they have been very close to the recommended maximum. This suggests that the guidelines add some rigidity to wage negotiations: once a maximum is specified managements apparently have some difficulty in negotiating deviations to account for a firm's specific situation. This interpretation is supported by empirical research which shows that wage agreements have failed to reflect conditions in the labour market and differences across firms in economic performance. Only in small firms is labour compensation closely correlated with profitability.[67]

The institutions which may affect labour market outcomes are in the process of undergoing further change. An Austrian-style chamber (Kammer) system involving compulsory memberships for all economic units is currently being established. While not formally responsible for wage negotiations, it will likely

influence the further development and cohesion of employers federations. From the employees side a proposal is currently before the Parliament which specifies trade unions as the recognised negotiating party. This could lead to their strengthening and decrease the *de facto* role of works councils. Whether the outcome of wage negotiations is likely to be improved is an open question depending as much on the development of financial discipline as anything else.

Wages in the budget sector – including budget-financed organisations such as schools and hospitals – are discussed in a separate Interest Reconciliation Council. Although the position of the central authorities is quite strong, and budgetary wage policy is a matter of law, the government is nevertheless subject to other constraints. Thus the large wage increases in the budget sector during 1994 were mandated by Parliamentary legislation dating from 1992.

Instruments of wage policy in 1995

The original intention of the government was to incorporate the wage guidelines into a broader social pact covering general macroeconomic strategy and social policy. It was felt that this would compensate for the envisaged reduction of wage growth relative to inflation in 1995. In the event an all embracing social pact had not been concluded by the beginning of 1995 with the result that by the middle of March (prior to the supplementary package) no agreement on wage guidelines had been reached; employees were still proposing average wage increases of 18-20 per cent and employers 12-13 per cent.

For 1995, the authorities are seeking to implement real wage cuts in enterprises through the exercise of ownership rights. As part of the March stabilisation package the increase in wages in companies under state ownership was limited to 10 per cent, special approval needed for increases as high as 15 per cent. For those firms whose debts are subject to negotiation or have been written off, wage increases are to be confined to 6 per cent. The HSHC requested all enterprises not to implement wage increases until the general assembly of the company takes place, usually in the March-May period, an action strongly criticised by employees' representatives. Some firms increased wages in January to avoid the deadline, while fringe benefits might be expected to increase. At this stage there are reasons to remain uncertain about whether the government's action will be effective and not further distort the labour market and enterprise behaviour.[68]

Unlike measures concerning enterprises, wage policy in the budget sector combines controls with some incentives. The original 1995 budget provides allocations to all budgetary units based on an assumed wage increase of only 6 per cent. However, budgetary units are given freedom to split this in any way they please: lower employment could be combined with higher wages. The problem with this otherwise appropriate step was that the public service employment codes and wage structures severely limited flexibility. The March supplementary package reduced the overall wage allocation to central budget institutions by a further 3 per cent, but at the same time changed the civil service employment laws so as to allow more flexibility in restructuring and reducing budget sector employment. The target of a 15 per cent reduction in employment by central budget institutions has been incorporated in the 1995 supplementary budget.

Monetary and exchange rate policy

Based on the judgement that the economy had been successfully stabilised, Hungarian monetary policy was eased in early 1992 as part of an overall economic strategy to help restart economic growth. Within a year it became clear that the policy stance, along with external shocks and the recovery of domestic demand, had created a large and growing current account deficit. The monetary authorities began to reverse course in mid-1993, trying to re-establish external balance while maintaining the incipient recovery. This has proven extremely difficult to achieve and the authorities have not been successful in reducing the current account deficit despite the tightening of the policy stance over the last two years. Policy makers have had to operate with a limited range of instruments, and the instruments at their disposal have been constrained by budgetary financing obligations, the structure of the banking system, and the effects of capital inflows. The monetary authorities themselves have had numerous and conflicting objectives, and especially an ambivalent attitude with respect to how severely to restrain enterprise credits and foreign capital inflows so as to curb domestic demand and thereby reduce the current account deficit.

This section reviews monetary developments in two parts. The first provides a brief chronology of monetary developments, highlighting the gradual evolution of the policy stance from expansionary in early 1992 to deflationary in 1995. The

second part describes the monetary instruments at the disposal of the authorities. The section concludes with a brief assessment.

Shifting priorities of monetary policy

Supporting growth

At the beginning of the transition, Hungary was faced with a severe foreign debt problem, a current account deficit, and relatively high inflation (around 35 per cent). By early 1992 it appeared that these problems had been brought under control; the current account had moved into surplus in 1990 and had been improving steadily, gross and net foreign debt had decreased, and inflation had decelerated. In light of these developments the NBH shifted its primary goals towards supporting economic growth by lower real and nominal interest rates. Beginning in April 1992, interest rates on refinancing credits were steadily lowered to bring them in line with the improvement in inflation, falling from 26 per cent to 20 per cent by October of that year. At the same time the nominal exchange rate was held relatively constant in order to maintain downward pressure on inflation.

The initial effects of the shift to an expansionary fiscal and monetary policy were mixed. The most important effect was on the current account, which deteriorated by over $700 million between the third and fourth quarter of 1992.[69] Deposit rates fell, albeit slowly and with a lag, causing real deposit rates to become negative (Figure 6). Lending rates proved more resilient as banks, faced with the need to provision for rapidly rising non-performing loans,[70] increased spreads, so that real lending rates remained high. Monetary growth accelerated, but lending to enterprises stagnated. Instead, banks used the opportunity of the growing budget deficit to substitute less risky government securities for enterprise loans; the net effect was that in 1992 nominal domestic credit to enterprises rose by only 1 per cent[71] and real credit fell by some 10 per cent, while the large budget deficit was financed without difficulty (Table 20). The policy of a relatively fixed nominal exchange rate resulted in an appreciation of the real exchange rate as inflation, rather than falling, accelerated slightly.

Despite the deterioration in the current account in 1993, the monetary policy stance initially remained unchanged. At the time of formulating the 1993 monetary programme, GDP and other observable output indicators were continuing to

Table 20. **Monetary indicators**

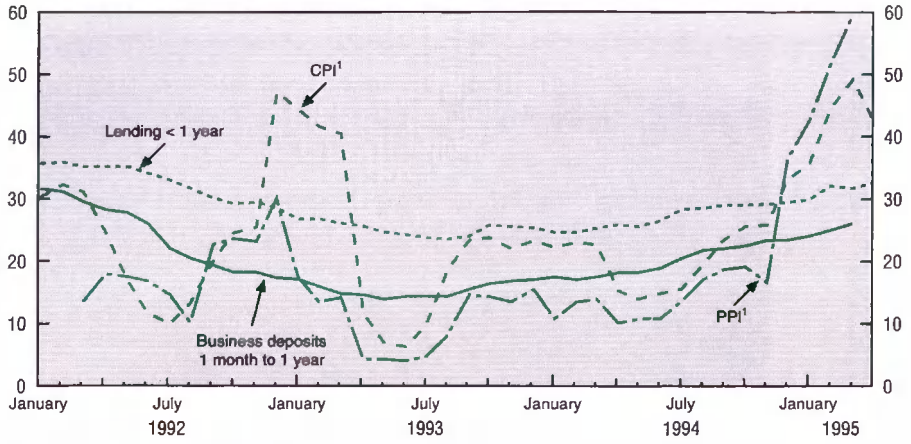
HUF billions

	1991-Q4	1992-Q4	1st January 1993	1993-Q1	1993-Q2	1993-Q3	1993-Q4	1994-Q1	1994-Q2	1994-Q3	1994-Q4
Currency outside of banks	260.2	322.4	322.4	310.8	334.8	357.0	371.3	378.6	391.4	402.4	411.5
Total forint deposits	727.4	967.6	962.7	963.7	987.1	1 000.5	1 057.7	1 014.6	1 056.8	1 068.4	1 176.7
Total foreign exchange deposits	195.4	215.8	215.8	231.2	238.6	276.6	329.7	337.8	367.4	401.5	405.1
Broad money	1 183.0	1 505.8	1 500.9	1 505.7	1 560.5	1 634.1	1 758.7	1 731.0	1 815.6	1 872.3	1 993.3
With consolidation											
Credits to enterprises[1]	765.3	768.1	704.0	723.2	732.8	750.8	761.9	787.0	838.5	866.1	876.3
of which: Foreign Exchange credits	47.3	61.8	60.2	65.8	75.3	70.0	65.6	71.7	70.6	87.8	93.9
Credits to General Government[2]	872.3	1 060.9	1 060.9	1 079.4	1 140.4	1 155.5	1 096.3	1 138.0	1 189.9	1 163.6	1 214.3
Total domestic credit	1 864.5	2 057.4	2 074.6	2 104.1	2 191.7	2 222.3	2 402.4	2 468.0	2 659.4	2 666.2	2 806.8
Foreign liabilities[3]	1 328.5	1 196.3	1 196.3	1 245.9	1 284.8	1 271.3	1 190.1	1 265.3	1 318.0	1 296.5	1 314.4
Memorandum:											
Credits to entreprises excluding consolidation	765.3	768.1	768.1	787.4	812.1	830.1	893.9	919.0	971.1	998.7	1 008.9

1. Including credits to small entrepreneurs.
2. Without consolidation bonds.
3. At constant March 31 1993 exchange rate.

Source: National Bank of Hungary, Monthly Reports.

Figure 6. **INTEREST RATES AND INFLATION**
Per annum (%)



1. Moving average one month in advance and the two previous months.
Source: National Bank of Hungary.

decline, while the deterioration of the external account was not yet apparent.[72] Under these circumstances, the 1993 monetary programme planned for a continuation of the 1992 policy geared toward establishing the conditions for growth by lowering nominal interest rates. The authorities expected that the external balance would deteriorate slightly, but that large foreign direct investment inflows would continue to permit foreign exchange reserves and net foreign assets (NFA) to increase (Table 21).[73] Faced with continuing high levels of inflation of around 20-25 per cent and a marked real exchange rate appreciation in 1992, exchange rate policy began to shift towards trying to achieve two goals at once: restraining inflation and supporting the current account. To achieve this compromise, the authorities aimed at maintaining a constant real exchange rate on average, but compensating for inflation only *ex post* so as to maintain some pressure on domestic prices.

Despite continued monetary ease during the first half of 1993 the growth rate of broad money slowed even though budget financing needs were fulfilled by monetary emissions. The slow growth of forint deposits was attributable to the decline in real deposit rates[74] which had become negative since around the middle

Table 21. **Monetary framework and outcomes**

Previous year = 100

	1993		1994		1995
	Projection	Actual	Projection	Actual	First projection
Monetary base (NBH)[1]	106.4	113.8	109.0	109.4	126.7
Broad money	123.9	117.2	117.4	113.3	113.2
Currency	115.0	115.2	118.3	110.8	115.6
Total deposits	126.0	117.7	117.1	114.0	112.7
Domestic credit (excluding consolidation)[2]	112.1	110.1	113.1	115.4	108.5
To central government:	114.2		114.3		106.6
Without consolidation		103.3		110.8	
With consolidation		120.1		115.8	
To enterprises:	111.7		109.5		107.9
Without consolidation		119.8		120.4	
With consolidation		108.2		120.3	
Net foreign liabilities[3]	85.8[4]	99.5	100.0	110.4	92.1
CPI					
Dec-to-Dec	112-115	121.1	116-122	121.2	116-118
Year-on-year	114-118	122.5	116-122	118.8	120-122
GDP[5]	100-103	98.0	100	103.0	100
Domestic absorption[5]	100-102	105.9	100	105.5	98

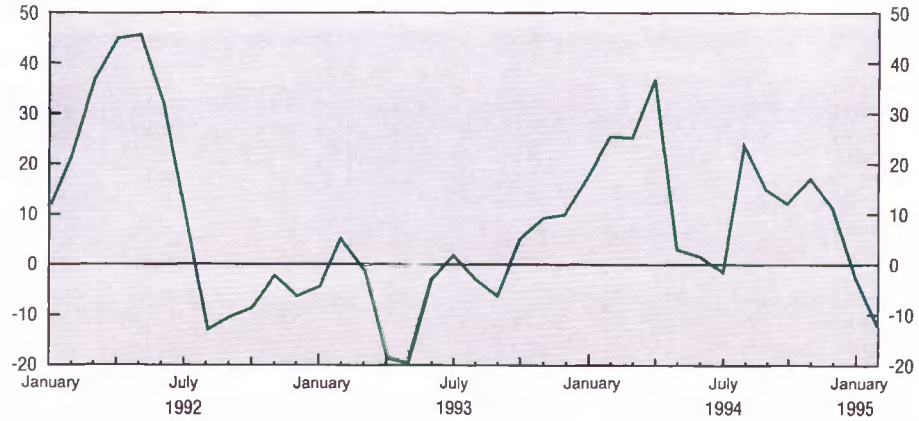
1. Cash plus reserves, actual figures from NBH Monthly Bulletin.
2. Excluding bonds issued for bank recapitalisation and for the purchase of non-performing loans from the banks.
3. March 31, 1993 exchange-rate.
4. September 30, 1991 exchange-rate.
5. Net of MIG aircraft.

Source: NBH, *Monetary policy guidelines*, 1993, 1994, and 1995.

of 1992; reduced confidence in the currency;[75] and possibly to a return of household savings behaviour to the lower rates which had prevailed prior to the housing purchase programme of 1991 (see Chapter I). The continued and growing current account deficit, which did not improve as had been anticipated, caused NFA to decline. In contrast to this negative contribution to money supply, budgetary financing needs increased. Treasury bill interest rates did not move up with the market,[76] so that budget financing was accommodated by an increase in high-powered money and the money supply. As a result the natural contractionary consequences of a current account deficit were weakened.

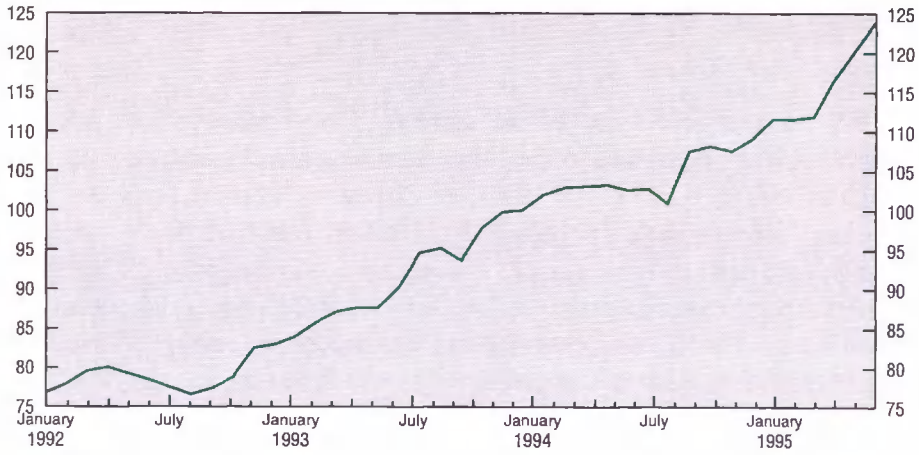
The spring of 1993 first witnessed two partially contradictory developments which were to characterise all of 1993/1994: depreciation pressure on the forint in the foreign exchange market, and large external borrowing by enterprises, and

Figure 7. ***EX POST* DOLLAR RATES OF RETURN**
Percentage



Note: Calculated by multiplying the interest rate on 90-day treasury bills by the change in the forint/dollar exchange rate over the same period.
Source: National Bank of Hungary, OECD Secretariat calculations.

Figure 8. **NOMINAL EXCHANGE RATE**
Forint/US$



Source: National Bank of Hungary.

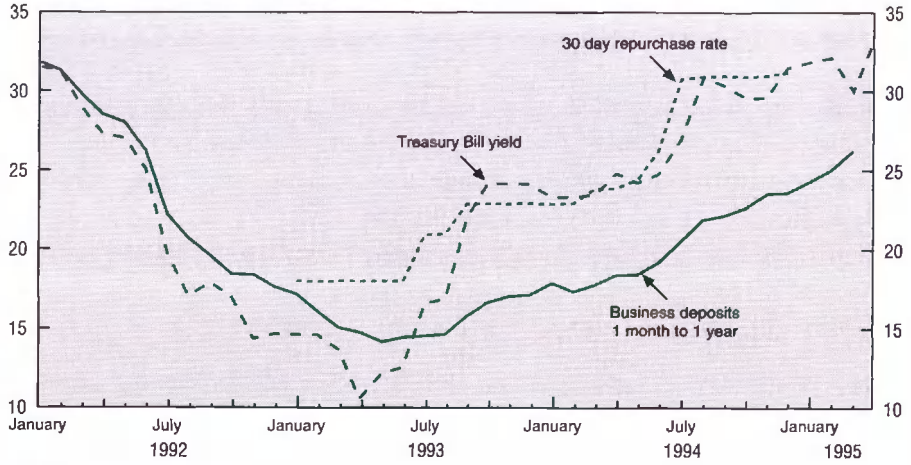
later by commercial banks.[77] The pressure on the forint to depreciate was largely attributable to the current account deficit, highly negative dollar rates of return on forint securities and the real appreciation which had occurred in the previous six months (Figure 7). The exchange rate remained at the top of the intervention band for much of the spring and the NBH was forced to sell several hundred million dollars in support of the rate; speculation against the forint through the swap window was substantial (Figure 8). Capital inflows were stimulated by high domestic borrowing rates which, despite the exchange rate risk, encouraged foreign borrowing by enterprises, especially those with some foreign ownership or export sales, which would hedge the exchange rate risk of foreign borrowing.

Controlling the current account while supporting growth

The NBH was initially reluctant to reverse course on interest rates or to accelerate the pace of devaluation, which it felt would foster inflation; given normal statistical delays the continued decline in the current account was just becoming apparent, and was still thought to be temporary. Indeed at the time of completing the last OECD Survey in early 1993 the monetary policy stance was judged appropriate. By the spring of 1993 the NBH finally decided that a rise in interest rates was necessary, but felt the need to convince the fiscal authorities, who remained reluctant. However, by mid-1993, it became clear that the current account balance was continuing to deteriorate and was not only a result of the recession in Western Europe or other exogenous shocks. The accumulating evidence of declining savings, pressure against the forint in the foreign exchange market, and rising inflation indicated that the macroeconomic policy mix was at least partly responsible. Despite the reluctance of the government, the NBH began to tighten in July: the authorities increased repurchase rates by three percentage points and devalued the forint by three percentage points (Figure 9).

From mid-1993 through the first half of 1994, the NBH sought to balance controlling the current account deficit with preserving the nascent economic recovery, and placed less emphasis on lowering inflation. These two objectives were in conflict and led to ineffective policy settings. Policy was constrained by the requirement to support government financing operations: for the last quarter of 1993 repurchase rates were kept below Treasury bill rates to facilitate bank financing of the deficit and for the first half of 1994 forthcoming national elections made any further monetary tightening difficult. The NBH raised interest

Figure 9. **INTEREST RATES**
Per annum (%)



Source: National Bank of Hungary.

rates four more times through May 1994, but nearly all of these moves were increases of one percentage point or less, and most of them followed movements in the market as growing domestic credit demand kept interest rates rising. With forint deposits stagnating, weak commercial bank profitability, and increasing recognition of the size of banks' non-performing loan problem, the authorities were cautious to take any actions which might make banks' financing more difficult: no measures were taken to drain reserves, nor to increase reserve requirements. Volume restrictions were not placed on access to central bank refinancing but interest rates on the facility were increased. The exchange rate was devalued again in September 1993 by 4.5 per cent, and the pace of devaluation accelerated slightly in the first half of 1994, with the objective of stabilising the real exchange rate.

Priority to controlling the current account

With national elections concluded in May 1994 and economic growth underway, the NBH began to focus exclusively on controlling the current account, receiving some support from the newly-elected government for more aggressive measures. The NBH strengthened its interest rate policy: base rates were increased by 3 percentage points in June to 25 per cent and repurchase rates

were increased by a total of 7½ percentage points between early June and the end of July 1994, reaching 31 per cent. Bank deposit and lending rates, which had risen slowly over the course of 1993, finally began to respond more quickly to higher interbank rates and tighter policy, rising an additional two to three percentage points. Nonetheless with the current account deficit continuing to deteriorate and fiscal policy unchanged, expectations of a large devaluation mounted, and speculation against the forint increased: in June and July the NBH is estimated to have sold nearly $1 billion in support of the forint and around another $500 million through the swap facility. In early August the authorities reached an agreement with the new government for a devaluation of 8 per cent,[78] accompanied by a supplementary budget to reduce the deficit.

When actually passed in September 1994, the supplementary budget delivered half the cuts initially promised and the NBH was unwilling to raise interest rates further without additional fiscal consolidation or wage restraint. In their view, any additional tightening would have been ineffective: further devaluation would only serve to validate inflation, and interest rate increases would simply raise fiscal debt service or accelerate capital inflows. For the rest of 1994, the NBH pursued a strategy, already begun at the beginning of the year, of improving the effectiveness of monetary policy by restricting banks' access to some of its credit facilities, eliminating others, and making external financing of domestic lending more difficult. This policy stance was maintained until February/March 1995 when a new monetary regime was established.

Monetary instruments

The Hungarian monetary authorities have had a restricted range of efficient instruments at their disposal with which to conduct monetary policy. The use and effectiveness of these instruments was often limited by the institutional structure of the financial system, and by legal obligations to support budget financing. Recapitalisation of the banking system has removed one of these constraints to some extent, and allowed the authorities to take steps over the past year which they had felt unable to pursue earlier to improve policy effectiveness.

Up until the end of 1992, the primary form of central bank credit, and of monetary control, was the refinancing window. Banks were also able to use the foreign exchange deposit credit (FXDC) facility, foreign exchange swap facility, and a number of smaller facilities for special financing purposes. Beginning in

January 1993, the NBH instituted a voluntary repurchase facility[79] with maturities extending up to one year, which replaced the refinancing window as the major source of central bank credit and instrument for affecting the level of bank reserves.

Because NBH credit serves not only as a source of liquidity for the banking system but also as a source of financing for bank lending, the NBH has been reluctant to place volume constraints on its facilities. The principal tool of monetary policy has been the setting of interest rates on central bank credit facilities, particularly repurchase agreements, and to a lesser extent, changes in the base rate. The other mechanism available, changing reserve levels – either through open market operations, changes in reserve requirements, or administrative measures – was not used during 1993/94. In the case of reserve requirements, until the end of 1994 it was assigned the role of helping to bring down lending rates by lowering banks' costs, and therefore spreads.[80] As reserve requirements have been tightened steadily since then, the NBH has been careful to systematically increase interest payments on compulsory reserves to offset the impact on bank costs.

The reluctance of the authorities to act on the volume of reserves largely derived from the structure of the banking system and obligations to help finance the budget deficit. The major distortion in the financial system has been the skewed distribution of deposits. As is common in most of the economies in transition, the bulk of Hungary's household deposit base resides with two institutions, whereas most of the commercial loan portfolio is held by other banks. While this imbalance is generally mediated by the operation of the interbank money market, the NBH has felt that the market is sufficiently one-sided and money demand sufficiently unstable that any draining of reserves could cause severe liquidity problems for those banks which were net borrowers of reserves, *i.e.* those banks holding most of the enterprise loan portfolio. This consideration was reinforced by the fact that some of these same banks were in a weak capital position because of the huge increase in non-performing loans in 1992/93 (see Chapter IV).

The Hungarian monetary authorities have made little use of open market operations as a monetary instrument because of obligations regarding budget financing and technical difficulties.[81] Throughout the review period the NBH has had the legal obligation to purchase securities or grant loans to the budget up to a

given percentage of projected budget revenues (see fiscal policy above). Although the NBH was legally required to buy only a portion of government debt, it was under substantial pressure in 1993 to guarantee a market for Treasury securities. This it agreed to do, but only after the Treasury bill yield was first allowed to increase toward the repurchase rate. In 1995 budget financing is specified only up to a ceiling, allowing the NBH greater freedom to conduct open market operations if it desires. At the time of writing, the NBH had agreed to provide support for budget financing in 1995 until privatisation receipts materialised.

Hungary has employed a fixed exchange rate regime with periodic devaluations, and an intervention band around the mid-rate. In 1992 the NBH still actively supplied funds to the market. This practice was terminated in 1993 and since then the NBH has only bought or sold to support the rate at the limits of the band, so that a true interbank market has been established.[82] Until March 1995 exchange rate changes were not preannounced. General policy was to keep devaluations smaller than the intervention band prevailing at the time to prevent profitable speculation, while gradually widening the band[83] as the foreign exchange market broadened and deepened. Physical, but not legal, persons were permitted to maintain foreign currency accounts in domestic banks; legal persons were able to maintain foreign currency accounts abroad with special permission. In March 1995 the NBH made two changes in the exchange rate regime. It instituted a preannounced crawling peg, with a monthly rate of devaluation of 1.9 per cent from April to June, and 1.3 per cent for the remainder of the year of 1995 (approximately the rate of expected inflation). Second, legal persons were given full rights to have foreign currency accounts in Hungarian banks, but only for the purposes of facilitating foreign trade.

The 1995 Monetary programme

At the time of writing, the monetary guidelines for 1995 were still being reviewed in the light of the March package of economic measures and the supplementary budget. To meet legal requirements the NBH submitted the original guidelines to Parliament for discussion, these had been drawn up in accordance with the 1995 budget. This document clearly shows the unease of the NBH with the level of fiscal consolidation originally intended in 1995. In their view the simultaneous realisation of the current account and the public sector borrowing

targets could only have been feasible with very high interest rates to stimulate domestic saving. This would have led to a recession. The NBH thought that a revision of the budgetary targets would be unavoidable, but that the monetary programme could not be adjusted beforehand. It is expected that the revised set of guidelines will affect predominantly targets for the main monetary aggregates rather than final and intermediate objectives or the main instruments of monetary policy. The monetary guidelines envisage the development of more efficient instruments of monetary policy which will aim to: 1) separate the maturity structure of money market operations and government financing, 2) limit the NBH's money market operations to very short term maturities, forcing banks to turn to the inter-bank market for longer term liquidity; 3) cut the costs of financial intermediation and reduce the competitive disadvantage of the banking sector by increasing the interest paid on reserves.

The original monetary programme was based on the economic policy objectives of the government: a deficit on the current account (US$2.5 billion) financed entirely by non-debt capital flows, and a high public sector borrowing requirement (around HUF 460 billion including full realisation of the ambitious projection for privatisation revenues). GDP was expected to stagnate and inflation to increase slightly (to 20-22 per cent on a year-on year basis) but to slow by the end of the year (December-to December: 17 per cent). Domestic demand was to be restricted by low wage growth which would reduce real wages, as well as by a substantial reduction of real credit to the enterprise sector – it was projected to become a net creditor of the banking system.

The original 1995 monetary programme was accordingly set to be very restrictive, and the actual performance in the first half of 1995 indicates that this policy is being largely followed even after the March package of measures. During the first half of 1995 reserve requirements have been raised several times as has the interest they earn, the base and repo rates have been increased and binding limits on the volume of refinancing credit have been imposed and then reduced, both with respect to individual banks and overall. Less pressure on the currency has permitted the overnight repo rate to decline somewhat.

Assessment

The conduct of monetary policy during the review period has been very difficult: the authorities have faced the problem of too many goals and too few

instruments, requiring clear priorities to be set. The authorities have maintained the same general goals throughout the period – supporting economic growth, controlling inflation, and stabilising the level of net foreign debt – but the relative priorities have changed as macroeconomic developments unfolded, shifting away from the nominal target of inflation control toward real objectives for domestic growth, and then to stabilising the current account. The ability to achieve these goals was hampered by restrictions on the use of a number of the major instruments of monetary policy, and the weak influence of these instruments on key economic variables.

The difficulties of operating policy under these circumstances can be seen most clearly in the case of exchange rate policy. The goals of exchange rate policy gradually shifted away from controlling inflation toward supporting the current account. In 1992, the exchange rate was held essentially constant, serving as a nominal anchor. In 1993, exchange rate policy shifted towards using small devaluations to keep the real exchange rate constant in terms of producer prices to help support the current account, but lagging those devaluations so as to maintain some downward pressure on inflation. Gradually, the authorities showed a willingness to relax their commitment to reducing inflation in order to take pressure off the foreign exchange market, culminating with large devaluations in August 1994 and March 1995.

Changing objectives for exchange rate policy were not fully supported by other monetary policy instruments. When pressure on the exchange rate appeared – which it did often over the period – the NBH usually provided the market with large amounts of foreign exchange from official foreign exchange reserves, replenishing them with increased external borrowing. Interest rates were only tightened gradually between June 1993 and June 1994, while no action to drain reserves from the banking system was taken until winter 1994/1995.

It is difficult to assess how much of the NBH's reluctance to take firmer steps to achieve its current account goals was caused by ambivalence regarding competing goals, a lack of effective instruments, or by the contradictory stance of fiscal policy. In the case of raising interest rates, it appears to have been a little of all three, but primarily the latter. The NBH would have gladly welcomed a more rapid and larger rise in deposit rates (and consequently domestic savings) than actually occurred, and was frustrated in this by the response of the banking sector. However, the authorities were also ambivalent about the effects of higher

interest rates on credit to enterprises and economic growth. Because of the weak transmission mechanism of interest rates to credit demand, real credit to the remaining enterprise borrowers would had to have fallen significantly to have a real impact on domestic demand. The NBH appears to have judged that in the absence of significant fiscal adjustment, the price of contracting domestic demand through this mechanism was too high. Perhaps the most effective transmission mechanism of higher interest rates is the impact on the general government budget deficit through their effect on public debt service. The monetary authorities appeared to have been quite reluctant to increase debt service commitments of the budget and thereby to force fiscal consolidation; the lack of Parliamentary support, especially as revealed in the 1994 amendments to the NBH law addressing budgetary financing, did not help in this regard.

The NBH's reluctance to effect changes in reserves derived largely from their concern for the smooth functioning of the banking system, as well as legal requirements for budgetary financing. Open market operations, while facing technical problems, were not undertaken largely in deference to the budget. Until the end of 1994 the NBH did not use the one tool at its disposal which would have unambiguously led to monetary contraction: raising reserve requirements. This appears to have been driven equally by concern over the impact on bank financing and by the effects on lending rates and enterprise borrowing. Weakness in the financial system was one factor in the authorities' hesitancy to place volume restrictions on central bank credit facilities, or to eliminate facilities and maturities which undercut policy. Once the capital adequacy of the banking system improved with bank recapitalisation the authorities began this process, and have been able to accelerate it as awareness and concern over the twin deficits have increased.

Whether, or to what degree, steps to curtail capital flows should have been taken depends, in part, on whether these inflows were autonomous or accommodating (as well as the type of demand they were financing). Foreign direct investment inflows have been autonomous, and have been treated as such by the NBH in setting their current account targets. Given the large and growing presence of foreign-controlled firms and joint ventures in Hungary, some foreign borrowing by such firms would be normal, though evidence from other countries indicates that foreign firms borrow extensively in their host country when conditions are favourable, the mix being sensitive to relative interest rates and the

currency exposure of the firm's financial flows.[84] At the same time, domestic borrowers who were able to borrow abroad and manage the currency risk clearly did so. The evidence presented in Chapters I and III indicates that some of this was for financing investment, but not necessarily investment in the traded goods sector. On balance, it appears that around three-quarters of capital inflows were not autonomous, but a means of financing the current account deficit induced by high interest rates.

While the reluctance of the monetary authorities to try and effect a reduction in domestic demand to reduce the current account deficit, particularly without support from fiscal consolidation or electoral authorities, is understandable, it has had its costs. The policy of gradual tightening was ultimately not successful in restoring external balance, and instead led to a steady erosion of policy credibility. This was most clear in the case of exchange rate policy. The policy regime of periodic unpreannounced devaluations may have been viable as long as the NBH kept devaluations within the intervention band. As the NBH moved away from its inflation goals and effected larger devaluations outside the band without other supporting policy measures, it simply encouraged increased speculation against the currency, while the exchange rate itself lost any role as a nominal anchor. To re-establish the credibility of monetary policy may now require higher interest rates for a longer period of time than before, and larger supporting fiscal consolidation. An important component of this will be to build on the steps already taken to make monetary policy more effective and less constrained: increasing and codifying central bank independence, and either restructuring or privatising the banking sector, or both.

Recent developments and short term prospects

At the time of writing (June 1995) fragmentary and sometimes contradictory data presented a picture of continuing strong output and demand growth carrying over from 1994 combined with growing signs of a slow down since the spring of 1995. Industrial production continued to grow until January but fell in the following months in line with domestic sales. Export sales have been highly irregular, surging in August after the large devaluation and again in January when they rose on a seasonally adjusted basis by an astounding 42 per cent. Exports continued to grow at double-digit rates in the first quarter of 1995, but imports

were even stronger, possibly because of the (correctly) anticipated devaluation. Indirect measures of consumption, which had shown continued strength at the end of 1994, declined in the first few months. Wages and savings both fell in real terms, as inflation surged following the VAT and energy price increases which went into effect in January; the mid-March 1995 devaluation reinforced this trend so that annual inflation was running at around 30 per cent in May. Budget data for the first two months of 1995 indicated a much larger deficit than projected in the 1995 budget law as privatisation revenues failed to materialise. The budget deficit stabilised in March and since then the deficit has been growing slowly as policy measures have begun to take effect.

On the assumption that the supplementary budget will be fully implemented and that the crawling peg exchange rate will be defended by the authorities, short term prospects will depend on whether the amount of fiscal consolidation (about 3 percentage points of GDP) and the contraction of real wages are sufficient to support the large devaluation which is planned for the year: 29 per cent which would represent an *ex ante* real devaluation of around 16 per cent measured in terms of producer prices. To form a judgement it is important to take timing into consideration: while a substantial part of the devaluation occurred in the first quarter, the new fiscal measures other than the import surcharge are not likely to have a major impact until the second half. Moreover, the contractionary effect of the wages policy will only be fully felt after inflation has eroded the consumer real wage. What happens to consumer demand will ultimately depend on the evolution of employment and enterpreneurial incomes. The latter might be expected to increase quite quickly. Output, demand and inflation would thus only slow gradually in the first half with a marked slowdown in the second, while the budget deficit would only show a significant improvement late in the second half. Exports could be expected to increase but so will imports, despite the import surcharge, since on past experience domestic prices will rapidly adjust to the devaluation. GDP might therefore grow by around 1.0 per cent and inflation is likely to accelerate from 19 per cent to 29 per cent (Table 22). The current account is projected to decline from $3.9 billion to around $3.0 billion, considerably higher than official projections.

In contrast to 1994, the package could be expected to result in a marked improvement in the financing of the current account. The crawling peg exchange rate together with the introduction of foreign exchange accounts for enterprises

Table 22. **Macroeconomic projections**

	1994 (est.)	1995	1996
Exports (US$ billions, BOP basis)	7.7	8.9	9.6
Imports (US$ billions, BOP basis)	11.5	12.0	12.5
Current account (US$ billions)	3.9	3.0	3.0
GDP (real growth in per cent)	2.5[1]	1.0	3.0
Rate of inflation – CPI (per cent)	18.8	29.0	20.0
Unemployment rate (per cent)	10.4	10.0	9.0
General government budget deficit (excluding privatisation revenues – per cent GDP)	–8.0	–6.0	–4.0

1. The first official estimate is 2 per cent but this is widely considered to be on the low side.
Source: OECD Secretariat.

might encourage the prompt repatriation of export proceeds while foreign borrowing by enterprises and foreign direct investment should remain at levels corresponding to 1994. However, while the current account deficit could be covered without increasing official foreign debt, the underlying weakness which characterised 1994 would continue: foreign savings would be mainly used not to augment investment but to cover domestic dissaving in the form of the budget deficit.

The fundamental risk with the central projection concerns credibility though this has been allayed somewhat by the strong parliamentary support for the March package. In view of the experience during 1993/1994, the commitment of the authorities to a back-loaded consolidation in the second half together with a preannounced exchange rate policy may lack credibility, especially if privatisation revenues fail to materialise and monetisation of the deficit is prolonged. If this proves the case, then the authorities would have to be prepared to implement additional measures at an early stage.

An important risk to short term prospects concerns wages policy. As discussed above the possibility for slippage is significant especially in view of the large devaluation which is planned. Under such a scenario, inflation would not decelerate, bringing the exchange rate under pressure while the budget deficit would remain at the high levels reached in 1994.

Looking ahead to 1996, further consolidation and structural reform measures are necessary. Even if the 1995 budget target of 6 per cent were to be

reached it remains too high and the deficit would continue to crowd-out the enterprise sector. A further reduction will be necessary but it will not be possible to cut wages for a second year in succession: indeed, in the experience of other countries a substantial rebound of wages is a distinct possibility. Further structural reforms will therefore be necessary and ideally should be announced as part of a medium term fiscal consolidation programme. The projection assumes that such a package will be put in place in the course of 1995. Given the significant microeconomic changes in banking and enterprise restructuring which have already been achieved, a recovery of the economy and slow down in inflation could thus be expected in 1996 (Table 22). If the worst case scenario were to develop in 1995, difficult stabilisation measures would be called for in 1996 to bring inflation under control and could result in a return to stagnation.

III. International competitiveness

Introduction

There are many definitions of competitiveness.[85] In Hungary, it is often used in reference to trade performance: a sluggish supply response to strong domestic demand, the marked collapse of exports in 1993, and a large current account deficit have all contributed to concern by the authorities that Hungary has lost international competitiveness. On the other hand, Hungary remains competitive in the sense of being able to attract large inflows of foreign direct investment and being able to access international credit markets.

Properly understood, competitiveness must be placed in the broader context of economic growth and its determinants: entrepreneurship, technology and investment.[86] This chapter is concerned with a much narrower and more conventional concept: cost or price competitiveness. But even here, these simple indicators require examining the underlying forces determining their evolution – including not just nominal exchange rates, but wage behaviour, productivity and enterprise profitability. How these variables evolve will in turn be conditioned by the efficiency of factor and product markets, the constraints facing individual enterprises, and broader macroeconomic developments. Examining competitiveness from this perspective sheds some light on any underlying structural weaknesses. Inevitably more questions are posed than can be answered here.

This chapter begins with a review of various indicators of price, cost and wage competitiveness, followed by a review of profitability indicators for non-financial enterprises. This is followed by discussion of the impact of foreign direct investment on trade. Trade and competition policy, and other structural issues which also will affect competitiveness are pursued in Chapter IV. The

chapter concludes with a broader macroeconomic analysis which seeks to disentangle demand and cost determinants of the trade balance, and an assessment.

To summarise, since the beginning of 1993 several measures of competitiveness have been steadily improving and the profitability of exports appears to have recovered, but improved price signals for resource allocation have not, however, translated into a lower trade deficit because of a weak aggregate supply response and low domestic savings. The improvement in cost competitiveness has probably been achieved at the price of reduced employment: higher nominal and real wages have been supported by raising labour productivity through cutting staff rather than by increasing total factor productivity.

Assessing international competitiveness

Structure of exports and imports

Prior to 1992 Hungarian exports had been growing rapidly. Looking back to the beginning of the transition, the major source of growth in convertible currency exports was the redirection of trade from the CMEA to market economies following the collapse of the CMEA. By 1992 this was largely completed, and the share of Hungarian exports to the OECD appears to have since stabilised at a little over 70 per cent.

Once this reorientation was completed, it appears that the export dynamic has declined. Hungarian exports still remain concentrated in traditional sectors like agriculture, apparel and clothing, food and beverages, chemicals and basic metals: these together accounted for 52 per cent in 1992, and still comprised 48 per cent of total exports in 1994 (Table 23). This reorientation, while seemingly impressive, was mostly accounted for by a decline of around 13 per cent in exports from these sectors, whereas the remaining sectors experienced only marginal growth (Tables 24 and 25). While difficult to see at the 2-digit level, growth in new sectors like communications equipment, certain types of transportation equipment and electrical machinery was quite rapid, but started from a very low base.

The major sources of the steady and substantial increase in import demand have been investment goods and industrial inputs.[87] While import liberalisation and macroeconomic considerations have no doubt played a role, part of this is

Table 23. **Hungarian exports, by size**

	1994 Exports (US$ millions)	Share (per cent)	Cumulated share (per cent)
Food and beverages	1 676	15.6	15.6
Chemicals	1 149	10.7	26.3
Basic metals	858	8.0	34.3
Machinery and equipment	768	7.2	41.5
Wearing apparel	745	6.9	48.4
Electrical machinery	708	6.6	55.0
Agriculture	656	6.1	61.2
Textiles	513	4.8	65.9
Motor vehicles and trailers	504	4.7	70.6
Radio, television and communications	466	4.3	75.0
Petroleum products	356	3.3	78.3
Leather	349	3.3	81.6
Other transport	323	3.0	84.6
Rubber and plastic	256	2.4	87.0
Fabricated metals	253	2.4	89.3
Furniture	229	2.1	91.5
Other non-metal minerals	206	1.9	93.4
Medical, precision and optics	173	1.6	95.0
Wood	169	1.6	96.6
Paper and paper products	120	1.1	97.7
Forestry	66	0.6	98.3
Petroleum and gas	44	0.4	98.7
Publishing and printing	43	0.4	99.1
Tobacco	31	0.3	99.4
Office, accounting and computers	27	0.3	99.6
Uranium mining	14	0.1	99.8
Other mining	8	0.1	99.9
Fishing	7	0.1	99.9
Metal ores	5	0.0	100.0
Coal and lignite	4	0.0	100.0
Total	10 726	100.0	

Source: Central Statistical Office, data from industrial sources.

certainly the normal investment surge one would expect in any transition economy: in agricultural machinery, imports increased by 250 per cent in dollar terms, but the market share of imports declined as domestic sales increased fourfold. However, as noted in Chapter I, a great deal of Hungarian investment has been in infrastructure, where the pay-off in terms of tradeable goods is usually indirect and dependent on appropriate economic policies. Large foreign direct investment inflows have probably brought with them increased inflows of

Table 24. **Hungarian exports, by growth rate**

	Growth rate 92-94	Foreign share of exports 1993[1]
Uranium mining	55.0	0.0
Agriculture	67.0	28.9
Wearing apparel	76.8	48.1
Forestry	78.6	0.6
Publishing and printing	79.9	35.4
Metal ores	82.5	0.0
Other mining	83.1	84.4
Leather	84.1	41.9
Fabricated metals	88.3	62.3
Office, accounting and computers	92.1	83.2
Motor vehicles and trailers	94.4	49.4
Other non-metal minerals	99.3	62.8
Food and beverages	99.4	53.4
Textiles	100.5	52.0
Wood	102.0	44.6
Machinery and equipment	102.5	48.5
Basic metals	102.9	14.9
Chemicals	104.6	31.4
Petroleum products	105.6	5.0
Fishing	105.8	26.6
Furniture	107.2	39.9
Rubber and plastic	112.1	60.5
Medical, precision and optics	115.5	47.6
Coal and Lignite	126.1	25.4
Paper and paper products	127.3	80.5
Electrical machinery	129.8	89.7
Tobacco	132.4	84.4
Radio, television and communications	149.6	68.2
Other transport	295.0	55.8
Petroleum and gas	481.0	0.0
AVERAGE	100.6	

1. Share of exports by firms with more than 10 per cent foreign ownership.
Source: Central Statistical Office.

imported capital goods and increased demand for imported inputs, and are discussed below.

Indicators of cost and price competitiveness

After appreciating steadily from late 1989 through early 1993[88] the real exchange rate steadily depreciated throughout 1993 and 1994, declining some 10 per cent in comparison to the levels reached in February 1993 (Figure 10)

Table 25. **Hungarian exports, contribution to export change**

	Change in levels 92-94 (US$ millions)	Cumulated change	Foreign share of exports 1993 (per cent)[1]
Agriculture	–322.8	–322.8	28.9
Wearing apparel	–225.6	–548.4	48.1
Leather	–65.8	–614.3	41.9
Fabricated metals	–33.4	–647.7	62.3
Motor vehicles and trailers	–29.9	–677.6	49.4
Forestry	–18.0	–695.6	0.6
Uranium mining	–11.6	–707.1	0.0
Publishing and printing	–10.8	–718.0	35.4
Food and beverages	–10.6	–728.6	53.4
Office, accounting and computers	–2.3	–731.0	83.2
Other mining	–1.6	–732.5	84.4
Other non-metal minerals	–1.5	–734.0	62.8
Metal ores	–1.1	–735.1	0.0
Other transport	213.3	213.3	55.8
Electrical machinery	162.7	376.0	89.7
Radio, television and communications	154.6	530.6	68.2
Chemicals	50.5	581.1	31.4
Petroleum and gas	35.1	616.1	0.0
Rubber and Plastic	27.7	643.8	60.5
Paper and paper products	25.7	669.5	80.5
Basic metals	24.4	693.8	14.9
Medical, precision and optics	23.2	717.0	47.6
Petroleum products	18.9	736.0	5.0
Machinery and equipment	18.7	754.6	48.5
Furniture	15.3	769.9	39.9
Tobacco	7.6	777.5	84.4
Wood	3.3	780.7	44.6
Textiles	2.8	783.5	52.0
Coal and lignite	0.8	784.3	25.4
Fishing	0.4	783.9	26.6

1. Share of exports by firms with more than 10 per cent foreign ownership.
Source: Central Statistical Office.

Mirroring these developments, cost competitiveness as measured by unit labour costs in a common currency has also been improving since the beginning of 1993 (Figure 11). Measured in terms of the ECU the decline in competitiveness was more pronounced in 1992 and the subsequent improvement has been less pronounced than with respect to the dollar. These differences are important given the commodity composition of Hungarian trade: approximately one-third of Hungarian trade – exports and imports are roughly similar – is denominated in US

Table 26. **Growth rate of imports, 1992-1994**

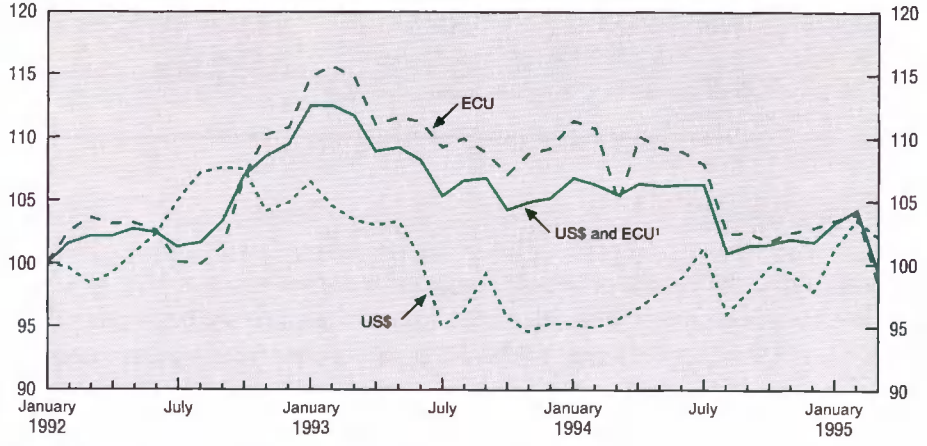
US$, in per cent

Office, accounting and computer equipement	13.0
Medical and precision instruments	18.8
Wearing apparel	23.4
Textiles	24.8
Paper	25.7
Chemicals	26.2
Furniture	28.8
Basic metals	28.9
Radio, television, communications	31.5
Recorded media	31.7
Leather; luggage, bags, footwear	37.3
Machinery and equipment	41.9
Motor vehicles	43.5
Wood and cork excluding furniture	44.6
Rubber and plastic	49.6
Other non-metallic and plastic	56.3
Food and beverages	60.3
Metal products excluding machinery	64.5
Electrical machinery	70.9
Coke and petroleum	126.1

Source: Central Statistical Office.

Figure 10. **REAL EXCHANGE RATES VERSUS MAJOR CURRENCIES**

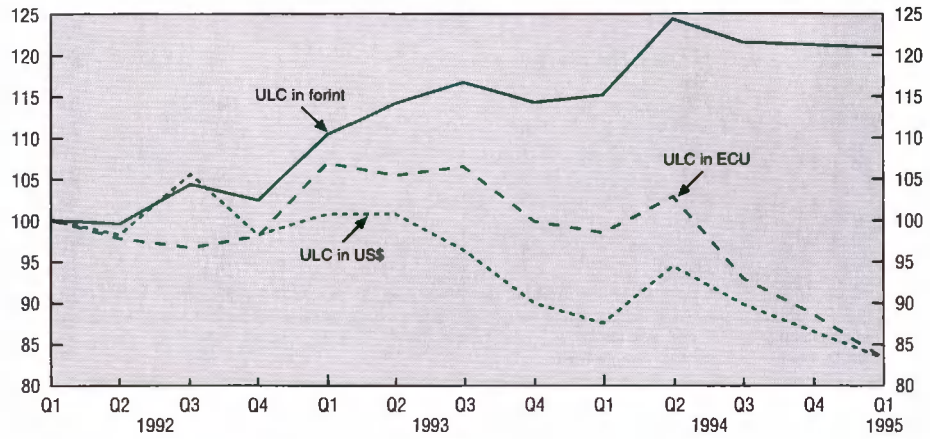
January 1992 = 100



1. (0.7*HUF/ECU + 0.3*HUF/US$) deflated by producer prices in manufacturing.
Source: OECD Secretariat.

Figure 11. **UNIT LABOUR COSTS IN MANUFACTURING IN DIFFERENT CURRENCIES**

1992 Q1 = 100



Source: Hungarian Central Statistics Office.

dollars, one-third in DM, and most of the remainder in other European currencies.

Compared to its nearest competitors, the other Visegrád countries to whom Hungary lost market share in Western Europe in 1993/94 (Table 27),[89] Hungarian cost performance was mixed. Over the survey period Hungarian and Polish unit labour costs, (expressed in a common currency) hardly changed, while ULCs in the Czech Republic and Slovakia significantly increased. However, unit labour costs in Hungary still substantially exceed that of the other Visegrád countries,[90] and the same is true for wage rates, which are more easily compared.

Another way to look at competitiveness is through the development of the relative price of tradeables to non-tradeables, which is a way of defining the real exchange rate. Utilising the producer prices of domestic sales as a proxy for non-tradeables and either manufacturing or export prices as a proxy for tradeables indicates that there has been a steady real devaluation over the period (Figure 12). Export prices have closely followed world prices (expressed in forints) during the review period. Moreover, although it is impressionistic it would appear that

Table 27. **Share of Visegrád exports to the European Union**[1]

	Total Visegrad exports to EU		Hungary exports to EU		Hungary share in Visegrad
	Level	Growth	Level	Growth	
1992-Q1	4 878		1 219		25.0
Q2	5 149	5.5	1 236	1.4	24.0
Q3	5 741	11.5	1 415	14.4	24.6
Q4	5 726	–0.3	1 348	–4.7	23.5
1993-Q1	4 636	–19.0	1 069	–20.7	23.1
Q2	5 199	12.1	1 135	6.2	21.8
Q3	5 098	–1.9	1 131	–0.4	22.2
Q4	5 807	13.9	1 329	17.5	22.9
1994-Q1	5 638	–2.9	1 233	–7.2	21.9
Q2	6 166	9.4	1 301	5.5	21.1
Q3	6 686	8.5	1 510	16.1	22.6
Q4	7 945	18.8	1 823	20.7	22.9

1. Excluding Austria, Finland and Sweden.
Source: OECD, Monthly statistics of foreign trade.

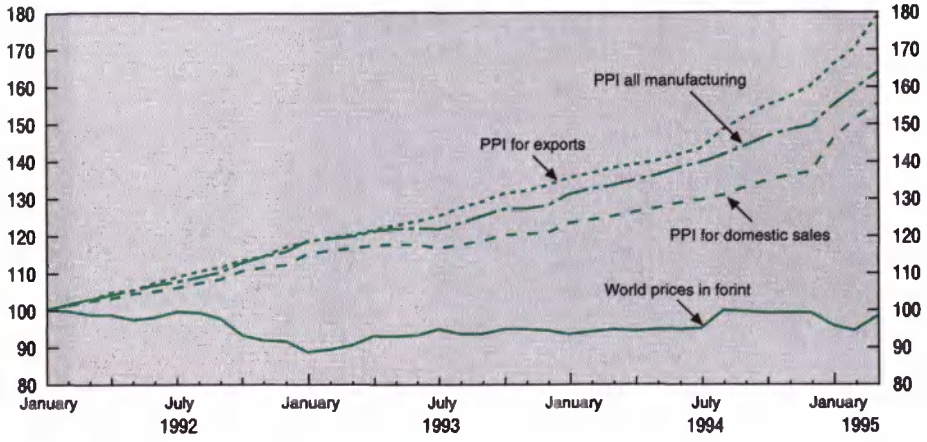
nominal exchange rate devaluations are not passed through in the form of lower foreign currency prices but retained as higher forint prices. The reasons for the relatively slower growth of domestic sales prices are difficult to pin-point. One factor which is mentioned by observers in Hungary is the quality of goods: lower value goods with a lower rate of inflation are produced for the less discriminating local market.

Real wages, labour productivity, and the profitability of traded goods production provide additional measures of competitiveness. Over the review period real producer wages – including social security contributions and certain non-wage labour costs – rose by around 20 per cent against manufacturing prices[91] (Figure 13). The rise in real wages was associated with a marked decline in employment and an increase in output; accordingly, a rise in measured labour productivity offset the increase in real wages[92] (Figure 14). Put another way, if unit labour cost was evaluated at full employment labour productivity, it would likely indicate a marked deterioration in competitiveness. This indicates the prevalence of capital shortage unemployment in the same manner as in the new Länder of Germany, though less extreme.

As noted in Chapter I the financial condition and operating results of the enterprise sector improved during 1993 and 1994, and this was particularly true

Figure 12. **CHANGING RELATIVE PRICES OF TRADEABLES AND NON-TRADEABLES**

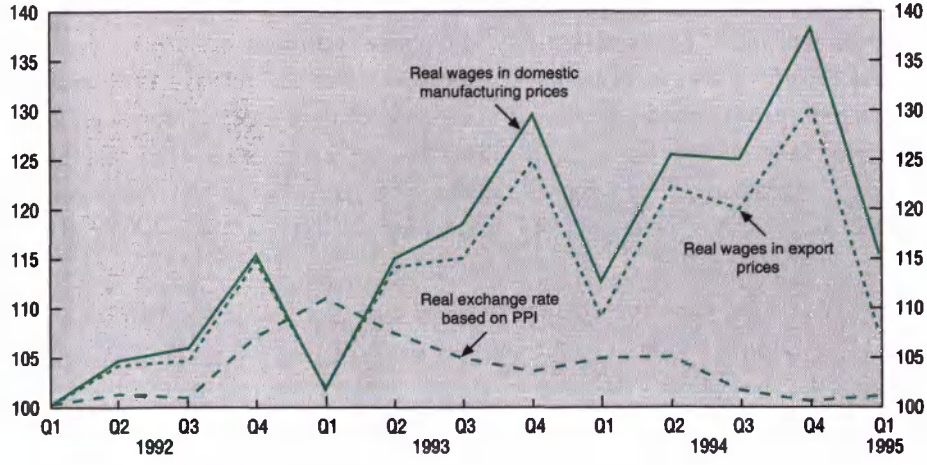
1992 January = 100



Source: Hungarian Central Statistics Office; OECD Secretariat.

Figure 13. **REAL WAGE MEASURES OF COST COMPETITIVENESS**

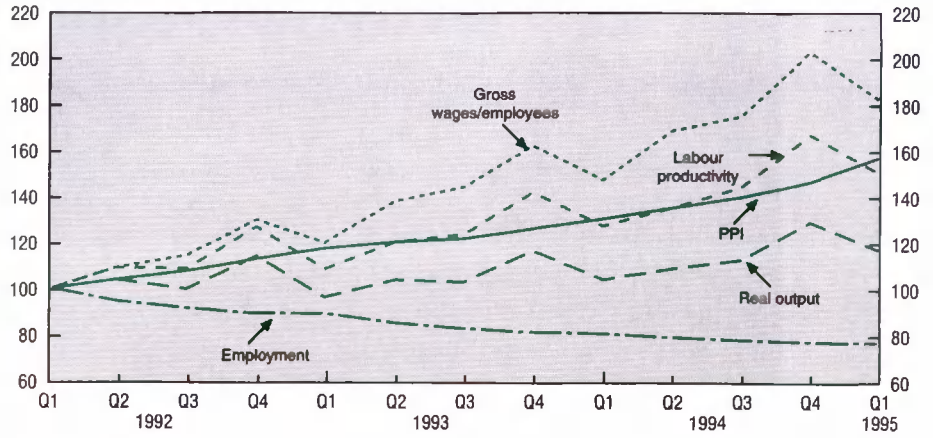
1992 Q1 = 100



Source: Hungarian Central Statistics Office; OECD Secretariat.

Figure 14. **THE COMPONENTS OF REAL WAGES AND UNIT LABOUR COSTS IN MANUFACTURING**

1992 Q1 = 100



Source: Hungarian Central Statistics Office.

of exporters.[93] In a small open economy, export activity is inevitably concentrated by enterprise and by product lines increasing the sensitivity of the economy to individual corporate performance and idiosyncratic factors. Enterprise profitability data do not allow judgements to be made about the relative profitability of exports *per se*, but sorting the data into companies with large shares of exports in their total sales and those without allowed some insights into the relative performance of exporting companies during 1992 and 1993. The most pertinent stylised facts which emerge from a detailed analysis of non-financial firms include (see Annex II):[94]

- exporting firms are characterised by a large and rapidly increasing share of foreign ownership; the foreign share of registered capital doubled to 30 per cent in 1993, whereas state capital dropped from 60 to 41 per cent. Similar trends existed for non-exporters, but were much weaker;[95]
- both exporters and non-exporters as a group continued to make losses in 1993. However there was a dramatic decrease in the level of losses between 1992 and 1993, particularly among exporting companies; for

these firms the ratio of pre-tax profits to equity increased from –12.9 per cent to –2.1 per cent. Within the category of exporting firms, there was no correlation between the share of exports and profitability. For non-exporting companies the level and rate of loss-making improved only marginally.[96] By 1993 the rate of return on equity of both categories was roughly comparable;

- splitting the sample into firms making operating profits and losses shows that three-quarters of the improvement in overall profitability among exporters was accounted for by a reduction of operating losses, a reduction in losses on financial transactions, and an increase in extraordinary profits (presumably from asset sales). Much of this came from large loss-makers; in 1992 close to one-fifth of total exports were produced by firms with extremely high losses (more than 15 per cent pre-tax loss on sales), but in 1993 their share hardly exceeded one-tenth[97] as total sales of loss-making exporters declined by 25 per cent.[98] For non-exporters, there was only a marginal decrease in operating losses, while both the sales and the number of loss-makers increased, the latter substantially;
- exporting firms were able to reduce the share of wages in total costs by over two percentage points, and had a 36 per cent increase in labour productivity. For non-exporters, the wage share was unchanged and labour productivity increased marginally.[99]

The picture that emerges is one of a consolidation of the export sector. In 1993, uneconomic capacity was cut – largely a delayed response to the reorientation of former CMEA exports to the OECD – so that losses were substantially reduced, leaving a smaller but more profitable volume of exports than before. The bankruptcy law which went into effect in 1992 contributed to this process,[100] but this was simply a part of a broader improvement in financial discipline. In 1994, exports rebounded to 1992 levels, while profitability continued to increase.

Foreign direct investment

Attracting foreign direct investment

A measure of Hungary's competitiveness – in the broadest sense of the concept – has been its ability to attract large flows of foreign direct investment: foreign direct investment in Hungary had reached over $7 billion by the end of

1994, more than double the level at the end of 1992, and has played a more important role there than in any other economy in transition.[101] Sales from foreign-owned firms now account for about 16 per cent of the total Hungarian market, though still less than the pre-World War II share,[102] but this figure grossly understates the importance of foreign direct investment to the Hungarian economy. Most foreign investment has gone into manufacturing, so that in 1993 foreign-owned firms[103] accounted for 39 per cent of domestic sales, and 47 per cent of gross investment. Foreign-owned firms are now represented in most industrial branches but are particularly important in engineering, the food industry, and in consumer goods.[104] Four major automobile manufacturers have located plants in Hungary accounting for $750 million in investment:[105] Suzuki, Ford, GM, and Volkswagen-Audi.

The potential impact of FDI on competitiveness

In assessing the role of FDI the perspective is often far too narrow: what ultimately matters is whether it contributes to improving production and total factor productivity rather than the volume of imports and exports which may be directly associated with foreign firms. These latter decisions will ultimately depend on domestic economic conditions and economic policy rather than FDI *per se*. To shed some light on these framework conditions this section briefly reviews the evidence about the connection between trade and FDI.

It appears that a significant proportion of exports and export growth is attributable to firms with some foreign participation (Table 28). According to industrial production figures provided by the Central Statistical Office, foreign-owned firms accounted for fifty per cent of Hungarian exports in 1993 and, for 45 per cent of foreign-owned firms, exports account for more than 25 per cent of total sales. Similarly, foreign-owned firms accounted for all of the increase in exports between 1992 and 1993 in the tax-data sample discussed above, though they did not increase the proportion of their output going to exports.

The domestic content of exports, and production, by foreign-owned firms is a subject of great interest. Without a complete input-output table it is impossible to measure total domestic value-added, however at the initial level – output less material inputs – the tax data show that foreign-owned firms had "value-added" levels about 30 per cent above state-owned firms and double that of private firms. On the other hand, there is substantial evidence that the import content of

Table 28. **Role of foreign firms**[1]

Per cent of total economy, 1993

	New investments	Exports	Domestic sales
Agriculture	8.1	28.9	3.6
Forestry	0.0	0.6	0.4
Fishing	0.0	26.6	0.1
Coal and lignite	2.9	25.4	5.1
Crude petroleum and gas nat.	0.0	0.0	0.0
Uranium and thorium ores	0.0	0.0	0.0
Metal ores	0.0	0.0	0.0
Other mining and quarying	95.1	84.4	62.4
Food and beverage	74.8	53.4	45.1
Tobacco	100.0	84.4	100.0
Textiles	76.2	52.0	25.3
Wearing apparel	65.1	48.1	24.7
Tanning and dressing of leather	41.7	41.9	10.7
Wood	61.4	44.6	28.0
Paper and paper products	88.6	80.5	65.5
Publishing and printing	61.8	35.4	41.5
Coke and refined petroleum products	1.7	5.0	1.6
Chemicals and chemicals products	60.1	31.4	43.3
Rubber and plastic products	82.2	60.5	54.7
Other non-metallic mineral products	82.9	62.8	48.3
Basic metals	14.4	14.9	13.1
Fabricated metal products	62.1	62.3	35.0
Machinery and equipement	46.0	48.5	26.3
Office, accounting and computing machinery	93.3	83.2	35.4
Electrical machinery	89.0	89.7	52.7
Radio, television and comm. equipment	83.4	60.1	49.4
Medical prec. and optical instr., watches and clock	57.2	47.6	39.2
Motor vehicles, trailers and semi-trailers	56.3	49.4	34.4
Other transport equipment	72.9	55.8	60.7
Furniture and manufacturing N.E.C.	62.8	39.9	18.8
Recycling	17.0	51.3	14.3
Electricity, gas, steam and water supply	2.7	0.3	2.3
Collection, purification and distribution of water	0.0	0.0	0.3
Construction	43.0	35.1	25.2
Sale, maintenance and repair of motor vehicles, sale fuel	37.8	68.4	50.3
Wholesale trade	45.1	45.2	30.6
Retail sale	25.7	36.1	18.9
Hotel and restaurants	29.6	31.4	26.8
Land transport, transport via pipelines	0.5	10.8	4.5
Water transport	0.0	3.8	1.1
Air transport	99.9	99.9	98.6
Supporting and auxiliary transport activities	27.1	47.4	28.7
Post and telecommunications	87.8	92.7	61.5
Real estate activities	49.5	59.6	11.7
Renting of machinery and equipment	48.2	55.6	22.7
Computer and related activities	24.1	57.5	27.4
Research and development	46.0	22.1	10.4
Other business activities	53.5	41.3	36.9
Education	10.4	47.2	17.3

Table 28. **Role of foreign firms**[1] *(cont.)*

Per cent of total economy, 1993

	New investments	Exports	Domestic sales
Health and social work	70.3	18.0	42.5
Sewage and refuse disposal, sanitation and similar activities	15.3	79.1	16.2
Activities of membership organisations N.E.C.	0.0	5.3	16.6
Recreational, cultural and sporting activities	9.3	70.2	18.7
Other services	11.4	84.5	5.7
Total	49.3	45.1	26.9

1. Firms with more than 10 per cent foreign ownership.
Source: Central Statistical Office.

material inputs and investment by foreign-owned firms may be relatively high. A large proportion of foreign direct investment has been in the form of in-kind contributions of capital goods. According to an NBH study, more than half of the investment undertaken by majority foreign-owned firms is in the form of imported machinery, as opposed to one-third by joint ventures and one-quarter by domestically-owned firms. In terms of inputs, many foreign-owned firms report difficulty in finding domestic suppliers[106] while another study has found that firms purchased by foreign investors decrease their use of domestically-supplied raw materials.[107]

Assessing the overall impact of foreign direct investment on Hungarian industrial performance goes far beyond the scope of the report. Nevertheless some general indicators are useful to convey the scope of FDI. Evidence from corporate tax reporting for 1993 shows that foreign-owned firms, defined as firms with a foreign ownership share greater than ten per cent, experienced the most rapid growth in sales and other balance sheet measures of firm size. Foreign-owned firms in manufacturing had higher levels of labour productivity, but also higher wages and unit labour costs; the ratio of operating profits and pre-tax profits to sales were also higher than those of domestic firms.[108] Industry studies indicate that foreign-owned firms have been highly successful and profitable in consumer-oriented sectors like food and beverages, where improvements in packaging, marketing, quality control and financial management were capable of yielding quick results. Performance in engineering has been decidedly more mixed.

Quantifying the relative importance of factors determining the trade balance

Although the various measures of cost competitiveness discussed above point to a deterioration in 1992, followed by improvements in 1993-1994, there is no presumption that the trade balance was significantly affected. Other factors might also have had a role. As noted earlier, the trade liberalisation of 1989-91 and need for industrial restructuring may have increased demand for imports. Domestic demand grew rapidly in both 1993 and 1994 while aggregate supply was affected by the drop in domestic agricultural production – about 15 per cent in 1992 and another 24 per cent in 1993 – and by improving financial discipline. Hungarian exports were hit by the recession in Western Europe: real GDP in the European Community (EC) fell by 1.3 per cent, and did not return to early 1992 levels until 1993Q4; for Hungary's major trading partner, Germany, the decline was much steeper – 2.8 per cent.[109] In addition to these major factors, Hungarian trade was also affected by the ongoing embargo on exports to former-Yugoslavia and a ban on meat imports by the EC for several months in 1993.

Estimating the impact of these various factors on the trade balance is difficult, given that they were occurring simultaneously, and in some cases are endogenous variables. For example, excess demand could be expected to lead to an increase in wages and prices and thus to an appreciation of the real exchange rate. The Secretariat has attempted to statistically decompose the contribution of demand, competitiveness and supply shocks[110] on the trade balance by using multiple regression analysis, described in detail in Annex III. This analysis is intended to be suggestive rather than rigorous given the constraints under which these regressions were estimated.[111]

These caveats notwithstanding, some fairly strong results do emerge from the equation estimates. The single most important factor in the trade balance appears to have come from the high growth of domestic demand. Import growth accounted for 80 per cent of the deterioration of the trade balance, net of reprocessing. Estimates of the import equation indicate that growth had a strong import bias to it: the import elasticity of demand for non-agricultural imports in Hungary was quite high – above 2 – and this estimate was very robust. Moreover, a similarly high elasticity was estimated for agricultural and food imports, even after taking into account the effects of declining domestic production.

Domestic demand contributed to the poor performance of exports too. While the estimates are not very robust, it appears that a one per cent increase in domestic demand was accompanied by an equivalent decline in non-agricultural exports. This suggests that as domestic demand rose, firms shifted their sales to the (perhaps less demanding) domestic market. On balance, the expansion of demand in 1993 and 1994 was associated with about one-half of the deterioration of the trade balance.

The impact of the real exchange rate appreciation which occurred between early 1992 and mid-1993 is a source of substantial dispute in Hungary, with many observers believing it to have been largely responsible for the poor trade performance of 1993/1994.[112] This view appears to be partially true, though, as argued above, the evidence indicates that real exchange rate appreciation was largely endogenous, and is more accurately pictured as rising unit labour costs, driven by rising real producer wages. This view was further confirmed by replacing real exchange rate movements with unit labour costs in the equation estimates, which showed the latter to have greater explanatory power, though the two variables largely move together. All exporting sectors were sensitive to movements in price or cost measures (an elasticity of around 2), and for reprocessing exports the real exchange rate (or unit labour costs) was the sole significant variable. In all cases it was the measure relative to the ECU, not the US dollar or the NBH basket, which was important. This is not surprising since Hungary's major export market is Western Europe, and is consistent with the fact that it was the ECU real exchange rate which appreciated for an extended period.[113]

At the same time, imports appear to be insensitive to price or exchange rate movements;[114] regression estimates pointed to no significant positive relationship between exchange rate movements and imports. This finding is confirmed by simple observation; ignoring seasonality, imports rose monotonically over the survey period despite swings in the real exchange rate. Nor is it surprising: the combination of import liberalisation and restructuring associated with transition implies a steady increase in imports as Hungary further integrates itself into the world economy.

As compared with the effects of domestic demand, the impact of the West European recession and falling agricultural production was relatively small. Reprocessing and agricultural exports were unaffected by movements in foreign demand, consistent with their more commodity-like nature and the fact that

Hungary is a small open economy. Demand elasticities for non-agricultural exports ranged between 2.5 and 4.0 depending on the particular independent variable used,[115] even the higher estimate indicates that the European recession could have only accounted for about one-third of the drop, and then only for 1993.[116] The impact of agricultural supply problems was in a range of $3-500 million.

These results, with all their associated statistical uncertainty, have two implications. First, the majority of the decline in the trade balance came from domestic sources: domestic demand and real exchange rate/unit labour cost movements, rather than exogenous shocks. Placing indicative orders of magnitude on these effects suggests that the rapid growth of domestic demand may have accounted for about 40-45 per cent of the decline in the trade balance, the real exchange rate appreciation about 20-30 per cent, the recession in Western Europe 10-20 per cent and agricultural supply problems the remainder.[117] Second, while Hungarian export elasticities were found to be somewhat higher than import elasticities, the difference appears to be small, so that Hungarian growth will be constrained by the growth of export markets, at least until the process of structural transformation is further advanced.

Assessment: what is the nature of the competitiveness problem

Most indicators of cost and price competitiveness indicate improvements during the review period. At the same time, loss-making exports have been reduced and labour productivity improved so that export activity now appears to be on a more solid economic foundation than before. Part of this improved basis is due to the impact of FDI on the Hungarian economy, although an assessment of foreign investment should not be conducted in terms of its trade impact alone. Trade policy has by and large resisted protectionist pressures although the structure of effective protection might still serve to tax exporters and discourage the development of domestic suppliers.[118]

Nevertheless the authorities remain concerned and for good reason. These improvements were accompanied by a further deterioration in the trade balance and by a relatively slow recovery of exports in 1994 – slow in comparison to the very high rates registered elsewhere in the region. The import intensity of growth appears to be quite high so that a rapid expansion of exports will be necessary to

maintain moderate overall growth within the constraints of non-debt creating capital flows. However, it should be noted that this is not necessarily a question for cost competitiveness. Fast growing countries are usually characterised by a high income elasticity of demand for their exports because they have been successful in continually altering their product mix through active entrepreneurship, high levels of saving and profitability, and significant reallocation of productive resources across sectors. Cost competitiveness has certainly played a role, mainly by keeping aggregate wage growth within the limits of total factor productivity growth.

Set against such strategic considerations a number of policy issues are better highlighted. First, real wage costs have been growing rapidly in Hungary. They have been validated by scrapping marginal capacity and by reducing employment: the productivity increase, while welcome as a sign of improved financial discipline, is of the wrong kind. While real exchange rate appreciation did contribute significantly to the deteriorating external balance, it appears to have been largely an outcome of rising real producer wages. Under such circumstances, exchange rate devaluation might only lead to an increase in wages and thus prove ineffective.

Second, it appears that the supply response remains weak, and in that context the macroeconomic policy balance appears to be inappropriate. While the evidence does have to be treated with care, it appears that the decline in the trade balance has been due in good measure to the inability of aggregate supply to respond to growing domestic demand. In 1993-1994 cost competitiveness improved but not the trade balance: strong exports in 1994 were not accompanied by an improvement of the deficit as imports continued to rise rapidly. This would indicate that the declines in loss-making and enhancements in productivity need to be further improved upon, and that the reallocation of resources and new investments have been insufficient to permit a sustained increase in the supply of traded goods. Some of the institutional reasons why the supply response has been weak are discussed in the next chapter.

The macroeconomic context of the competitiveness problem can be illustrated by means of a simple model (see Box). Hungary is faced with a current account deficit which is not considered sustainable: there is already a high level of foreign debt and foreign savings are being used to finance a high level of consumption rather than high levels of investment. From the point of view of the

International competitiveness in a simple macroeconomic policy framework

The simple model draws on the insights of the tradeable/non-tradeable goods dichotomy: traded goods are ones whose prices are determined on world markets so that a change in the exchange rate does not alter the relation between the prices of imports and exports. Non-tradeable prices are determined solely on domestic markets or by government regulation. These assumptions, together with basic economic behaviour on the part of enterprises, defines a measure of cost competitiveness relevant for determining the level of net exports: it is the weighted average of tradeable prices with weights determined by supply elasticities and consumption shares, deflated by a measure of wages. A devaluation will initially lead to an improvement in competitiveness, but the key question is the impact on the prices of non-tradeables and eventually how both changes will influence nominal wages.

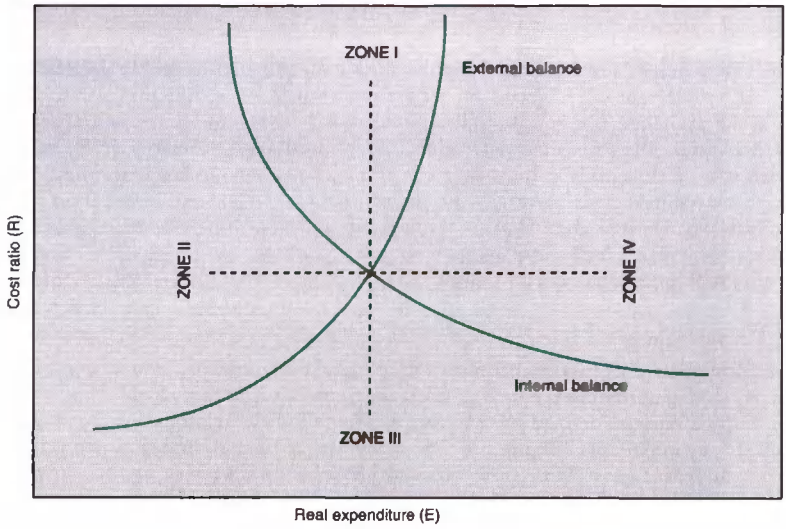
Cost competitiveness so defined needs to be placed in a macroeconomic context. For a given level of employment, terms of trade, aggregate productivity, and capital stock, internal balance may be defined by a negatively-sloped curve relating cost competitiveness and domestic demand (Figure 15) For lower levels of real domestic expenditures, cost competitiveness must increase in order to generate sufficient net exports given the supply potential in the economy. To the right of the curve is a zone characterised as internal disequilibrium – over-full employment, inflation, uneconomic enterprises etc.

External equilibrium must be defined. For given capital flows and private transfers the curve defining external equilibrium is upward sloping becoming very steep at the point of intersection with the full employment curve; the higher are domestic expenditures, the greater must be cost competitiveness in order to produce a given level of net exports with assets of lower marginal productivity.

Considering both internal and external equilibrium – something of key importance in the Hungarian situation – defines four zones of economic disequilibrium. Hungary might be situated in either zones III or IV. The framework brings out the difficulties of determining an appropriate policy mix: the zone matters only partly for policy. In zone IV, a decline in expenditures is unambiguously required, but whether there is a competitiveness problem depends on the exact combination of external and internal disequilibrium. In zone III there is clearly a competitiveness problem but whether there is expenditure remains ambiguous depending on whether the economy is to the left or right of the vertically dotted line.

authorities the economy has an external imbalance and therefore can be characterised as located to the right of the external balance line in Figure 15. More difficult is the question of internal balance. Despite the existence of unemployment the economy appears to be characterised by excess demand. The focus

Figure 15. **COMPETITIVENESS IN A MACROECONOMIC FRAMEWORK**



Zone I: Over-full employment and balance of payments surplus
Zone II: Under-full employment and balance of payments surplus
Zone III: Under-full employment and balance of payments deficit
Zone IV: Over-full employment and balance of payments deficit

Note: The cost ratio R is defined as an index of tradeable prices, appropriately weighted and converted into local currency, divided by an index of nominal labour costs. Thus a rising R would indicate lower real producer wages.

Source: T.W. Swan, "Policies for internal and External Balance" in *Macroeconomics Themes,* ed. M.J.C. Surrey, Oxford University Press, 1976.

of policy in the medium term should be on expanding the capacity of the economy through structural reforms including privatisation and competing for foreign investment. In the meantime external and internal balance need to be handled simultaneously, unless one aspect is to be improved only at the expense of a deterioration elsewhere. There is a strong probability that, unless a stronger supply response is forthcoming, restoring balance will require both a contraction of domestic demand and steps to lower the producer real wage measured in world prices.

IV. Progress in areas of structural reform

Overview

At the time of the previous Economy Survey the enforcement of bankruptcy and the financial condition of the banking system were of particular concern to the authorities. The initial impact of the pathbreaking bankruptcy law, which had come into effect in early 1992, had been a wave of filings and concern was being expressed about both the economic impact of the law and about its sustainability. At the same time, the scale of non-performing loans and the insufficiency of measures taken in late 1992 to preserve bank solvency were becoming increasingly apparent. In the intervening period the bankruptcy law has been amended and an out-of-court procedure introduced while the banks have been recapitalised and some non-performing loans taken off their books at substantial cost to the budget. The first section reviews these developments from the perspective of the progressive development of financial discipline in the Hungarian economy.

Privatisation has since its inception remained plagued by controversy. As a result, institutions and sales methods have continued to change in line with political pressures and accumulating experience, and a new privatisation law finally entered into force in June 1995. Over the review period the relative importance of asset management and privatisation activities of the two state agencies (SPA, HSHC)[119] has altered, and non-cash sales techniques have become increasingly important. The government has proposed a strategy which will change the emphasis of the privatisation programme in important areas such as financial support for enterprises prior to privatisation and the balance between cash and non-cash sales methods. The principal features of the strategy and the main policy issues which have emerged over the review period are discussed in the second section.

Agriculture has remained a difficult area of the economy with structural changes proving more difficult to implement than was at first thought. Moreover, poor performance in this sector has had an important macroeconomic impact on trade and output. The principal structural policy issues are briefly reviewed. The evolution of Hungary's trade commitments and the stance of competition policy are examined in the final section.

Continuing efforts to improve financial discipline

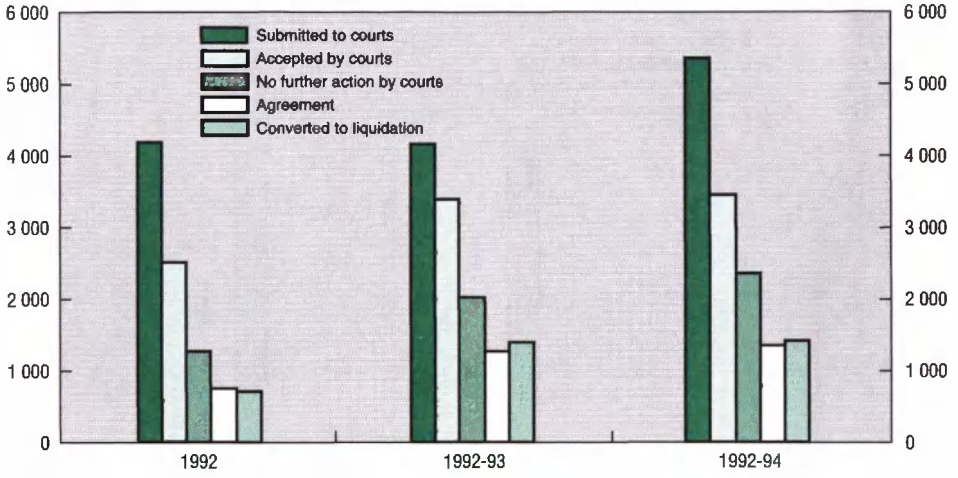
Implementing the bankruptcy law

The bankruptcy law of 1992 was path breaking in the region, especially in its requirement for compulsory filings. In the second quarter of 1992, immediately after the law went into force, the number of filings for bankruptcy[120] and liquidation were overwhelming:[121] altogether close to six thousand procedures were initiated. In the subsequent four quarters the number of new filings per quarter stabilised at around 400 bankruptcies and more than two thousand liquidations. The legal infrastructure, which was unprepared to deal with the huge number of cases registered at the outset, became increasingly incapable of coping with its task (Figure 16).

Prompted by pressure on the existing institutions – as well as by the conviction that not only insolvent companies but also illiquid ones were falling under the Act's provisions – significant amendments to the bankruptcy legislation were introduced in September 1993. The most important modifications included: *a)* phasing-out of the "automatic trigger", *b)* the application of qualified majority voting instead of unanimity to approve a reorganisation agreement, *c)* withdrawal of the automatic 90-day moratorium on debt service payments making it dependent instead on majority agreement, and *d)* a reduction of the period within which a re-organised company could return to bankruptcy from three to two years. The automatic trigger has been the target of most criticism in Hungary.[122] However, it is more likely that the early deficiencies – and for such path breaking measures there were always likely to be some – were more related to the low threshold (arrears of 90 days) and to the requirement for creditor unanimity.

The number of new applications for bankruptcy and liquidation rapidly receded after the amendments came into force: from the last quarter of 1993 to

Figure 16. **CUMULATIVE BANKRUPTCIES**

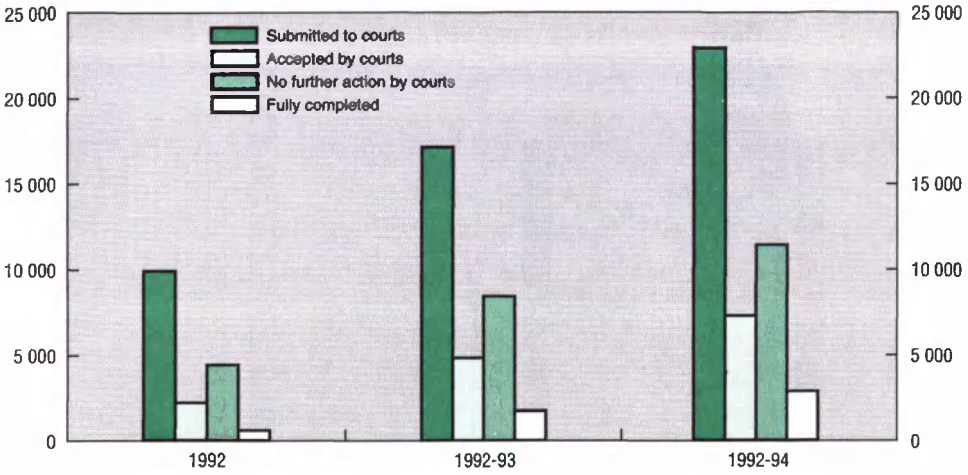


Source: Ministry of Finance.

the end of 1994 quarterly filings were generally less than 100 in the case of bankruptcy, and less than 1 300 for liquidations. However, due to the large number of accumulated registrations before the courts, the gap between the submitted applications and those actually accepted by the court remained quite wide, especially in the case of liquidations (Figure 17). Two other factors were also significant in reducing the number of applications: the development of out-of-court settlement procedures in 1994 and financial support by the government for some large firms which kept them out of the courts. These two factors are discussed in the following section.

Measured in terms of the number of enterprises affected, the first two years of bankruptcy legislation have produced impressive results: until the end of 1994 more than five thousand bankruptcy filings and close to twenty three thousand liquidations have been submitted to the courts. The number of fully completed cases was above 2 700 in the case of bankruptcies (half of which became liquidations) and close to three thousand in the case of liquidations. The relatively large number of petitions for liquidation which received no further

Figure 17. **CUMULATIVE LIQUIDATIONS**



Source: Ministry of Finance.

attention by the courts (close to half of the total filings) arose because many applications were not complete or multiple applications were received for the same debtor. In a large number of cases the creditors withdrew the application either to save costs or in response to an agreement with the debtor.

Assessing the law's impact

In view of the large number of applications for bankruptcy and liquidation, there is a widespread belief in Hungary that the bankruptcy law has been damaging; such a view is exaggerated and misleading. It is extremely difficult to gain an accurate picture since business entities under liquidation procedures do not have to provide balance sheet figures for the tax authorities and the court of registration. As a result, the major follow-up studies have had great difficulty identifying firms under bankruptcy and liquidation and matching their performance before and after the bankruptcy process. More importantly, there are quite a number of methodological problems in estimating the impact of bankruptcy: estimates can only refer to the activities of enterprises subject to the procedures

and can neither measure the costs for the firm involved – many of them stay in production – nor for the economy as a whole (*i.e.* lost production of one firm may be replaced by another, and the losses incurred by creditors must be considered).

Although accurate information is difficult to obtain, two studies of the scale or incidence of bankruptcy suggest that:

- companies (business entities) subject to bankruptcy or liquidation procedures – in the sense of submitting applications to the courts – in 1992 accounted for 17 per cent of total Hungarian employment, 26 per cent of exports and 14 per cent of gross production in 1991.[123]
- companies under published bankruptcy and liquidation procedures at any time between the start of 1992 and September 1994 accounted in 1993 for less than 2 per cent of gross production (3.2 per cent of sales), 4.2 per cent of employment and 10 per cent of the liabilities of the (double-entry bookkeeping) company sector.[124]

Taken together, the two studies appear to indicate that, in comparison with 1991, enterprises subject to proceedings had incurred substantial reductions in output and employment by 1993 – although it still does not measure economic cost as such. This judgement is, however, premature. The former study was based on submissions for bankruptcy many of which were in fact rejected by the court – often on the basis that the file was incomplete – or sometimes withdrawn by the creditors. The latter study, by contrast, focuses on those cases accepted by the courts and there was a great deal of effort to correctly identify the firm. The study suggests that the firms subject to bankruptcy proceedings were not large so that, despite their numbers, they accounted for a small share of aggregate output, employment and exports; large firms, which dominate the Hungarian economy, for one reason or another were able to avoid the bankruptcy law, which is not to say they were unaffected by it.

In assessing the impact of the bankruptcy law, wider factors have also to be considered, including the impact on payments discipline and the quality of restructuring plans for debtor enterprises. There are indications that payments discipline has improved since 1992 and that enterprises have started to pay greater attention to the solvency and liquidity of their customers. Inter-enterprise arrears (covering companies with arrears greater than HUF 25 million), which

had amounted to some 6.8 per cent of GDP in April 1992, declined by around HUF 100 billion in the period up to March 1993.[125] Not all of the decline can of course be attributed to improved payments discipline following the introduction of the bankruptcy law, but it is indicative of a general tightening.[126] Improved behaviour was not at the cost of other creditors: arrears toward state creditors (tax and customs authorities and social security) kept rising, but after making allowances for the debts of firms under bankruptcy and liquidation, arrears also declined. As noted in the previous chapter, most of the increased arrears toward the social insurance funds was due to the accrual of penalty interest, rather than to an increase in new liabilities.

At the time of the last Economic Review there was some concern that restructuring agreements reached between creditors and debtors might be *pro forma* and would not lead to effective market-based restructuring of the economy. To some extent this might have been true in 1992 but the institutions have since evolved and economic actors have gained by experience. A number of firms which gained agreements with creditors in 1992 have gone into liquidation in 1994 showing that the attitude of creditors has changed in the meantime, and that such debtors have failed to place their enterprises on a sound financial basis. Most knowledgeable observers believe that courts and liquidators have gained considerable experience and handle the difficult problems of implementing bankruptcy in an economy in transition in a pragmatic fashion.

Bank passivity

A marked feature of the experience in Hungary has been the apparent passivity of banks which in part accounted for the relative absence of larger firms from the bankruptcy process: by the end of 1993 they had only initiated 1.5 per cent of all applications for liquidation.[127] There were several reasons for this passivity. Up to early 1994, when banks were recapitalised and consolidation agreements signed with the Ministry of Finance (see below), banks were not in a position to threaten large clients, preferring instead to roll-over maturing loans. Moreover, as discussed in the following section, there was every reason to expect a government initiated bail-out of large enterprises. The banks have also viewed the liquidation process as costly and have therefore sought to settle problems bilaterally and out of court. Indeed some of the better banks are said to have decided in 1993 which clients were likely to be viable in the longer run and to

have come to restructuring agreements with them including debt-equity swaps and enforcing the splitting-up of the debtor companies.[128] For other clients there will be a longer process of disengagement and not always via the courts.[129]

From the perspective of banks – and to a great extent other creditors – the current bankruptcy procedures have a number of weaknesses. First, it is felt that the court-appointed liquidators enjoy too much freedom to decide the course of a liquidation and are not subject to sufficient controls with regard to cash flows. For example, liquidators have often kept loss-making firms in operation and creditors, not only banks, feel that they have insufficient powers to control this.[130] Second, banks only have a high priority in satisfaction of claims if their loans are secured. Non-secured loans are preceded by claims of state creditors. While in recent years banks have tended to grant loans only against collateral, earlier credits are generally unsecured. Third, the higher priority accorded secured loans is threatened by the right of state creditors to resort to foreclosure which they may exert already during the moratorium period. Thus banks, as a rule, do not agree to the initiation of liquidation proceedings until state creditors first give up this right. Fourth, the liquidation value of collateral is usually substantially less than the loan valued as a going concern. In maintaining the business banks often feel that a bilateral arrangement is preferable. The danger is that the rights of other creditors could be compromised.

If not as initiators, banks do get involved in bankruptcy and liquidation procedures as affected partners. While at the start of the bankruptcy wave most of the relatively small number of banks handling the vast majority of the bad loan portfolio simply did not have the necessary managerial skills and organisational units – apart from lacking incentives – to deal with these clients, significant progress has been achieved in this field during 1994. Recapitalised banks established their workout units – within or outside the bank – hired the required staff and started to implement a thorough clean up of the loan portfolio.

Dealing with enterprises outside the bankruptcy framework

Government intervention to save enterprises: moral hazard

Throughout the period the government and the two property agencies (SPA and the HSHC) have often supported financially firms threatened with bankruptcy. Support has been extended by outright purchase of company debt from

Table 29. **Selected financial measures to aid enterprises**

HUF billions

Purchase of debt from banks	
1) March 1993, 2 647 debtors	102.5
2) End of 1993	61.0
3) Additional purchases spring 1993	20.0
Other measures	
Guarantees from budget and SPA to banks – 1993	6.1
Guarantees from budget and SPA to banks – 1994	2.2
Guarantees from HSHC to banks	n.a.
Administration of purchased debt	
Bought by Hungarian Investment and Development Bank	41.6
Administered by banks under contract	40.0
Sold by tender 1994	7.0
Foregiven by HSHC in 1994	23.0
Subject to debtor consolidation program[1]:	26.4
Sold	5.0
Written off	15.3
Rescheduled	6.1

1. Based on 235 consolidation agreements concluded until the end of 1994.
Source: Ministry of Finance.

the banks, extension of restructuring funds by the SPA and the HSHC, rescheduling of debt due to the state, and increasingly the extension of credit guarantees to the commercial banks by the agencies and the government (Table 29). Debt purchased in this manner has been handled in one of two ways. First, some has been sold on the secondary market mainly to the state-owned Hungarian Investment and Development Bank. While they have succeeded in restructuring several enterprises, about 90 per cent of the loans have been placed in liquidation. Second, debt has been transferred to either the SPA or the HSHC under debt management contracts. The SPA has in turn sold back some of the debt to the firms, often at a substantial discount, while the remainder is being handled within the framework of the debtor reconciliation programme. The HSHC forgave about HUF 23 billion outright (Table 29).

In February 1995 a steel company in north-eastern Hungary threatened with closure as a result of a liquidation process was repurchased by the state: at the government's wish, the enterprise was repurchased by the HSHC for HUF 22 bil-

lion in order to support the companies' major creditors – including those owned by the HSHC. The objective of the government was to maintain employment in a very difficult region but it was also honouring commitments given by the previous government. The repurchase constitutes a dangerous signal to other companies not only that they could be rescued within framework of regional considerations, but also that their bad debts might be taken over by the state. Financial discipline and commercial behaviour could thus be weakened. Moreover, supporting the creditors of a firm in liquidation is hardly a sound basis for regional policy. At the time of writing, the transaction was under review as part of the June supplementary budget.

Because of the recurrent and *ad hoc* nature of the financial rescues it is reasonable to suppose that many firms – and banks – grew to expect it and accordingly changed their behaviour: the danger of moral hazard was not controlled. The various schemes envisaged the introduction of binding restructuring agreements with the enterprises. However, it appears that such agreements were viewed by the entreprises in a relaxed manner during 1993 and probably also during the first half of 1994.[131] As a result, for much of the period the objective of the government to promote financial discipline has been systematically undermined in major branches of the economy.

The debtor reconciliation programme

As part of the programme to recapitalise banks which came into force at the end of 1993, the government introduced a debtor reconciliation programme with the intention that banks would clean their loan portfolios. The scheme has some similarities to that introduced in Poland but the differences are even more significant. The major features of the Hungarian scheme were:

- banks were to notify all entities whose loans they had provisioned of the possibility to start negotiations with the banks and state creditors to settle their qualified debt. Around 13 000 debtors with loans totalling HUF 200 billion were notified but only about 2 000 responded. Apparently, a large number of borrowers could not even be contacted at the given postal address. Out of those which responded, about 1 200 with debts amounting to HUF 84 billion have started negotiations. Reasons for the low take-up rate include the complexity of the information form, the detailed nature of information being requested and the fact that state

creditors would also be involved in the process. Originally the programme was to be completed by the end of 1994;
- unlike in Poland, only banks and state creditors are involved, not the other trade creditors;
- the banks have not received any additional legal powers. In order to achieve a settlement they are permitted to use any commercial instruments such as debt/equity swaps and debt reduction. Settlements are to be conditional on the presentation of a restructuring plan. Failure to reach a settlement carries with it no penalties such as an automatic reference to liquidation.

Three different procedures were established: the accelerated, normal and the simplified. In the accelerated programme the line ministries were responsible for selecting 55 companies with debts of about HUF 80 billion. The reorganisation plans were to be approved by the ministries, official creditors and the relevant banks within sixty days. If a bank rejected an approved plan, the owner had the right to buy the debt at its net value in the bank's books. Failing this any of the creditors could request that liquidation procedures be initiated. The normal scheme was similar to the accelerated one but without a time limit. Seventy seven companies were placed in this programme based on the suggestions of the banks. Unlike the accelerated and normal schemes, the simplified programme did not include a buy-back provision on the part of the owners and the negotiations were conducted between only the creditors and the enterprise concerned.

From the start the repurchase provision represented a major problem, banks often preferring to sell a debt to the SPA rather than accept the restructuring programme. The SPA and the HSHC bought some debt but lacked resources to intervene on any large scale. The quality of many restructuring programmes might have left something to be desired although there are conflicting assessments on this point.[132] What is however clear is that the large number of parties involved, including ministries, represented a major barrier to reaching agreement. At the end of 1994, 13 of the SPA companies in the accelerated programme, had been placed in liquidation, 10 had been removed from the programme on account of privatisation, 13 had reached agreements and 7 were still in progress. At the time of writing no information was available as to outcomes for the programme as a whole.

At the end of 1994 the government terminated the accelerated and normal parts of the programme but extended the remainder of the programme to July 1995. The large number of cases were proving difficult for the banks to handle. Another factor which was serving to slow the negotiations was the uncoordinated position of the tax authorities, the social security funds and the banks. At the outset the authorities had assumed that, as in Poland, the tax authorities would follow the lead of the banks – in fact in Poland the tax authorities were required by law to compromise. This happened at the beginning but as the year progressed the situation deteriorated in line with the pressure on the authorities after July 1994 to improve tax collection.

Reforming the banking system

Since the last Economic Survey there have been a number of policy initiatives aimed at improving the financial soundness, structure and performance of the banking sector, and in changing the administration of non-performing loans. The authorities have reversed the previous policy of purchasing non-performing loans, and now generally leave such loans with the banks themselves. To create an incentive for better managing such loans the banks have been recapitalised, in part through an increase in their equity base. Important weaknesses in the implementation of this generally desirable strategy have been apparent: the amount of recapitalisation has not been set in advance thereby increasing the danger of moral hazard on the part of banks and enterprises; the programme has not been credibly one-off but drawn out over time; recapitalisation has not been effectively tied to bank reorganisation and has preceded the latter; privatisation has not been an integral part of the programme. Nevertheless by mid-1994 a suitable foundation for further advances had been established and policy toward the banking sector has since become more coherent.

Increased levels of non-performing loans in 1993

The most salient feature of the banking situation since 1992 has been the build-up of non-performing loans which continually threatened to eliminate the capital of most major banks. At the end of 1992, provisioning for non-performing loans threatened to reduce the capital/asset ratio of some major banks below zero. Purchases of such classified loans by the government in December – the transaction was finalised in March 1993 after the banks withdrew some of the proposed

Table 30. **Development of bad debts**

HUF billions

	Dec. 1992	Dec. 1993 old	Dec. 1993[1]	Dec. 1994
Problem free loans	1 451 (88%)	1 661 (82%)	1 377 (71%)	1 776 (73%)
Non performing loans	186 (11%)	352 (17%)	548 (28%)	664 (27%)
of which: Bad debts	84 (5%)	186 (9%)	254 (13%)	218 (9%)
Total loans	1 637	2 013	1 925	2 440
Specific provisions	73	244	287	240
Capital asset ratio of those banks subject to recapitalisation:				
After recapitalisation			0.0 %	7 %
Overall bank profitability (% assets)			–8.0 %	1.4 %

1. After loan consolidation scheme.
Source: National Bank of Hungary.

loans – restored their capital asset ratio to 0.0 per cent. However, in the course of 1993 non-performing loans surged from 11 per cent of the loan portfolio to 19 per cent by December while loans classified as bad increased from 5 per cent to 10 per cent (Table 30). The increase in non-performing loans once again threatened to eliminate the capital of most major banks.

The rapid rise of non-performing loans during 1993 was primarily due to the belated recognition of what had been the situation throughout 1992 – and possibly even earlier. In addition, under Hungarian accounting law interest accrues on non-performing loans – it must be fully provisioned – so that such loans would have increased in the course of 1993 on this account alone by some 30 per cent. Recognition of past bad debts resulted from legal and regulatory changes which had been introduced in 1992.[133] The bankruptcy law, an accounting law and a new act on financial institutions provided a better benchmark for judging performance and an internationally acceptable system for categorising risk, and made it compulsory to make provisions for non-performing loans. At the same time, the tax law was changed to allow tax deductability for provisions, a factor designed to both preserve bank capital and to encourage conservative provisioning. Although it is not possible to give precise estimates, these changes appeared to account for the bulk of the significant increase in non-performing loans during 1993.

At the end of 1993, modifications were made in the way that non-performing loans were to be assessed leading to a further increase in such loans by some 4 per cent of total loans – mainly in the category classified as bad debts. In comparison with the previous system, banks had to provision against all assets and not only loans, and within risk categories were free to increase the level of provisions if they felt the situation so warranted. By mid 1994 the situation appeared to have stabilised. Table 30 shows only net flows so it is not possible to identify new bad debts; moreover some old debts were probably written off in 1994.

Bank recapitalisation

In order to preserve bank solvency while at the same time provisioning for bad debts, the government has on three separate occasions purchased outright non-performing loans from banks at either a discount or at the net value on the banks' balance sheet (Table 31). Up till the end of 1993, loans with a face value of HUF 179 billion had been purchased from banks against Treasury bonds. The consolidation bonds issued to banks have a maturity of 20 years and are freely negotiable. In the same manner as other medium and long terms bonds issued by the Ministry of Finance, the interest rate is variable and based on a basket of three month bond yields.

In the course of 1993 it became evident to the authorities that the loan consolidation programme did not represent a feasible option for dealing with the non-performing loans, and that a broader programme would be required. The Bank Consolidation Programme developed during 1993 drew on the experience of the Polish programme: bad debts were to remain with the banks and were not to be allocated to any new or existing institution. Rather, banks were to be given the incentive to try and recover as much as they could from these loans by being recapitalised and through creating special bad debt workout departments. Recapitalisation has proceeded in several stages, progressively raising the capital asset ratio. The strategy adopted has varied by size of bank and according to the potential for finding new sources of capital. The larger banks have been recapitalised by equity increases – which has diluted some "private" equity stakes – but the smaller ones have mainly received subordinated loans (Table 31). At the end of the process banks were to be privatised.

Table 31. **Financial measures to aid banks**

1 End of 1991: government guaranteed half of doubtful loans inherited by banks from NBH in 1987.

2 End of 1992: loan consolidation scheme for 14 banks and 78 savings cooperatives covering bad loans outstanding at end of 1992. The Ministry of Finance bought the loans with bonds at prices, 50 per cent of loans qualified as bad before 1992, 80 per cent for loans qualified as bad during 1992; 100 per cent for special companies. Loans and capitalised interest amounting to HUF 102.5 bought for HUF 80 billion.

3 In 1993 selective measures for particular banks. Amount: HUF 20 billion.

4 End 1993. A substantial portion of debts of 11 large enterprises bought at 90-100 per cent of face value. Loans to the food processing sector by banks not participating in the bank consolidation scheme also bought. Amount HUF 57 billion. Face value HUF 61 billion.

5 End 1993, bank recapitalisation, first stage: capital of eight banks increased to bring capital/asset ratio to 0.0. Equity capital (HUF 2.9 billion) and subordinated loan (HUF 5.9 billion) given to the new umbrella bank of the savings cooperatives. Total of HUF 114 billion. Bank restructuring agreements signed with Ministry of Finance. Subordinated loan (HUF 5 billion) given to the savings bank (OTP). Amount: HUF 130 billion.

6 May 1994. Pre-announced injection of equity to bring capital adequacy to 4 per cent. Amount: HUF 18 billion.

7 End 1994. Further capital injection and subordinated loans to bring average capital adequacy of three large banks to 8 per cent based on 1993 balance sheet (HUF 15 billion).

Till December 1994, treasury bonds issued for HUF 332 billion of which HUF 20 billion are subordinated loans.

In the course of its elaboration and implementation significant modifications were made which weakened the programme's incentive structure:

- In contrast to the Polish programme, the value of non-performing loans, and therefore the amount of recapitalisation, was not specified in advance allowing an opportunity for banks to overstate their requirements – and possibly for firms to exploit the situation; recapitalisation was based on the balance sheet at the end of December 1993, yet the programme had been under discussion for quite some time.
- Although banks participating in the programme entered into agreements to develop reorganisation programmes, recapitalisation was not explicitly linked to the acceptability of these programmes and preceded their formulation. Late in 1994, the plans of two major banks were rejected as not being satisfactory, but their recapitalisation nevertheless proceeded. While this was probably unavoidable – the authorities were not likely to revoke the license of a major state-owned bank – it should have been

possible to more closely link recapitalisation to performance via, for example, management changes.

- Determined efforts to change banking behaviour were not undertaken early enough and were often undercut by other policy measures. For example, it was only in July 1994 that an explicit warning was issued to bank directors that they would be held personally responsible for non-commercial loans. However, the authorities have continued to encourage forms of non-commercial lending by extending guarantees for particular enterprises and by moral suasion.
- In order to preserve flexibility, non-performing loans did not have to be transferred to a special work-out department and could still receive new credits: there is no ban on new lending unless the firm is subject to bankruptcy proceedings. The difficult question is whether such flexibility was warranted by the effectiveness of the banking system, and whether it may have conveyed a false impression to enterprises that they would ultimately be financed by the budget.

Current policy issues and general assessment

Despite the drawn-out nature of the programme banks have nevertheless been recapitalised and a start has been made on regularising the management of non-performing loans. In assessing the current situation and considering the direction for policy four inter-related areas appear particularly relevant: adequacy of recapitalisation, management and ownership of banks, the organisation and performance of the banking sector, and corporate governance of non-financial enterprises.

A key issue is whether the bad debt problem has been resolved or whether old patterns of dependency could lead to a recurrence. Many close observers believe that the situation is now stable with bad debts fully provisioned, and indeed there is some indication that the more prudent banks might even have overstated their exposure in order to benefit from the government's capital injection. Bank managements now appear to be more conscious of risk but the question remains whether they are sufficiently motivated to be able to deal with difficult lending decisions – and in turn whether they are convinced that the recapitalisation programme is finished. While profits have risen in commercial enterprises, losses are still significant in a group of important firms and it is

unclear how these losses are being financed – only a portion appear to be covered by budget guarantees. Vigilance will be necessary on the part of the authorities and banking supervision to ensure that banks' exposure to these clients does not build-up, even if it were to conflict with other objectives of the government. For the small banks, recapitalisation has been restricted; the government's strategy is to force these banks either to merge, find new equity, or go out of business. Whether the authorities are credible in this last course of action remains to be seen.

Although recapitalisation has been accompanied by moves to restructure banks, a more fundamental change in the way they function remains on the policy agenda. Significant measures have been taken to improve ownership supervision by the Ministry of Finance as well as to better co-ordinate the fragmented system of banking supervision. However the question remains whether this will be sufficient, especially in view of policy conflicts within the government about the desirability of financially supporting particular enterprises. Bank privatisation – a necessary though not sufficient condition for improving the banking system – is only now beginning and will certainly take some time. What is needed is a clear plan for the privatisation of each bank which will encourage a change in management orientation. In the experience of OECD countries, the pre-privatisation period can be important in improving management.

Retarding privatisation plans are structural features of the banking sector which need to be resolved. The organisation of the banking system remains dualistic with the household deposit base highly concentrated. This reduces the effectiveness of monetary policy and, in light of the underdeveloped state of the inter-bank market, probably also reduces bank intermediation. In addition, banks' costs remain high – in part it would seem due to overmanning – accounting in part for relatively high interest rate spreads. High costs and high lending rates in turn increase the danger of reducing commercial banks to marginal lending activities as the better clients learn to tap the international markets for capital. Finding the way out from such a vicious circle will be a major concern of policy for some time. What needs to be done is to encourage the development of effective competition. To this end the transfer of competition questions to the competition office is welcome as a first step. Still required are measures to permit

or to encourage a restructuring of the banking system perhaps at the same time as privatisation.

The broader question of banking sector reform – and the ultimate guarantee that the bad debt problem will not reappear during the next phase of the transition – concerns its role in corporate governance and in enforcing financial discipline. Until the experience with the debtor conciliation programme can be assessed it is difficult to make a judgement about the ability of banks to assess and oversee corporate restructuring. It is in any case unrealistic to expect banks to make good for the deficiencies in enterprise management. Particularly important will be the tone the government sets in terms of encouraging and enforcing financial discipline more generally. In this respect over the review period it has given mixed signals continuing to bail out firms selectively and encouraging further bank lending to others.

Privatisation: changing techniques and policy orientations

Over the period 1993/1994 privatisation has made steady though decelerating progress. Non-financial methods[134] (compensation vouchers, E-loans) have been used extensively and there have been some large sales to foreign investors (Table 32): total privatisation receipts in 1994 were somewhat below the level for 1993 but cash transactions reached only half the 1993 figure. With the change in government in July 1994, the intention to introduce a mass privatisation programme – discussed in the previous Economic Review – was abandoned but plans were announced to both alter methods with a view to accelerating asset sales as well as to deal with continuing accusations of irregularities. At the same time, financial aid to enterprises prior to privatisation was to be sharply reduced. To underline its determination, a Commissioner of Privatisation was appointed promptly, responsibility for privatisation was passed to the Ministry of Finance, and a new privatisation law was submitted to the Parliament. By February 1995 the first two initiatives had been reversed. After significant alteration, the new privatisation law entered into force in June 1995. This section reviews the key policy issues which have arisen over the last two years, before discussing the new privatisation strategy.[135]

Table 32. **Progress in privatisation**

	Number of enterprises			
	SPA	HSHC	Other	TOTAL
Ownership before privatisation	1 848	167	64	2 079
Divested as of December 1993:				
Liquidation	439	..		
Privatisation	556	2		
Partial privatisation	41	4		
Divested as of March 1995:				
Liquidation	536	13		
Privatisation	681	0		
Partial privatisation:				
– greater than 50%	208	9		
– less than 50%	41	14		

	Costs and revenues (HUF billions)			
	1993		1994	
	SPA	HSHC	SPA	HSHC
Revenues				
Cash sales	43.2	89.9	22.1	10.2
E-loans	21.7	0.9	20.2	..
Compensation vouchers – with interest	16.9	2.6	47.5	18.9[1]
Compensation vouchers – without interest	13.0	n.a.	52.7	19.3
Other	2.4	4.2	1.9	2.5
Total	77.9	92.6	105.1	29.5
Disbursements				
Privatisation costs	11.9	38.8	10.6	16.5
Restructuring and maintaining firms	5.9	0.6	8.2	5.9
Repayment of state debt[2]	22.2	..	29.3	..
Withdrawal of compensation vouchers[3]	13.0	1.4	52.8	12.5
Payments to budget	2.4	28.0	4.0	13.2
Other payment to budget[4]	..	13.3	..	..
Surplus/Deficit	..	12.3	..	–21.0
Total	79.1	94.2	105.6	48.1

1. November 1994.
2. Comprises E-loan proceeds which are immediately payed to the NBH so as to reduce the non-securitised debt of the budget. E-loans are granted by banks and refinanced through the NBH.
3. Bookeeping operation to cancel compensation vouchers received from asset sales.
4. Comprises concession fee on partial sale of the telecommunications company, paid to the Ministry of Transport.

Source: Ministry of Finance.

Issues in the privatisation process

Three major inter-related policy issues have arisen regarding the privatisation process: discharging the states responsibility for compensation vouchers, setting contract conditions and ensuring transparency, preserving the value of state property.

Compensation vouchers: putting restitution into effect

Compensation vouchers[136] were originally intended to meet the legitimate demands for compensation of past confiscation of property and personal losses while avoiding the interminable problems associated with physical restitution as happened in the new Laender of Germany. However, in 1993 and again in 1994 the authorities have been overwhelmed with claims: the law was extended in 1993 and as a result 600 000 new requests were submitted in early 1994 – 100 000 had been expected. Each claim has to be checked and evaluated. Moreover it seems that the process may not be ended with a recent Supreme Court decision appearing to suggest the need for additional compensation measures for further injured parties. By the end of 1994, HUF 118 billion of compensation vouchers had been issued (excluding interest), while HUF 42 billion had been used in either public share offers or privatisation transactions (around HUF 25 billion excluding interest).

By issuing compensation vouchers the state has a legal obligation to provide property – land, buildings, enterprises and shares – which the vouchers can be used to purchase, a responsibility which it has to a great extent avoided: the state has generally shown a preference for restricting the availability of assets preferring where possible to acquire cash or to sell to strategic investors. The property rights associated with the vouchers have also been restricted: agricultural land[137] may only be bought by the original voucher holders, but there have been unofficial attempts to restrict the sale of land only to village residents. With respect to other assets – especially in agricultural industries – there have also been actions, despite the law, to limit property rights to agricultural cooperatives which were original holders. On occasion this has been done by assigning different prices to the vouchers of primary and secondary holders.[138] Moreover, the pricing of vouchers (per share) has varied across privatisation transactions. With around 10 per cent of the population affected by compensation vouchers, it is important that the issue of asset backing be finally resolved.

Other compensation and restitution issues concern the social insurance funds and local governments. As noted in Chapter II the government is under an obligation to transfer HUF 300 billion of property to the social security funds. The government delayed the transfer until property management rules were finalised which would include ceding to the SPA and the HSHC powers to act on behalf of all shareholders during a privatisation. At the time of writing, agreement had been reached to transfer HUF 65 billion in equity to the funds. Local governments often own the land on which enterprises are located. In order to expedite privatisation the SPA and the HSHC are empowered to sell the land with the enterprise but must compensate the local government. This has been accomplished only to some extent by cash payments: often the local government has received shares in the enterprise. The privatisation agencies have contingent liabilities for compensation to local government amounting to some HUF 2.4 billion. The situation needs clarification if the government's intention to accelerate privatisation is to be accomplished.

Transparency

In common with other countries in the region, privatisation has been accompanied by continuing complaints about lack of transparency and, indeed, the case of compensation vouchers is a good example of this. Although improved administrative procedures have been implemented[139] privatisation techniques are contributing to the problem. During the last two years the SPA and the HSHC have made greater use of conditional sale contracts such as employment guarantees and investment undertakings which decrease transparency for both the public and for potential investors.

One concerning aspect has been the tendency on the part of the SPA – and now the government – to seek re-negotiations after a competitive tender.[140] While there are difficulties in conducting tenders in shallow markets there are a number of risks with the course of action being pursued. From the viewpoint of an investor, winning a competitive bid only opens the way to future negotiations which must be factored into the original price. The transparency of competitive tenders could thus be undermined and the original legislative intention subverted.

Preserving the value of state property

Over the review period it has become increasingly apparent that the longer a great deal of commercial property remains in the hands of state agencies the less

valuable it has become. There are several inter-related aspects of this problem. In the event of an unsuccessful tender, a company may remain for several years in a state of uncertainty as to its future leading to a decline in its market value. While the evidence is only anecdotal, it also appears to be the case that some managers of smaller firms have deliberately kept results poor or mediocre in the hope of buying the firm themselves at some time. In other cases, profitable assets have been contributed into partnerships and this has reduced the apparent value of the parent company.

One special feature of Hungarian privatisation to date has been the tendency of the state to maintain significant minority holdings in privatised firms: at the end of 1994 the SPA and the HSHC held stakes of up to 50 per cent in 289 enterprises accounting for a significant percentage of the formers portfolio.[141] The state agencies are the first to recognise that they do not have sufficient knowledge to secure the value of their investment, but in the longer term there is a more important question about the logic and implicit commitments of these holdings.

Privatisation strategy for 1995 and beyond

The government's intention[142] is to complete the sale of most state-owned firms by 1998 – around 900 enterprises – while reducing the number in which it has an equity holding from 252 to 161. The state intends to maintain full ownership of only 35 companies, including the post and railways, and in the remaining 115 which include utilities, it will reduce its stake to 25-50 per cent.[143] The guiding principles of the strategy are broadly similar to those followed since 1989 stressing the case-by-case approach, competitive bidding and a key role for cash payments. These features are to be strengthened. In addition existing management is to be involved at all stages of the decision process, Parliamentary and government oversight will be ensured and attempts to restructure companies before sale will be discontinued as this has not been successful in the past. The envisaged modalities involve changes in both institutions and methods.

The original strategy called for the merger of both the SPA and the HSHC into a new state holding and privatisation company (APVRt) under the control of the Ministry of Finance. Parliamentary supervision or oversight was then to be exercised via nominations by the Parliament of experts to sit on the supervisory board. With the substantial reduction of companies to be held permanently by the

state it was not felt justified to maintain two separate organisations with different forms of corporate control and management rights over their portfolios.[144] In the event, before the scheme could be approved by the Parliament the situation changed. In February the Commissioner of Privatisation resigned and a new Ministerial post – but without portfolio – was created with responsibility for privatisation. Long delays in passing the new Privatisation Law reduced the morale of the SPA and HSHC and slowed completed transactions to a trickle. Finally in early May another resignation over the question of responsibility for bank privatisation and operation occurred, while the vital energy and oil and gas privatisation appeared to be once more open to debate.

The new privatisation law was finally passed by the Parliament on the 16 May and entered into force on the 16 June. The most salient features are:

- Parliamentary oversight will be established via six nominations to the supervisory board of the new APVRt. In addition, the Interest Reconciliation Council will appoint two representatives. The Chairman of the board will be appointed by the government on the nomination of the national audit office. The board may only review the legality of transactions, not the commercial logic.
- The new institution will come under the control of the Minister in charge of privatisation rather than the Ministry of Finance which was originally intended. However, all privatisation transactions involving guarantees – a substantial number in the past – will have to involve the Ministry of Finance.
- Day-to-day control of the banks will reside with the APVRt but privatisation of banks which have been recapitalised will remain with the Ministry of Finance.
- The Chairman of the APVRt and the board of directors will be appointed by the Minister in charge of privatisation in agreement with the Minister of Finance.
- The formal power to accept a privatisation tender will reside with the board of directors. However, the Chairman will have the power to halt a transaction and refer back to the government in exceptional circumstances.
- Ministries will have the right to express an opinion about a proposed transaction but will have no formal right of veto. Provisions have also

been made for unions and, where appropriate, local councils to present opinions about proposed sales.

- The new law codifies procedures for invitation, tendering, evaluation and the announcement of tender results. Most important of all is the requirement for full reporting of the reason for each selection.

The government's privatisation concept foresees that modalities will vary systematically by the size and nature of the enterprise. Three groups of enterprises are envisaged:

- The first group would comprise 30-40 large enterprise in the energy and infrastructure areas, or in areas of "national interest". Responsibility for approving the concept, method and timing of these sales would remain with the government, the APVRt only being responsible for executing the decision. A reasonable share of these enterprises would be sold to strategic foreign investors. Unclear at this stage is the rationale for the state continuing to hold a large – albeit substantially reduced – block of shares in these companies, how they will be managed, and whether they could interfere with the normal task of establishing a sound regulatory structure.
- The second group would comprise medium-sized firms having an equity greater than HUF 600 million and with more than 500 employees but without strategic importance to the economy. These firms would be privatised by the APVRt without the prior approval of the government. If the company cannot be sold for cash after repeated efforts to strategic investors or by public offering, they will be tendered for asset management with an option to buy. Shares in these firms might also be allocated to one or two equity funds.
- The third group would comprise small and medium sized firms whose privatisation plan will be drafted by their management. Techniques would include management buyouts, sales to employees on credit and direct sales. Prices will be determined on the basis of book values with the APVRt permitted to accept a cash offer up to 20 per cent below this threshold.

Backing for compensation vouchers is to be improved by increasing the number of sales and the ceiling in each which can be subscribed by vouchers.

This policy came into effect at the end of 1994 after the government approved the privatisation strategy. Under the new policy, equity funds are also to be created and set aside in part for the holders of compensation vouchers. An earlier idea to allocate a large number of poorly performing companies for sale by voucher was replaced by a proposal in which shares in such companies would be contributed into equity funds also comprising the shares of the profitable utilities. The proposal does not address the question of what is to be done with such companies since it is not evident that their incorporation in such funds would improve their management and prospects. How the equity funds are to be run – for example, whether they will be able to invest in the companies – is also undecided.

There are several risks involved in the announced strategy which will need to be carefully balanced if privatisation is to be accelerated. The new law makes provisions for a large number of additional parties such as unions, ministries and local government to express their "opinions" about a transaction. At the same time, it is the government's intention to make more use of non-pecuniary clauses in sale contracts (*e.g.* employment protection clauses). Unless carefully controlled, interest groups might seek to have their "opinions" reflected in non-pecuniary clauses to the detriment of transparency while at the same time slowing the privatisation programme.

The privatisation strategy, which since November 1994 represents government policy, makes a good case for seeking to avoid costly restructuring prior to privatisation, apart from some simple financial and organisational restructuring. However, a number of instances of financial aid to enterprises (discussed above) raise the question whether sufficient attention has been given to separating the issues of crisis management from normal restructuring, and in establishing clear lines of authority and criteria for decisions. Without such criteria interest group lobbying will continue and expectations on the part of managements will remain unchanged.

The case of agriculture

During the survey period Hungarian agriculture suffered from a series of droughts and continuing structural adjustment to changes in ownership and unfavourable movements in relative prices. Taken together these factors caused a significant reduction in production and most farm activities became unprofitable.

Gross agricultural output declined by 19.9 and 6.9 per cent, respectively, in 1992 and 1993 before recovering 3 per cent in 1994. The drop in crop production in 1992/93 was associated with a continuing drought, a substantial increase in fallow land in 1992/93 – alone accounting for as much as one-quarter of the decline – and a decrease in the use of inputs such as fertilisers and seeds. All three of these factors were reversed in 1994[145] and crop production increased by 6.9 per cent, though remaining well below 1992 levels. Livestock production has fallen steadily for the last three years; partly in response to decreases domestic consumption levels: 1994 production was 55 per cent of 1991 levels.[146] Recent statistics indicate that higher prices for meat, in part associated with increases in import tariffs in November 1994, might stabilise breeding herds in early 1995.

Agricultural production was affected during 1992/93 by the redistribution of land as part of the restitution programme. Hungary decided to avoid direct restitution of property seized during the Communist period (as well as other damages) and instead adopted a voucher-based compensation system. Given the importance of land collectivisation, it was correctly anticipated that the majority of vouchers issued would be for claims against lost land. Accordingly the compensation law required collective and state farms to set aside land to be auctioned to voucher holders; 2.1 million hectares of land were set aside, with about 90 per cent originating from collective farms. The process was initially beset by numerous legal disputes, filing of late claims, and problems in validating claims, but was particularly plagued by difficulties in surveying, registration and boundary demarcation. These problems at first affected cooperative lands more than state farms as the latter were better able to make use of a legal provision entitling the sower of fields to reap the harvest.

The problems associated with compensation were largely resolved by late 1994. By the end of 1994 nearly all of the land initially set aside from cooperative farms had been auctioned; about 2.07 million hectares was sold to over 500 000 people. Auctioning of state farm land began in the autumn of 1994 even though land had not been fully allocated for this purpose. In 1994 the government decided to initiate additional possibilities for compensation – over 600 000 claims were received – and to set aside an additional 185 000 hectares for auction; auctions will be completed in 1995.

Parallel to compensation, the government has pursued a policy of transforming collective and state farms into more market-oriented forms. This goal has

largely been achieved. Over 90 per cent of the original 1 273 agricultural collectives were transformed into cooperatives – 168 were liquidated. Many large collectives were split into several smaller cooperatives, often around village lines so that the current number of cooperatives exceeds the original number of collectives. Most former collective members have not withdrawn their land from the new cooperatives – only about 10 per cent of the former members left taking with them an average of about 5 hectares each. Of the land sold at auction for compensation vouchers, most of it has either been leased to the new cooperatives or been used to enlarge small plots previously being farmed.

Privatising state farms has been slower than the transformation of collectives. Hungary entered the transition with 121 very large state farms. The initial step was the transformation of 97 of these into smaller corporate entities prior to privatisation;[147] their initial size was too large to be either efficient or attractive to a potential purchaser. The process was initially delayed by disputes over which lands were to be set aside for compensation purposes and other considerations: about two-thirds of state farm lands were subject to claims, and in several cases they exceeded the total area available locally. Many farms were in poor financial condition; as of mid-1993, 25 farms were in bankruptcy and 11 more were under liquidation. Existing workers and tenants showed little interest in purchasing portions of state farms despite favourable credit term (*e.g.* E-loans), in part because purchasers had to assume existing debts. By the end of 1993 substantial progress had been made in resolving many of these problems: final decisions on land for compensation had been reached and all farms were corporatised, some successful debt consolidation was achieved, and 10 farms were liquidated. Whereas 10 farms had been privatised at the end of 1993, this figure had increased to 35 a year later.

As a result of the transformation of collectives and privatisation of state farms, average farm size has shrunk substantially, but the widespread fragmentation into tiny plots found in other central and eastern European countries has not occurred. In 1994 the average size of both cooperatives and state farms was under 2 000 hectares, down from around 7 000 and 4 000 hectares, respectively, in 1989. As was originally intended, a large number of companies – over 1 000 – have emerged from the initial 130 state farms. Together the large-scale cooperatives, farming companies and agricultural enterprises cultivated around 4.6 million hectares in 1994, while 2.8 million hectares were in private hands. At the

same time, the number of individual full-time farmers has declined to around 60 000, though this has been offset by an increase in the number of part-time farmers to around 1.2 million, about half of whom are retirees. Part-time farmers usually have farms with a size classed as beneath subsistence levels.

The current structure of farm organisation is likely to remain fairly stable now that compensation auctions and the transformation of collectives have been largely completed. The cooperative law made it fairly easy for members to leave with some assets during the transformation process, but once the process is completed physical assets cannot be removed without approval of the general assembly, and other members have the right of first refusal on the sale of business shares.[148] Transformation of cooperatives into joint-stock companies, which would facilitate their breakup, remains difficult despite several legal changes in the law in 1994.

Constraints on land sale and leasing, and cooperative organisation, will tend to maintain the existing structure, but inhibit additional reorganisation or consolidation. Land obtained through compensation purchases cannot be sold for three years without paying capital gains tax on the full value, and must be cultivated within the same time limit or it can be reclaimed by the state. Such land can be leased, a practice which has become widespread, with the rental value of one gold crown (land quantity unit) fixed by the government at the stock exchange value of 15 kilograms of wheat. The new Land Act of June 1994 contains numerous restrictions on ownership; the most widely criticised is the prohibition of legal entities or any organisation from owning farm land – cooperatives must lease land from their members or other owners. The law limits ownership by natural persons to 300 hectares – pre-existing holdings were grandfathered – with additional limits on the size of leasing.

Direct agriculture subsidies and price supports from the government are small but growing; the largest programmes remain export and credit (interest rate) subsidies. Price support systems exist for some products but trigger prices are set sufficiently low so that these programmes have a very limited impact – total budget expenditures were HUF 7 billion in 1994. Direct subsidies for grain cultivation will remain constant in 1995 at HUF 2 000/hectares but state guarantees will increase in 1995 to HUF 16 000/hectare from HUF 10 000/hectare in 1994. Export financing has been the major source of agricultural support, accounting for 40-55 per cent of budgetary expenditures on agriculture over the

1992/1995 period.[149] The export subsidy programme has been revised for 1995. Subsidies will be more narrowly targeted for greater impact: the number of eligible products has been reduced from 700 to around 300, and the average value is expected to rise from 13.8 to 16.0 per cent of sales value. Subsidies are now fixed in forint terms relative to dollar export proceeds in order to neutralise the impact of forint devaluations. The Hungarian government and foreign donors offer a wide range of credit subsidies. Most important are subsidised credits granted by the government for purchases of agricultural inputs and for grain storage. About two-thirds of farms receive subsidised credits of some kind. Despite these supports, the producer subsidy equivalent remains small by the standards of most OECD countries.

Trade and competition policies

Over the review period pressures to limit competition have continued to be felt: a number of firms and commentators have attempted to use the large trade deficit to press for selective trade protection while in the area of competition policy governmental agencies have often made proposals with respect to privatisation and regulation with scant regard to the need to establish a competitive framework for the activity. The government has generally been successful in dealing with these pressures, in part because of binding international commitments, but this has run the risk of reducing public support for these agreements; there is a benefit to Hungary from promoting competition quite independently from international undertakings. This section briefly reviews the salient developments in both trade and competition policy over the period.

Trade policy: a comprehensive framework of international commitments

Trade liberalisation has been supported by international agreements which tightly constrain the potential for any reversal of policies. Since the end of the Tokyo Round, Hungarian tariffs have been fully bound on 90 per cent of tariff lines on industrial products and 25 per cent on agricultural products. The more important bindings concern the EU including the ex-EFTA countries. All tariffs and para-tariffs on industrial products originating in the EU have been bound

since March 1992, as have quantitative restrictions and measures having an equivalent effect.

Despite the general reduction of tariffs, the structure might remain distortionary with some activities heavily protected and others consequently subject to low and even negative effective protection. Tariff reductions have been concentrated in the areas of intermediate inputs and goods not produced in Hungary. As a result, the tariff cascade has increased and this led to at best no improvement in the spread of effective rates of protection. At the end of 1991, 14 out of 70 product classifications had rates of effective protection greater than 100 per cent (*i.e.* the level of protection equalled value added at world prices), and 27 had rates greater than 50 per cent.[150] Effective rates of protection reported for nine sectors for 1992 and 1994 (*i.e.* after the initial round of tariff reductions under the Association Agreement) do not show a great change in the structure of protection. However, there are indications that the tariff reductions which are scheduled to take place up to 1997 will have a substantial impact on the structure of protection, in some cases effective rates falling by two-thirds.[151] The reason for this is two-fold. Hungary has an obligation *vis-à-vis* the EU to eliminate fully tariffs on a wide range of industrial products until 1997. More importantly, tariffs on the highly protected "sensitive goods" are to be lowered by 35 per cent – with a total elimination by the year 2001.

The Hungarian trading system is by now fairly open with liberalised imports now accounting for 90 per cent of imports based on both a tariff line count[152] and on the basis of import value. In line with commitments arising from the Association Agreements with the EU, Hungary has reduced industrial tariffs affecting 75 per cent of the value of imports from the EU in January 1995 and further liberalisation measures have been programmed from now until the year 2001. The average tariff on industrial products as a result declined further from 9.2 per cent in November 1993 to 8.9 per cent in January 1995. In addition, Hungary is a founding member of the WTO and since January 1995 it has started to implement its agricultural and industrial market access agreements. Its main commitments include a tariff reduction from 9.6 per cent to 6.9 per cent, an increase of duty free imports from 19 per cent to 21 per cent and an increase in tariff bindings from 89 per cent to 93 per cent.

Two areas of the trading system remain restrictive: agricultural trade and the global quota on some consumer goods. Agricultural trade policy has been less

controlled by international agreements than is trade in industrial goods. The Uruguay Round has changed this: Hungarian agricultural tariffs are now fully bound and previously applied administrative restrictions have ceased to apply to agricultural and food products. Agricultural tariffs averaged 19.5 per cent in November 1993 but in response to pressure from farming interest groups they were increased to an average of around 37 per cent in November 1994, shortly before tariff bindings entered into effect. The increased tariffs were set at a level calculated for and accepted in the Uruguay Round tariffication exercise. Some agricultural exports are, as noted in Chapter II, subsidised. Producer subsidy equivalents remain low in comparison to the majority of OECD countries.

The global quota on selected consumer goods covers about 7 per cent of total imports. The quota has been set at $750 million in both 1993 and 1994, up $100 million in comparison with 1991. Individual quotas are first determined for over twenty product groups by negotiations in the Customs Tariff Committee. The criteria for specifying these quotas are unclear but appear to be influenced by industrial policy considerations. The overall quota has been increased and goods removed from the system while some product categories have been narrowed. Passenger cars, which were previously subject to licensing, have been added to the quota.

The individual quotas have been allocated on the basis of past performance which, while administratively simple, may limit the restructuring of trade flows. This negative feature is to be removed in 1995 when 20 per cent of a product quota is to be reserved for new importers. The Hungarian authorities grant about 50 per cent of individual product quotas to EU exporters. In some instances the Association Agreement contains explicit obligations for Hungary to grant the EU a share no less than 50 per cent of a quota. Under the agreement, 40 per cent of exports from the EU must be removed from the quota between 1995 and 1997, and first measures to accomplish this have been taken in 1995. While discrimination against non-EU trading partners would in principle increase, up to the present the liberalisation process has taken place on an *erga omnes* basis. If past practice is followed, non-EU trading partners would thus also benefit from the agreed liberalisation.

Despite the web of trade commitments Hungary has nevertheless sought to establish an active trade and industrial policy in response to requests from foreign investors and latterly from domestic interest groups as they have become better

organised.[153] In 1993 Hungary informed the EU that it wished to use the exceptional provisions of the Agreement to increase tariffs on three products classified as infant industries, on eleven products in industries undergoing restructuring, and on three products in industries facing social problems. The definition of these categories is unclear and the policy proposals do not appear to have been based on a explicit assessment of economy wide costs and benefits. By the end of 1994 agreement had been reached in regard to eight products; Hungary has refrained from introducing unilateral measures.

Domestic interest groups have also been pressing for active anti-dumping and safeguard measures but with some small exceptions with respect to safeguards these have been resisted. However, as noted in Chapter II, an import surcharge has been introduced in March 1995. It is included in the definition of selling price for the calculation of VAT so that the protective effect is greater than would first appear to be the case. The Hungarian authorities have notified the OECD in accordance with the Trade Committee's notification procedure and will enter into negotiations with member countries of the WTO's Balance of Payments Committee.

Competition policy

Competition policy has continued to evolve with an increasing body of enforcement decisions to draw upon: 119 decisions were handed down by the Competition Council in 1994 and fines of about HUF 627 million were imposed. However, many of the cases appeared to relate to consumer protection cases such as misleading advertising. The following paragraphs briefly review only the major issues which appear to be emerging.

As with trade policy, the provisions of the Association Agreement will be an important influence on Hungarian competition law and practice: Hungary has several years from the entry into force of the full agreement (*i.e.* the beginning of 1994) to fully implement rules for the application of EU competition law. At present important amendments are being considered by the Hungarian government including a strengthening of the ban on restrictive agreements, notably by extending the prohibition of vertical agreements, banning bid rigging and including within the scope of the ban decisions by associations of enterprises and not only formal agreements. It is also proposed to introduce a block exemption system to complement the current case-by-case, individual exemption system.

This latter change will facilitate in particular vertical agreements. This is appropriate in view of the underdeveloped state of distribution systems and the high transaction costs associated with an economy in transition. Vertical restrictions may contribute to investment in these areas and to greater output while any anti-competitive effects would appropriately fall under the provisions of abuse of dominant market position.

With the aim of strengthening the enforcement of the Competition Act the government is also proposing to introduce a new definition of what constitutes an abuse of a dominant position and improving merger control by simplifying the threshold for notification: in future, a prospective market share greater than 30 per cent will be the sole criteria. These changes are considered necessary in light of experience gained during the first four years application of the Competition Act.

State aid is a key unresolved issue regardless of the Association Agreement: the Hungarian economy is now sufficiently heterogeneous so that aid for some enterprises could seriously distort competition and overall economic development. In addition, selective state aid may harm the whole economic environment by promoting the development of interest group activity and through changing economic behaviour (*i.e.* moral hazard as when preferential tax treatment for some leads to a decline in the tax morale of others). Issues to be resolved both internally and within the context of the Association Agreement include debt write-offs and taxation enforcement, public procurement, regional incentives and the dividend policy of the State Property Agency (SPA) and the Hungarian State Holding Company (HSHC). In the experience of other countries, effective control of state aid may require institutional changes so that the multifarious channels for the provision of aid can be better monitored and assessed for its potential to distort competition.

An issue which requires attention – in Hungary as well as in many other countries – is the relation of the competition authority with other state organs and the requirement for these institutions to consider competition questions when deciding policy measures. Two areas are particularly important: agricultural markets and the provision of infrastructure. Cartel behaviour is permitted by Hungarian law under the responsibility of the Ministry of Agriculture to weigh the costs and benefits. The competition authority can challenge the decision before the Administrative Court but the burden of proof is on them: the Ministry

of Agriculture is not under an obligation to justify the decision in terms of *economy wide* costs and benefits. In the interest of promoting competition the onus should be reversed, as indeed is the case in other product markets. With respect to other state organs the possibility for the competition authorities to challenge actions on competition policy grounds is also effectively limited. The six month time limit for challenging local government actions is often considered too short. In other cases there is no possibility for surveillance at all. For example, the decision to merge some electricity generators and coal mines could not be challenged since it was a government decision. Utility regulation will fall outside the competence of the competition authorities and reside in specialised institutions. It will be particularly important that they have a remit to encourage competition and to avoid anti-competitive structures, even though at the time of privatisation they might well increase revenues for the budget.[154]

With respect to privatisation the situation is complex requiring policy trade-offs to be made. At present the competition authorities may challenge a completed privatisation on competition grounds but only if the transaction fulfils the criteria for control of mergers and acquisitions (*i.e.* market share greater than 30 per cent and a combined value exceeding HUF 10 billion). The new privatisation law allows the competition office to give an opinion at an earlier stage of the transaction. There are costs and benefits of either approach but for the latter to be effective sometimes requires that the government be prepared to sacrifice immediate revenues in favour of longer run efficiency gains.

V. Conclusions

Assessment

Since the previous Economic Survey in early 1993, the economy has returned to growth. GDP continued to fall in 1993 due in part to a drought and external shocks, although industrial output stabilised and the financial condition of enterprises improved in the course of the year. The expansionary momentum continued into 1994 with a strengthening of industrial and agricultural output so that GDP is expected to have increased by some 2-2.5 per cent. Corporate losses appear to have fallen further while investment and exports have both increased. Unemployment declined continuously from early 1993 to the end of 1994 although the situation in the labour market has remained difficult. Privatisation has proceeded at a moderate if unspectacular pace, based mainly on sales to new owners by non-cash methods, and the number of registered businesses has continued to increase. While difficult to assess accurately, most indicators suggest that the private sector continued to grow both in terms of its share of GDP and of employment. Despite a high debt-service burden, Hungary has steadfastly honoured all of its commitments and possibly as a result has continued to attract foreign direct investment. Because of these factors, and a well-designed strategy of foreign debt management, Hungary was little affected by the direct aftermath of the Mexican crisis. Official foreign reserves have remained at levels of around 6-7 months of imports throughout the period while convertibility has been extended in the direction of accepting full Article VIII obligations of the IMF in the near future.

Set against such indications of progress has been the emergence of twin deficits and the threat of a debt trap. In both 1993 and 1994 domestic absorption exceeded production by around 7 per cent and the associated current account deficits of $3.5 to $3.9 billion annually could be financed only in part by non-

debt creating capital inflows; net foreign debt increased from $13.3 billion at the end of 1992 to $18.9 billion (around 48 per cent of GDP) at the end of 1994 although part of this increase was due to the weakness of the dollar. At the same time, the general government budget deficit (excluding privatisation revenues) increased to around 9 per cent of GDP in 1994 – an increase of some 3 percentage points over 1993 – and the public sector borrowing requirement was higher still. Public sector debt has increased by nearly 75 per cent during the review period to around 80 per cent of GDP, mainly due to the costly recapitalisation of the commercial banks and the revaluation of the foreign debt in the wake of steady devaluation of the currency. Interest payments on state debt are now starting to absorb an increasing share of budget revenues and GDP: 30 per cent and 9 per cent respectively in 1995. Indeed, with real interest rates significantly above the real growth rate, the formal conditions are in place for a debt trap to develop. Real interest rates have in turn been pushed up by the need to finance the budget deficit and by risk premia relating to inflation uncertainty. Inflation, after declining to low levels by mid-1993, has since been on a rising trend while wage increases over the review period have been strong.

Under these conditions the key policy question is the sustainability of external financing. During 1994 Hungary relied on non-official external borrowing by banks and enterprises, stimulated by high domestic interest rates, to finance about a third of the current account deficit. In addition, although the bulk of Hungary's official debt is medium term, there is still a need to refinance around $3 billion annually. Thus from both the stock and flow sides Hungary remains dependent on continuing access to world capital markets. Experience elsewhere suggests that for "emerging markets" in particular, investor confidence is sensitive not only to the quality of overall economic management but also to large current-account deficits as such. In this sense, the present deficit is clearly too large to be sustained.

There are at least three additional reasons for regarding the level of the current account deficit as excessive. First, debt financing of a portion of the current account has created a foreign exchange liability irrespective of economic performance. In order to service this increased debt it is important that the capacity and profitability of the tradeable goods sector expand. This is happening, but slowly. In particular, most of the increased investment activity during 1994 has been in the non-tradeable sector. More generally, foreign saving has

been mainly directed not towards increased investment but ultimately to financing the budget deficit and increasing consumption. Second, Hungary already has a high level of foreign debt. Increased enterprise borrowing raises this still further and could, if not carefully controlled, lead to increased resistance on the part of foreign lenders. Decisions by enterprises and banks to increase their foreign debts may fail to consider this macroeconomic link until too late. Third, unless borrowing by companies and banks is matched by foreign currency revenues they are open to foreign exchange risk. In these circumstances, any large devaluation in the future (and such a development cannot be ruled out *a priori*) could generate a spreading chain of insolvencies. While prudential regulations in Hungary largely control the open position of the banking sector, unless the firms to whom they lend are also covered they would still remain exposed indirectly.

In sum, the levels of both the budget and current account deficits at the beginning of 1995 appeared unsustainable. While the situation could not be regarded as a crisis, it still required immediate stabilisation measures. The new government, which came to office in July 1994, developed its policy response over the period from October 1994 to March 1995 when it presented a package of policy measures and a supplementary budget to the Parliament. To assess the adequacy of this response it is necessary to summarise the origins of the present situation: an inadequate aggregate supply response and inappropriate macroeconomic policies.

A noticeable feature of the Hungarian economy in 1993/1994 was the weak response of aggregate supply to strong demand. In Hungary this is often attributed to the operation of the bankruptcy law which, it is argued, has served to destroy export capacity. This position is not supported by a careful review of the currently available evidence which suggests that it was mainly the comparatively small enterprises which have been strictly subject to the procedures. A more important factor contributing to the overall weakness has been the marked rise of total real labour costs for producers. By reducing retained profits, this has diminished enterprises' ability to finance investment, while at the same time marginal capacity may have been scrapped: higher producer real wages have been financed by lower levels of employment (*i.e.* higher levels of labour productivity) and by the concentration of production on a smaller volume of productive capacity. These developments probably also accelerated the reduction of capacity which was uneconomical even in 1992; that such capacity was substantial is evidenced

by the large level of operating losses in the economy. Despite these developments, a number of private and privatised firms – especially those sold to foreign investors – and some state owned enterprises have been quite dynamic in improving their financial returns, output and exports, but this has not been sufficient to offset the problems elsewhere.

The overall supply response has been retarded by inadequate framework conditions to promote the effective use of resources. Delay in establishing a framework has arisen in part from the concern of the authorities to protect state enterprises and thereby cushion the transition, but the opportunity cost has been significant. Inadequate performance has been partly related to the privatisation programme: uncertainty over future ownership and long delays in developing alternative sales strategies after unsuccessful tenders has impeded performance in the better enterprises. Of most importance from the overall perspective, however, has been the time required to improve financial discipline. Several aspects need to be mentioned:

- Although a number of enterprises have been liquidated under normal bankruptcy proceedings, many of the largest and most important loss-making enterprises have been able to avoid the rigours of the law and this has contributed via moral hazard effects to poor corporate performance. While financial support has been accompanied by several rounds of restructuring plans, conditionality has been weak and it is only now that such plans are starting to become effective in some of the enterprises.
- Underlying the slowness of improving financial discipline is the fact that the necessary moves to recapitalise the banks and clean-up enterprise balance sheets were unduly drawn out. Bank recapitalisation is now essentially completed, though it was done in stages rather than in a credibly one-off way. Nor was it closely tied to the implementation by the banks of their own restructuring, which is only now being looked at in the context of privatisation plans that have themselves been subject to considerable uncertainty and delays. With respect to the associated debtor reconciliation programme (a simplified out-of-court bankruptcy procedure under which enterprise debts may be reorganised by the banks in return for restructuring undertakings by firms) the original objectives have been undercut to some extent in the course of implementation. In

particular, ministries have intervened to spare a number of major firms from the "market-based" rigours of the intended process, thereby contributing to an expectation by many enterprises that they too would be bailed out. Such expectations also diminished the incentive for banks to push hard for enterprise restructuring as the counterpart of loan restructuring, or to foreclose on enterprises lacking real survival prospects.

Time has thus been bought for many of the least performing firms in the economy, but this has been at a price: the better performing firms which could not borrow abroad have been starved for resources, the development of the banking sector has been retarded, and a great deal of additional pressure has been placed directly on the budget through increased debt servicing and loan guarantee commitments. The opportunity cost of these policy measures has not been adequately taken into account.

The policy response to the rising current account and budget deficits has also lagged, leading to a steadily worsening balance between monetary and fiscal policies. Monetary policy, which had sought to support a recovery in 1992 by lowering interest rates, aimed to become restrictive in 1993 in the face of falling household saving and the rapid emergence of a current-account deficit. The ability of the monetary authorities to implement a tight monetary policy was, however, limited by the need to assure that the budget deficit could be smoothly financed. This put pressure on the National Bank to limit the tolerable rise in interest rates. In addition, the Bank considered that the direct impact of higher interest rates would have only a small effect in slowing domestic demand (a position that is not implausible insofar as the interest-rate sensitive component of credit demands is probably quite small, in part due to government support measures for large enterprises). In these conditions, the primary channel for monetary policy to influence economic development is through the exchange rate; but in this regard the widening current account deficit made a strategy of using the exchange rate as a nominal anchor untenable. Indeed, monetary policy became progressively more oriented towards targeting the real exchange rate. At the same time the budget deficit, after some relatively minor consolidation in 1993, continued to deteriorate.

While the budget has been affected by the transition-induced decline in economic activity, its underlying dynamics have been driven by three key fac-

tors: the high level of employment in the budget sector, which accounts for about a quarter of total employment; the large proportion of transfer payments in budget expenditures; and the high level of state debt. The first two elements have made fiscal policy a hostage to political fortune and have delayed consolidation, which is necessary to finance debt service on a sustainable basis. The consolidated budget deficit is larger than is normally believed, especially when privatisation receipts are treated as financing (and not as current revenues) and all fiscal entities such as the railways and the state holding company (HSHC) are considered. The deficit represents a serious drain on domestic savings and, because of its heavy emphasis on transfer payments, has contributed much more to the stimulation of consumption than is indicated by the development of public consumption on a national accounts basis.

With aggregate supply effectively limited by inherited business structures and real wage developments, strong demand was bound to spill over into a current account deficit. High marginal import elasticities in response to domestic demand are partly linked to weak supply-side flexibility but also to further integration into the world economy. While it may be possible for a short time to run the economy at a high level of demand, keeping the external deficit in check by opting for a very competitive exchange rate, the international evidence is that inflation and wage growth generally pick up quickly in these conditions. Furthermore, such a policy approach reduces credibility so that it becomes increasingly ineffective over time.

A more aggressive policy of nominal exchange rate devaluations is an option quite often advocated in Hungary. To be effective in anything but the short run, it would need to generate a sustained decline of real wages in the tradeable goods sector: Hungarian experience over the review period would not give grounds for confidence on this score. Moreover, in a heavily indebted open economy, a policy of exchange rate devaluation needs to be treated with care for two reasons. First, a real devaluation will add to the liability of the budget for external debt service and this burden will eventually have to be passed on to the economy in one way or another. Second, an aggressive policy of devaluation can increase the risk premia demanded by savers, thereby increasing real interest rates. In attenuated forms, Hungary has suffered from both effects over the period.

In the face of this situation the new government took some time to act. There were two reasons for this. First, broad consensus was lacking with respect to the need for fiscal consolidation and wage discipline. After four years of declining GDP, the desire not to undertake any action which might threaten a recovery was great. As the macroeconomic situation worsened, general agreement as to the broad direction of policy formed slowly. Second, it has been very difficult for the government to come to terms with the situation politically: elected to reduce the social cost of the transition it was reluctant to launch itself into a course of fiscal consolidation and the inevitable consequence of reforming social welfare and public sector employment practices. Even now support by the public for such measures is extremely low, placing a premium on the government's ability and determination to take a long-term view of the situation, one which is needed for the future prospects of Hungary.

The government's strategy is reflected in the 1995 budget, presented in November 1994, and especially in the package of economic measures – including a supplementary budget – which were announced in March 1995. The measures were approved by the parliament in May while the new budget was, at the time of writing, expected to be adopted in late June. Emphasis has indeed been placed on fiscal consolidation, accompanied by a large pre-announced exchange rate devaluation and a shift to a crawling peg system. Wage moderation is the third essential element. With these measures it is hoped to reduce the current account deficit substantially to levels which can be financed by non-debt creating flows including privatisation proceeds (around $2.5 billion). The risk that these measures will entail a temporary stagnation of output is acknowledged. The November budget also indicated that privatisation is to be accelerated, with the expectation that asset sales could reduce the public sector borrowing requirement by perhaps as much as 3 percentage points of GDP in 1995. In summary the package comprises:

- Wages in the budget institutions are to grow by no more than 9 per cent and in majority state-owned companies by between 0 per cent and 15 per cent depending on the profitability of the enterprise and whether its debt is subject to negotiation. With inflation officially projected at some 28 per cent, these norms imply a significant fall in real wages. Lower real wages will not only reduce public consumption but also improve the finances of the large loss-making enterprises. Financial support for state-

owned enterprises is also to be cut and their privatisation expedited. Finally, budget sector employment practices are to be reformed, with a projected reduction in employment by central budget units of some 15 per cent in 1995.

- The 1995 budget foresaw a reduction in the consolidated deficit from around 9 per cent to 6 per cent, mainly due to privatisation receipts. The March package introduced expenditure cuts and revenue enhancing measures amounting to around 3 per cent of GDP, thus improving the credibility and economic content of the original plan.
- The March measures project expenditure reductions of around HUF 100 billion. One of the most significant measures is the curtailment of the present universal family allowance and maternity pay systems. Savings are expected to amount to some HUF 24 billion.
- An import surcharge of 8 per cent has been imposed until mid 1997 which is expected to raise HUF 50-55 billion.

Short term prospects will depend to a great extent on the ability of the government to implement its wide ranging policy package. Assuming that it is fully implemented, the confidence of foreign investors should be retained, allowing foreign debt repayments of about $3 billion to be rolled over and a still significant current account deficit (around $3.0 billion on the OECD Secretariat's estimation) to be financed. While the economy continued to show marked buoyancy in early 1995, growth is likely to weaken, particularly in the second half. For the year as a whole, GDP could grow by around 1.0 per cent. Inflation may rise from 19 per cent in 1994 to some 29 per cent in 1995, in view of the announced exchange rate policy which entails a pre-announced devaluation of 29 per cent from December 1994 to December 1995: a step devaluation of 9 per cent in March followed by monthly devaluations of 1.9 per cent until June and 1.3 per cent for the remainder of the year. On the assumption that fiscal consolidation and accompanying structural reforms continue in 1996, growth could recover to 3 per cent and inflation could start to decline.

Recommendations

The package of measures – announced by the government in March – goes some distance towards addressing the fundamental economic problems facing the

Hungarian economy. In view of the time which has been lost in formulating a comprehensive response to the situation it will be crucial to establish credibility at an early stage. The supplementary budget in September 1994 created the expectation that significant measures were to be implemented, but at the end of the negotiating process little concrete remained of these intentions. A recurrence of such an outcome needs to be avoided. To establish credibility for the present package it will therefore be crucial to avoid slippage in meeting the targets for the June supplementary budget and to implement the monetary programme which has been announced for 1995. Beyond that, it will be important to indicate future directions for fiscal consolidation, reform of the public sector and monetary policy. A medium term fiscal consolidation programme – incorporating a plan for ongoing structural reforms which serve to support macroeconomic policy – has proved useful for this purpose in other countries, because they allow individual spending programmes and structural reform measures to be assessed in the light of overall policy objectives. The need to achieve coherence and credibility will affect all aspects of policy, including fiscal policy, monetary and exchange rate policy, and privatisation, including measures to deepen further the functioning of the market economy and to withdraw the state from direct economic activity. Recommendations are made below in each of these areas.

Fiscal policy

Under the circumstances it is appropriate that fiscal tightening forms a key part of the policy package. Hungary faces a debt trap and steadily rising interest payments. Fiscal adjustment to attain a moderate primary surplus is clearly called for, and the sooner this is done the smaller the ultimate adjustment needs to be. In addition, fiscal consolidation is necessary to achieve a sustainable current account by increasing the level of domestic saving and also to preserve investor confidence so that maturing foreign debt can be refinanced. Finally, consolidation is required so as to ensure that the gains in competitiveness arising from the large devaluation announced for 1995 do not evaporate into higher inflation. Just what constitutes a sustainable level of the current account is impossible to judge *a priori* since it will depend on investor behaviour and perceptions – and in turn on the economic climate as a whole including the budget. But in any case, the current account is not itself a variable directly under the control of policy, in

contrast to the budget. For these three reasons – controllability, impact on savings, investor confidence – the budget deficit is a more relevant direct focus for policy deliberations and actions than the current account.

The government's intention to reduce the budget deficit by around 3 percentage points of GDP in 1995 is welcome. However, in view of the large devaluation which has been announced for 1995, the question remains whether the fiscal contraction will be sufficient to free resources for increasing net exports and to avoid the real risk of an excessive rise in inflation. It is difficult to make a judgement at this stage about savings and investment balances, particularly in view of the uncertainties attached to the development of household saving: in the past these have fallen as households have maintained consumption in the face of a decline in real incomes. However, if expenditures were to remain strong and wage guidelines to slip – which is possible in view of the provisions for state-owned firms to grant wage increases related to nominal profitability – further fiscal tightening might be needed. Without a timely tightening, inflation could fail to decelerate quickly, eroding the gains in cost competitiveness and the current account would remain unacceptably large. Going beyond the immediate issues, even if the target for 1995 were to be reached, the budget deficit is still too high in terms of both the level of debt and the state's claims on savings and on credit, and will need to be further reduced. Moreover, the planned consolidation in 1995 is heavily dependent on temporary measures – wage moderation in the public sector and an import surcharge – which will need to be replaced by permanent measures.

To be effective in promoting growth, fiscal consolidation will need to be undertaken in conjunction with reforms of both the expenditure and tax systems as well as in the functioning of the budget sector. Among the measures which need to be considered are:

- Wage restraint in the budget sector is to play a key role in the fiscal consolidation which is foreseen for 1995. To be effective, budgetary institutions need to possess the ability to adjust. In this respect the easing in May 1995 of public service employment regulations, including a relaxation of severance pay provisions, is welcome though consideration needs to be given to broader administrative reform. Such reform will be especially important beyond 1995 when it may prove difficult to

maintain the compression of budget sector wages. Across-the-board wage cuts, while administratively simple, are also often inefficient and probably not sustainable over time.

- A reform of the budget system is necessary so that the budgetary envelope of individual programmes will more closely reflect priorities. In addition, information systems need to be improved – at present an accurate consolidation of the budget accounts is not possible – and a control system established in the form of a centralised Treasury.
- Improved financial control of the consolidated deficit is necessary but will be possible only if inter-governmental financial relations are streamlined. The propensity to ear-mark revenues and to establish new budgetary institutions and extra-budgetary funds needs to be sharply curtailed (there is already some progress in this area but much more is needed) and the budgetary functions of these institutions more tightly controlled. Of particular significance are the two social insurance funds and the local governments where large deficits have emerged. These institutions enjoy a great measure of independence and have responsibility for major expenditure programmes. The issue which still needs to be resolved is their ability, either formally as in the case of local councils, or informally as with the insurance funds (which must have parliamentary approval), to finance their own deficits. Without effective limitations on the borrowing capacities of these units, the overall government deficit could be controlled only by continuous adjustments to the central budget, and this would require a flexibility which is not reasonable to expect. The new measure to limit local council debt service to no more than 70 per cent of their own revenues is a step in the right direction but the situation will require monitoring to determine whether the ceiling is appropriate.
- Financing of the consolidated budget needs to be made transparent and accounted on a consistent basis. Borrowing by the Hungarian State Holding Company (HSHC) to indirectly finance the social security and other extra-budgetary funds needs to be treated as a financing item in the budget rather than as current income of the respective funds as is at present the case. Moreover, domestic foreign currency borrowing from excess bank reserves needs to be handled with care if misinterpretation by the public is to be avoided.

- The reform of the family allowance system, which will come into effect in the second half of 1995, is welcome and broadly in line with the recommendations of the OECD's review of social programmes in Hungary. The programme was not cost effective. However, the new targeted family support system remains generous and one of the two entry criteria – assets – may prove difficult to implement and inefficient. To improve the system further it may prove useful to change the determination of entry criteria from per capita household income to one based on assessing needs according to the age structure of the household, as is done in most OECD countries. Consideration might also be given to changing other social security and assistance programmes in a similar manner.
- Reform of the pension and health programmes remains a key priority. The decision to increase the number of days of sick pay which will be covered by employers goes in the right direction by reducing the liability of the social insurance funds while at the same time creating an appropriate set of incentives to minimise abuse of the system. Much more needs to be done to remove costly abuses of disability pensions and extended sick leave. With respect to pensions, the phased increase in the retirement age of women, which was deferred from 1995, needs to be implemented and the announced plan adhered to in the future. Although a significant step in reforming the pension system has been taken with the introduction of private pension funds in 1993, a blueprint for overall reform is still lacking. Even though the full budgetary impact will be felt only a number of years from now, pension reform still deserves high priority.
- Cost improvements in the area of social insurance need to be matched by corresponding decreases of the very high contribution rates. Such high rates encourage evasion, increase labour costs, and distort resource allocation. One way of decreasing these rates is to markedly improve collection both from loss-making state-owned firms and from the grey economy. In order to improve collection by the social insurance funds, the authorities may wish to investigate the possibilities for a greater exchange of information with the tax authorities and the employment fund. In particular, shared identification numbers could improve control by allowing cross checking. In addition, access to benefits needs to be linked to proof of payment, thereby reducing the incentive for workers

and employers to collude in understating wages and in not paying contributions.

- The allocation of state-owned property to the social insurance funds, already mandated by law, needs to be urgently resolved. In particular the rights of the funds to finance their own deficits through property sales needs to be clearly defined as do their relations with the privatisation agencies. The current agreement of the government to restrict the transfer to property which can be used operationally by the funds is sound and deserves to be implemented.
- The 1995 budget has improved the structure of the tax system – especially the replacement of tax allowances by tax credits – but several areas for future action are apparent. The difference between the standard and reduced VAT tax rates remains very large and needs to be reduced if the misallocation of resources is to be minimised over the longer run.
- The import surcharge will need to be removed quickly: even though exporters will receive rebates on their import costs, the surcharge will nevertheless continue to tax them via increases in the prices of import-competing goods and through any induced increase of wages. At the same time, imported investment goods will be artificially favoured in comparison to domestic alternatives.
- A great deal of effort is being devoted by the authorities to establishing a retail network for bonds in an attempt to lower interest costs. While every effort should be made to minimise expenditures – including lower tax breaks for investors – the high level of government borrowing means that better marketing is not likely to reduce borrowing costs to the extent of the current difference between deposit and bond rates: banks will be forced to increase deposit rates in response to the new competition for household deposits and the yield they demand on treasury securities might also increase.
- In order to lower expenditures on goods while at the same time increasing efficiency, public procurement practices need to be strengthened. A public procurement law meeting national treatment obligations has now been adopted. Every effort should be made to facilitate its effective implementation.

A restructuring of social expenditures away from universal entitlements to targeted assistance will contribute to the longer term credibility of fiscal consolidation. Restructuring of sector employment in budgetary institutions and a tightening of eligibility conditions in areas such as sick leave and disability pensions is necessary but will unavoidably bring into the open increased poverty. Carefully targeted programmes are needed, without which the ability to carry through reforms in the first place may remain restricted. However, targeted programmes, including the new family support system, will need to avoid creating so called "poverty traps" whereby there is no incentive for households to increase their income above the cut-off level. This inevitably limits the generosity that can be built into such programmes.

Monetary policy

Fiscal consolidation and the move to a pre-announced series of exchange rate devaluations throughout 1995 change the framework for monetary policy quite significantly. Consolidation will relax some of the constraints on policy but at the same time the National Bank of Hungary will need to establish credibility in defending the announced exchange rate path. A change in both goals and instruments may be required. Among the most important considerations are:

- The NBH will need to be able to raise interest rates to whatever level is necessary to defend the exchange rate and to prevent inflation becoming embedded in the system. In the past, the NBH has often been under pressure to support the market for government securities and to hold down interest rates to assist the budget. Although fiscal consolidation will ease such constraints on monetary policy it does not eliminate them. The NBH was previously obliged to finance 3 per cent of projected budget revenues in 1995, but this has now been changed into an upper limit. This allows not only a lower level of budget financing but also the possibility to conduct open market sales throughout the year. This additional room for manœuvre may have to be exercised. At the same time, however, the overdraft limit on the current account of the central budget has been increased by 80 per cent of the cash balances of both central budget and extra-budgetary funds. This will complicate monetary control and highlights the need for a centralised Treasury to manage cash flow.

- The decision to introduce a pre-announced crawling peg exchange rate is opportune: the old system had become a source of continuous speculation and contributed to monetary instability and perhaps also to capital flight. It is important that the new system be accompanied by a change in the objectives of monetary policy away from an emphasis on real variables such as the real exchange rate. Unless this is done – and credibility established – expectations of further devaluations may prove difficult to control and the cycle of stop-go policy alternating between fighting inflation and restoring competitiveness will not be broken. To this end, the system should be seen not as a way of ensuring a given real exchange rate – for that it cannot do for long – but as a transition to a more stable nominal exchange-rate regime, which could be achieved by a steady reduction of the rate of devaluation.
- The intention of the Hungarian authorities to achieve full current account convertibility in the near future and thereby Article VIII status in the IMF is timely and welcome. At the same time, to realise the benefits of increased convertibility – both on the capital and current accounts – monetary policy, and economic policy more generally, will have to focus on creating a stable macroeconomic environment. This is another reason for monetary policy to focus on providing an effective nominal anchor, and for reducing the commitment to finance the budget deficit.
- The effectiveness of monetary policy has been reduced by credit guarantees and other special programmes to aid large debtors. These programmes need to be substantially reduced not only from the viewpoint of monetary policy but in order to facilitate the transfer of resources to other more efficient enterprises.

The high level of official debt and the realisation that a debt trap has developed have both led to suggestions that the budget deficit should in effect be monetised to a greater extent than at present. Furthermore, in more extreme form it has sometimes been suggested – though not officially – that a period of high inflation is necessary in order to reduce the real level of debt. The experience of Poland and Russia is often cited in support. In terms of the current economic strategy there is little room for further monetisation of the budget deficit: current account and exchange rate targets will need to be matched by a moderate growth

of the money supply and in credit to government. As a general proposition which has some support in the country a more detailed response is, however, necessary. The following considerations are relevant:

- Hungary's foreign debt, which comprises some two thirds of total public debt, cannot be reduced by increased monetisation and greater inflation. As noted above, a real devaluation will in fact increase the fiscal liability still further.
- Increased monetisation would certainly reduce the issue of interest bearing debt in the short run, but to the extent that it is not held as idle cash balances and spills over into a current account deficit, it would simply increase foreign debt.
- Increased inflation may initially decrease the real value of domestic debt, holders of medium and long term debt incurring a capital loss. However, experience in other countries shows that these effects would be quickly reversed through higher real rates of interest to cover increased risk, a substantially lower monetary base on which to levy the inflation tax, and a dollarisation of the economy.
- Potential effects of unexpected inflation are likely to be small in Hungary. Medium and long term debt carry floating rates of interest which are effectively indexed to the short term return on treasury bills, and savers always have the opportunity of substituting foreign for domestic assets.
- The sounder long run strategy is to create the macroeconomic conditions which will lead to a reduction in real rates of interest and to an increased demand for domestic money. The latter in fact serves to increase seigniorage revenues for the budget.

Advocacy of an exchange rate policy more closely targeted to providing a nominal anchor may be seen as anomalous given the experience in 1992 when the currency appreciated in real terms. There is, however, a great difference with the present recommendations. In 1992 a nominal anchor was accompanied by both expansionary fiscal and monetary policies. What is being advocated here is quite different: a set of mutually consistent policies. Such a policy move would need to avoid changes in the nominal exchange rate should inflation lead to an appreciation of the real exchange rate.

A key issue for Hungarian economic policy is to select an appropriate regime governing the capital account of the balance of payments. The present

system is asymmetrical with capital inflows *de facto* quite liberally authorised and outflows closely regulated. With respect to capital inflows, short term flows are discouraged but borrowing by domestic companies and banks with maturities longer than a year is subject only to light vetting procedures. Raising finance abroad through issuing securities is, however, tightly controlled in order to protect the nascent domestic capital market. Up till now, the attitude of the authorities to non-official external borrowing has been positive even though it has at times complicated the conduct of monetary policy: the inflows have helped finance the current account and, in the view of the authorities, have contributed to an increase in investment. Some problems are, however, apparent with the present regime broadly defined:

- Better enterprises have been able to borrow abroad, thereby leading to disintermediation and to a possible increase in systemic lending risk for the domestic banking system.
- The distinction between short and long term borrowing appears to ensure financial stability but this image could be exaggerated. For example, while the bulk of corporate foreign borrowing has been long term, about half of this is with related firms. Should macroeconomic conditions become unfavourable, such long term flows could disappear and even reverse quite quickly.
- Permitting foreign borrowing but not the issuance of securities abroad appears inconsistent and could be circumvented. It is vital to improve the mobilisation of domestic capital, but selective foreign exchange controls may not be the best way to proceed.
- Tight restrictions on capital outflows can obviously slow down adverse speculation, but the degree of insulation provided should not be over estimated. Speculation against the currency appears to have led to moderate capital flight and in periods of intense speculation to portfolio shifts: in the first quarter of 1995 households appeared to have made extensive use of their tourist allowances for the year to increase foreign exchange holdings in anticipation of a devaluation, while banks have been adept at using foreign currency swap facilities to speculate against the currency. A more fundamental concern of the authorities was underlined in March 1995: in response to news that the budget was to borrow from excess foreign reserves of the banking system around 10 per cent of foreign currency deposits by value were withdrawn.

While the risk of capital outflow has represented a concern to the authorities, risks associated with capital inflows in the course of pursuing stabilisation policies might also arise under conditions of rising capital mobility. In particular, given a legitimate concern – under present and foreseeable industrial conditions – to avoid a large appreciation of the exchange rate, large short-term capital inflows could prove destabilising. Monetary instruments for sterilising such flows are limited by the underdeveloped state of capital markets. In shallow markets, large scale sterilisation would likely have a significant impact on interest rates rather than simply on the level of liquidity; and this could stimulate further inflows in a sort of vicious circle leading to excessive money growth, higher future inflation, and increase vulnerability to a subsequent loss of confidence.

Risks associated with capital flows cannot be eliminated by capital controls – at best such controls only buy time. Under these circumstances what is crucial is to establish both a credible exchange rate regime and to improve the effectiveness of instruments for monetary control. The government's economic strategy is intended to do just this, although time will be required not only to establish credibility but also in some cases to strengthen existing institutions, in particular the banking system. These developments will have to be supported by fiscal consolidation but this will also take time: the 1995 package of measures is a step in the right direction but the important temporary measures will still have to be replaced by longer-lasting reforms. All this suggests that, following on the adoption of the new Foreign Exchange Law, some caution may be required with respect to further substantial liberalisation, but it does not imply inaction. Rather, many of the existing exchange controls need to be simplified, and rationalisation is also necessary, to improve both the efficiency and effectiveness of the currency regime. More fundamentally, to enhance credibility a clear timetable for capital account convertibility should be established in the framework of a medium term programme for fiscal consolidation and structural reforms.

Specific measures to improve the supply side of the economy

The fiscal and monetary policy measures discussed above will also affect the structure and the supply responsiveness of the economy. To reinforce these measures – as well as to improve the efficiency of macroeconomic policy instruments – a number of structural policy measures are required in areas such

as the banking system, enterprise finance and privatisation. In other areas such as trade and competition policy it is important that past reforms be consolidated:

- With respect to trade policy Hungary has entered into binding international commitments both to the GATT (and now to the WTO) and more importantly to the European Union. Nevertheless, these agreements do leave some room for manœuvre and the authorities have been subjected to strong protectionist pressures – not least from foreign investors – to make greater use of these possibilities. The authorities have generally not bowed to pressures for trade protection but remain, to some extent, in an institutionally weak position. In order to resist these pressures more effectively, greater transparency needs to be brought to the trade-policy process through, for example, using public enquiries to investigate the economy-wide cost and benefits of protectionist measures. In this respect the broadening of the inter-departmental tariff committee by including some consumer groups has been a step in the right direction.
- Although the implementation of competition law has worked relatively effectively, it is now time to consolidate the gains by selective extensions in two areas. State aid which serve to distort the competitive process need to be closely defined and suitable monitoring institutions established. The other area where improvements appear necessary is in the ability of the competition authorities to challenge anti-competitive decisions of other state organs. These powers may need to be extended to counterbalance the tendency of state agencies to give priority to objectives such as the maximisation of privatisation revenues rather than the promotion of competition.

Banking system

Continuing efforts are required to restructure the banking system not only from the viewpoint of improving financial intermediation but also to improve the effectiveness of monetary policy. Bank recapitalisation has been effectively completed, though the process was drawn out in a way that may have strengthened risks of behaviour conditioned by moral hazard on the part of both banks and enterprises. To control such risks, the emphasis must now be on definitive restructuring and on improving the operating environment for financial intermediation:

- Despite recapitalisation, interest margins remain high suggesting both a high level of costs and still limited competition. Privatisation needs to be forcefully pursued as a means of encouraging greater efficiency and reduction of costs.
- Reorganisation of the banking sector as a whole may have to be considered. The dualistic structure of the banking system whereby the deposit base is confined to only a few banks limits the conduct of monetary policy. For example, moves to drain liquidity from the banking system in aggregate may be seriously inhibited if such actions have disproportionate effects on banks with low primary deposits and large exposure in the inter-bank markets.
- Commercial banks have continued to be protected via credit guarantees and implicit commitments when loans have been extended in response to moral suasion. The use of guarantees needs to be severely curtailed, and moral suasion by ministries with respect to specific loans is unacceptable.
- The debtor consolidation programme covering the larger enterprises was poorly implemented due to the need to include too many interested parties. The decision to terminate important parts of this programme on December 1994 and to extend the normal proceedings only until July 1995 was thus appropriate.
- In order to protect creditors – not just banks – consideration might be given to permitting secured creditors to execute their claims without having first to go to court.

Financial support for enterprises

Over the review period the government has been active in financially supporting selected companies – which were often large exporters – either through direct financial support from state agencies or by the purchase and effective write-off of their debt from the banks. Such financial support does not appear to have had the intended consequences and has only occasionally led to a marked change in corporate performance. The government has announced on several occasions that such support would cease, most recently with the privatisation strategy initiated in November 1994. Despite this, the government has, within the framework of regional support for the steel industry, recently paid creditors of a

company large sums to prevent its liquidation under the Bankruptcy Act. While the desire to minimise highly localised pockets of unemployment is understandable, the message which is conveyed to other enterprises is potentially damaging. The real risk is that eventually these and other loss-making companies will have to be brought on budget with intractable long-run budgetary consequences – several OECD countries that pursued such policies in the past continue to be heavily burdened by the consequences.

Privatisation

Nowhere in the current economic programme is the need to establish credibility and transparency greater than in privatisation. Several highly publicised cases have contributed to an image of lack of commitment, but more importantly to the perception that decision making is discretionary and not rule based. The government's privatisation strategy announced in November 1994 is a step in the direction of improving the situation: it is sensible to separate the remaining privatisation into several classes and to promote speedy privatisation of small enterprises and especially those medium sized enterprises whose financial performance is weak and where management is poorly motivated. With the enactment of a new privatisation law in May 1995 a transparent legal framework has been created to implement the strategy and the accompanying institutional change is getting underway. What is now needed are timely and effective implementation measures which will confirm the depth of political support for the privatisation process. Several areas concerning implementation might require closer attention:

- Although the new law lays out a clear framework, it also specifies numerous parties which need to be consulted such as line ministries and, on occasion, local governments and trade unions. It will be important to ensure that the responsibility for privatisation decisions remains focused and transparent. Without this there is a risk that the large privatisations will be non-transparent with protracted negotiations over special conditions and price after initial tenders have been accepted.
- The government's intention to substantially reduce the number and level of minority stakes in enterprises is sound and needs to be expedited. However, the logic of retaining a minority holding in areas such as

utilities might still need to be further clarified with a view to clearly separating regulatory from ownership issues.

- If privatisation is to be accelerated and its transparency improved, the tendency to establish special conditions such as employment and investment commitments needs to be highly selective and carefully controlled. The new law calls for full reporting of selection decisions and this could be used to facilitate control, although in practice confidentiality considerations may weaken its impact. Moreover, the integrity of the bidding process needs to be preserved since otherwise bidders will incorporate in their tenders a margin to cover potential re-negotiations with the government or privatisation agencies.
- Despite significant improvements during 1994, asset backing for compensation vouchers needs to be improved and the terms on which vouchers can be exchanged for assets clarified. Delay in resolving these issues has probably contributed to the general feeling of unease about the commitment to privatisation as well as placing the state in the position of appearing to avoid legal commitments.

Several years ago Hungary was widely considered as one of the leaders of the transition with excellent prospects even in the short run: the country had initiated market reforms early, a potential payments crisis had been resolved, and inflows of foreign direct investment were strong. Set against these expectations, the economic situation at the beginning of 1995 was somewhat disappointing; while not a crisis, the combination of large fiscal and current account deficits, rising inflation, continuous pressure on the currency and diminished credibility of the privatisation programme represented a serious situation requiring immediate and comprehensive actions to prevent both a further deterioration and a loss of investor confidence. This situation arose for several disparate reasons but there is a common thread: policy has been implemented partially and gradually, often failing to respond to the demands of the situation. This finally led to an unbalanced policy mix. The budget deficit was not brought under control after problems became apparent in 1992 and the budget plan for 1994 even foresaw some increase in the deficit at a time when the need for consolidation was already clear. Supplementary budgets have not aggressively tackled the situation. Monetary policy was constrained by the need to finance the budget and also by the still unbalanced structure of the banking system. It has had to deal with an excessive

current account deficit while also trying to bring down inflation and not imperil recovery. In sum, monetary policy was overburdened by being called upon to support more objectives than it had instruments to achieve them. In the event, focus was lost. At the same time, structural reforms of the banking system were drawn out and partial, thereby exacerbating problems of moral hazard, while the government sought at times to loosen the financial discipline of large enterprises. Overall, the credibility of policy for the transition has been weakened and valuable time has been lost. However, the structural foundations are now broadly in place for a new beginning: the shell game which has accompanied the restructuring of corporate debt has largely run its course, banks are improving, many state-owned enterprises have effectively spun-off and restructured profitable activities, the private sector has remained dynamic and a new privatisation law is now in place. Most important of all, the government has shown its political determination to come to grips finally with the key macroeconomic imbalances with its March 1995 package of policy measures, which has been approved in May 1995 by a comfortable majority in the parliament. If the 1995 budget is held on course through these measures, and reinforced by further consolidation over the medium term, the Hungarian economy should once again justify the optimism in which it was previously held.

Notes

1. From the statistical perspective, growth from 1992 to 1993 was mainly driven by an end to inventory de-stocking which had been particularly strong in 1992. Some of this decline may have been attributable to the introduction of a new accounting law, and to the transformation of collective and state farms, which often involved the distribution of inventories to members.
2. Excluding the impact of imports of MIG aircraft. In 1993 Hungary accepted fighter aircraft (MIGs) from the Russian Federation in partial settlement of their old rouble debt remaining in the CMEA clearing account. The national accounts record the transaction as an increase in both imports and in public consumption, although the two are not identical. The transaction makes analysis of the national accounts difficult so that in this survey it has been excluded.
3. The measurement of savings is fraught with difficulties. Lacking independent estimates of household income, the reported statistics summarise information on the stocks of some financial assets. Table 3 includes two measures of savings, the first only financial assets in forints, while the second includes changes in the value of the stock of compensation vouchers, and forgiveness of housing loans.
4. Under the programme many households chose to immediately repay their housing loans, resulting in a marked decline in household deposits.
5. Bank financing for investment increased by nearly 10 per cent in real terms (PPI adjusted) in 1994 after falling at nearly the same rate in 1993, but it appears that most of this went to public utilities and transportation projects.
6. For the purposes of investment statistics foreign participation is defined as a shareholding greater than 10 per cent.
7. The strong recovery of exports in 1994 refers to customs based registrations – which on a net basis are used for national accounts' estimates – and not to exports on a payments basis which actually declined. Customs registration of exports are about $1 billion greater (2.4 per cent of GDP) than exports recorded on a balance of payments basis. The most important difference between the two is that customs data includes the full value of reprocessing exports, but for balance of payments purposes they are calculated on a net basis and recorded under services (for additional differences, see note 22). Moreover, small scale exports are probably not captured by the bank reporting system which forms the basis for balance of payments estimates but could be to a modest extent included in the estimates of unrequited transfers. Small businesses often avoid making trade transactions within the

banking system, instead using the personal foreign exchange accounts of the owners. This allows them to maintain foreign exchange accounts, *de facto*, for business purposes which is prohibited by the foreign exchange law. As of April 1, 1995 a new government decree allows entrepreneurs to maintain foreign exchange accounts for foreign trade purposes (see Chapter II).

8. Most of the drop in apparel was in reprocessing, which accounts for nearly 90 per cent of total apparel exports.

9. Prices increased quite rapidly after the mid-March 1994 devaluation, but subsequent reports of widespread price discounting indicate that some overshooting may have occurred.

10. The producer price index for goods intended for consumption purposes shows a much smaller differential throughout the period.

11. Many Hungarian economists believe that, given the size of informal sector, registered unemployment may overstate actual unemployment by a factor of 2:1. Labour force statistics indicate much lower levels of unemployment based on job search criteria; many individuals must register with the unemployment office in order to be eligible for various social benefits even if they are not actively engaged in job search.

12. The term government sector is used in a very broad sense, covering public administration (L, in the Hungarian and ISIC classification), health (M), education (N) and other communal, social and personal services (O). This is the same definition used to define public administration for measured investment in Figure 2. About half of economic agents covered under O are in fact enterprises, but most of these are owned by local governments. In order to construct Figure 5 it was assumed that the government sector comprises only units employing more than 20 people.

13. Throughout the rest of this section, unless otherwise noted, tax data covering firms maintaining a full set of accounts is utilised. They comprised 57 247 tax entities in 1992 and 70 718 in 1993. Smaller economic entities and individual entrepreneurs are excluded. See Annex II for details.

14. Non-financial enterprise losses for the last four years in billions of current forints were: 1991 – HUF 198.4; 1992 – HUF 383.7; 1993 – HUF 308.0. The Ministry of Finance estimates losses for *all* industrial firms at HUF 285 billion for 1994.

15. Although net pre-tax losses reported by the enterprise sector as a whole increased by some HUF 16 billion in 1993, reaching HUF 220 billion (about 6 per cent of GDP) the deterioration was solely accounted for by increased provisions for bad and doubtful debts by the banking system.

16. The corresponding figures for 1992 were 41 companies with 27 per cent of total losses.

17. 249 out of the 603 loss-making firms filed for bankruptcy or liquidation in 1992/1993, but only 17 out of 41 with the largest losses.

18. For details of the ownership criteria see Annex II.

19. One potential explanation for this is that smaller private firms are more successful in paying workers in non-wage forms so as to minimise social security contributions.

20. Much of the improvement came as a result of wider margins between energy imports and exports of refined energy products.

21. On a customs basis, exports were relatively flat over the same period, with a decline only appearing in the first quarter of 1993.

22. Transactions included in the customs data, but not the balance of payments are: reprocessing exports and imports; contributions in-kind to FDI; leasing; barter deals (such as some natural gas deliveries); in-kind debt repayments, such as the repayment by the Russian Federation of CMEA debts through the supply of MIG fighters; and items brought in for repairs. (A number of transactions involving aircraft have created significant movements on the Hungarian trade figures and differences between customs and payments figures.) Some trade transactions may be incorrectly recorded in the payments data as unrequited transfers or errors and omissions, but for the most part these appear to be composed of exports of services (*e.g.* tourism) and enterprise borrowing, respectively.

23. Simple regression of the customs less payments differential on a monthly basis on domestic real deposit rates.

24. The calculations presented in Table 6 attempt to put these data on a comparable basis, but must be regarded as at best indicative as customs and payments figures are measuring fundamentally different things, and are not really comparable, especially in the case of timing.

25. Profits repatriation has been negligible to date despite the large and growing stock of foreign direct investment.

26. Net unrequited transfers were $732 million in 1993, about two-thirds of net interest payments for that year. Transfers, both credits and debits, are composed of almost entirely private funds (98 per cent), as Hungary receives almost no official foreign aid in the form of grants. The bulk of unrequited transfers are probably accounted for by various types of unrecorded trade: cross-border transactions, unrecorded tourist spending, and trade by small entrepreneurs in areas such as apparel, as discussed above.

27. The implied interest rate calculations are consistent with the facts that US$ and DM LIBOR rates – accounting for about half of foreign debt – averaged 4.74 and 5.36 per cent, respectively, in 1994 and that Hungary has been able to issue bonds paying between 175 and 250 basis points above LIBOR rates, depending on maturity.

28. In addition to foreign direct investment there has been some portfolio investment. However, it has been limited by prohibitions on the purchase of government bonds by foreigners and by the modest size of the Budapest Stock Exchange. The prohibition was lifted in May 1994, but initial attempts to open domestic bond markets to foreign investors were not successful. An experimental forint treasury bond issue open to foreigners was launched in May 1994, but only 0.7 per cent of the issue was subscribed. The 25 per cent coupon rate appeared to have been insufficient to cover perceived risks. Several companies have issued shares abroad, including a $70 million issue by Hungary's largest retail group, Fotex, in March 1994, though this was less than the $100 million intended.

29. Part of the increase is due to the depreciation of the US dollar, especially against the yen and the mark.

30. At the beginning of the transition in 1990, Hungary was carrying a very high burden of foreign debt and debt service payments; the World Bank classified Hungary as a severely indebted middle-income country, with particularly high ratios of debt-to-GDP and debt

service to exports. By 1992 key debt and debt service ratios had decreased significantly, and terms for borrowing began to improve.

31. Debt service ratios are normally calculated using payments data. However, because of the wide discrepancy between exports measured on a customs and payments basis in Hungary, it is useful to consider alternative measures: the debt service to export ratio using custom's data was 37.8 per cent in 1994, some 10 percentage points less than the conventional measure.

32. This now seems to have stabilised at around 7-8 per cent of the total as enterprise borrowing has become more important.

33. Borrowing from official multilateral and bilateral sources was about $200 million annually.

34. This was partly offset by increased borrowing from banks on the part of Hungarian commercial banks and enterprises.

35. Semjen, A., "Some fiscal problems during economic transition in Hungary", in Mizsei, K., (ed), *Developing Public Finance in Emerging Market Economies*, Westview, Boulder, 1994.

36. Interest payments in both 1993 and 1994 do not reflect accrued interest with interest commitments on large issues being booked in the following year. For example, projected interest payments in 1995 reflect a full six months of interest payments which accrued in 1994, and 1994 also includes interest payments with respect to 1993.

37. In the inflationary environment characteristic of Hungary the nominal budget deficit is a biased indicator of the true budget position: the inflation component of net interest payments represents amortisation of outstanding stocks of debt and hence should not be viewed as a current expenditure or revenue item. It is also necessary to take into consideration movements of the real exchange rate – in 1993 and 1994 the real exchange rate appreciated in terms of the GDP deflator, lowering the effective debt burden. Because of data problems, the OECD Secretariat was unable to complete calculations of these effects.

38. There are three reasons why the deficit has not had a greater impact on gross public debt up to the present. First, financial assets are not considered in Table 12. These were run down in 1994 in part accounting for the anomalous decline in gross debt as a share of GDP that year. Second, privatisation revenues have represented a significant source of finance lowering the expansion of gross debt. The privatisation of MATAV in late 1993 brought the HSHC around HUF 80 billion while privatisation by E-loans (the proceeds of E-loans are refinanced by banks at the NBH, which then credits them against outstanding pre-1991 loans to the government) reduced public sector debt by around HUF 20 billion in 1993, though this created an equivalent increase in credit to the economy. Third, even though a great deal of the deficit has been financed by issuing bonds to the public – including banks – a small part of the deficit has nevertheless been financed by monetary creation, a liability not normally included as public debt.

39. For example, see Kornai, J., "Lasting growth as the top priority: macroeconomic tensions and government economic policy in Hungary", *European Bank for Reconstruction and Development Working Paper*, 15, 1994 which appeared in Hungarian first in August 1994.

40. This refers to the important fact that while the budget (*i.e.* NBH) must service the foreign debt it does not have the income earning assets to do so and must consequently raise funds through taxes, domestic borrowing or money creation.

41. The governing bodies are composed half of employee and half of employer representatives. Employee representatives are elected every four years from slates proposed by trade union associations. Employer representatives are chosen by employers associations, in proportion to their economic importance. The governing bodies' financial powers are constrained by the Parliament but many aspects of their financial powers and competence remain to be resolved.

42. In addition governments have traditionally presented major issues to the Interest Reconciliation Council (comprising the government and the social partners) before submitting them to Parliament, but no formal approval is required.

43. It improved to HUF 13 billion by the end of the year as the government made payments to cover some of the arrears of the state-owned railroads.

44. The law in question was imprecise, as often is the case with fiscal matters in Hungary, and left open important questions such as valuation, management, and income earning capacity of the assets.

45. As discussed below, there is a budget sector Interest Reconciliation Council which negotiates all questions of industrial relations, including wages.

46. Howard Oxley and John Martin, "Controlling government spending and deficits: trends in the 1980s and prospects for the 1990s", *OECD Economic Studies*, No. 17, Autumn 1991.

47. In particular medicine and household electricity were zero-rated.

48. It appears that raising VAT rates did not lead to a matching increase in revenues. Although discretionary policy changes increased taxes by 3.9 per cent of GDP in 1993, changes in effective rates on indirect taxes led to a decline of 2.4 per cent. One reason could have been a switch by consumers to lower rated products. See, *Eastern Europe – Factors underlying the weakening performance of tax revenues*, IMF Working Paper, 94/104, September 1994.

49. It has been Hungarian practice to introduce annually some adjustment to personal income taxes to offset the effects of inflation pushing tax payers into higher tax brackets – rather than adjusting the brackets themselves.

50. Banking capital has been raised by HUF 136 billion including the provision of HUF 20 billion of subordinated capital, and loans purchased from them for HUF 194 billion. The purchase price was 80-90 per cent of the face value.

51. Purchasers of government securities were permitted to deduct the full value up to 30 per cent of their taxable income, regardless of whether payment was 100 per cent or on margin. Financial institutions quickly created innovative instruments in response to this opportunity. This programme was in effect beginning in January 1994 and was eliminated in October as part of the supplementary budget.

52. The reduction in tariff rates corresponded to obligations under the Association Agreement with the EU.

53. Another problem with the original 1995 fiscal package was that it was inconsistent with the monetary programme. Given the impact on domestic monetary creation of expected capital

inflows – $4 billion – the NBH could not meet its legal commitment to budget financing and its own monetary targets without effecting a large reduction in the existing level of credit to non-government.

54. Erzsebet Gem, "The main features of the present Hungarian tax system", *Kopint-Datorg Discussion Papers*, No. 23, September 1994; *Crossed Paths: straightening the road to private sector growth*, Centre for International Private Enterprise, Budapest 1994; George Kopits, "Midway in the Transition", *Acta Oeconomica*, Budapest, 46, No. 3-4, 1994.

55. There are several aspects of this situation. The social security funds – they operate a joint treasury and accounting system for revenues – are not computerised and the registration number differs from that used by the taxation chambers and the employment fund which collects contributions to cover unemployment benefits. Hence a cross check of employment and payrolls is not possible. By contrast the information system of the tax office is in a much better state.

56. An important exception concerns pharmaceuticals which remain zero-rated.

57. The March 1995 supplementary package projects an increase of personal income tax receipts from 11 per cent to 12.2 per cent of central budget revenues.

58. There are now six brackets comprising: 0, 20, 25, 35, 40 and 44 per cent. Ministry of Finance data from 1991 indicates that 16 per cent of taxpayers were in tax brackets of 40 per cent and above.

59. Child allowances were already converted to such a basis in 1993. Jarvis and Pudney found that deductions served to decrease the progressivity of the system in the period up to 1994. *Ceteris paribus* this might be redressed to some extent in 1995 with the move to tax credits. Jarvis, S and S. Pudney, "Redistributive policy in a transition economy: the case of Hungary, *CEPR Discussion Paper*, No. 1117, London, 1995.

60. Small businesses are also subject to the personal tax system, but according to tax records report, on average, lower taxable income than the average household and therefore pay less taxes. Losses can be carried forward and might be one reason for sluggish revenue growth.

61. The Hungarian system currently permits 40, 60 and 100 per cent tax relief at the discretion of the authorities depending on factors such as the sector.

62. The authorities argue that existing double taxation treaties would reduce the tax to around 5 per cent. However, this does not apply to all treaties and would not improve the situation for Hungarian nationals involved in a joint venture.

63. The statutory contribution rates are defined as a proportion of wage payments net of the employer share, but gross of the employee share. Relative to gross labour costs the payroll tax is 36 per cent, but measured as the ratio of labour costs without contributions it is 55 per cent. Employees pay 10 per cent to the pension and health fund and 2 per cent to the solidarity fund for unemployment insurance.

64. From an equilibrium perspective what matters is the wedge between payments by the employer and receipts by the employee, not which party actually makes the payment. However, from the perspective of dynamics there is an expectation that a cut in the rate paid by employers would have a more immediate beneficial effect on performance. See

"Employer versus employee taxation: the impact on employment", *OECD Employment Outlook*, OECD, July 1990.

65. For details of the pension system and reform issues see *Social and Labour Market Policies in Hungary*, OECD, Paris, 1995, Chapter 4.

66. See also Jarvis and Pudney *op. cit.*

67. Commander, S., Kallo J. and Ugaz, C. "Firm behaviour and the labour market in the Hungarian transition", *Policy Research Working Paper* , No. 1373, World Bank, Washington, 1994.

68. Legally speaking the SPA and the HSHC can only direct firms in this manner in which they have more than 75 per cent of the shares. However, through their representatives on the boards they ultimately have a fairly large influence if the determination is present.

69. Given that the trade balance on a customs basis did not decline, it is possible that the combination of negative real deposit rates and an appreciating real exchange rate in 1992 may have caused Hungarian enterprises to retain export earnings overseas.

70. As discussed in the previous Economic Survey and in Chapter IV, during 1992 filings for bankruptcy soared following the new bankruptcy law. Banks finally began to recognise large levels of non-performing loans and to provision for them.

71. Credit rationing and strong risk aversion by banks is indicated by a significant build up of excess reserves at the same time that banks contracted lending. At the end of 1992, these excess reserves – excluding foreign currency reserves which had to be held under exposure rules – were equivalent to 115 per cent of total mandatory reserves.

72. The increase in the ratio of money to GDP was perceived as a shift in money demand due to an increase in credibility and confidence, rather than the makings of a potential monetary overhang attributable to an increase in money supply.

73. Hungary is in fact a net external debtor, so that an increase in NFA actually means a decline in net foreign liabilities. NFA were expected to increase by about HUF 120 billion, or nearly 15 per cent. This accounted for the difference between the projected growth rates of broad money and domestic credit, 24 per cent and 12 per cent, respectively.

74. Real deposit rates in Hungary are more than usually difficult to measure accurately because of spikes in the CPI, particularly from the VAT increase in January 1993. Figures in the text and tables are calculated based on actual monthly commercial interest rates for enterprises and a 4-month moving average of inflation centered around the month of observation. Studies by the NBH have shown that in Hungary household savings rates are sensitive to real interest rates. In the underdeveloped Hungarian financial system at that time, and to a lesser extent today, most financial savings instruments fall in the category of broad money, so that changes in savings affect money demand.

75. There appears to have been a shift in financial portfolios attributable to growing expectations of a large exchange rate devaluation as the real exchange had appreciated by 14.3 per cent between July 1992 and February 1993. Supporting this view, real household foreign exchange deposits grew by 5 per cent between February and June 1993, while real forint deposits fell slightly. Much of the drop in deflated forint deposits was in enterprise accounts,

consistent with evidence suggesting delays in foreign exchange repatriation may have increased at this time.

76. Interest rates in Treasury bill auctions were subject to ceilings set by the Ministry of Finance, which was reluctant to increase them. As a result the spread between interbank credit rates and Treasury bills widened from 3 to 7 percentage points in April 1993.

77. In the first half of 1993, enterprises had increased their net foreign borrowing by $450 million, financing about one fourth of the current account deficit. There is some evidence that there was simultaneously capital flight, which may have accelerated at this time.

78. The NBH is free to alter the mid rate by 5 per cent cumulatively without requiring government approval. However, there is some legal uncertainty with respect to the rights and obligations of both parties.

79. The facility is really more correctly characterised as a Lombard window. Repurchase facilities are available in so-called "active" and "passive" (reverse). Active repurchases are when banks deposit securities with the central bank and reclaim them after a fixed period, obtaining access to reserves during the interim period. Passive repurchases are just the opposite, commonly referred to as reverse repos, and serve as a method of draining reserves by the central bank. As a Lombard-like facility, they are not taken into account when determining the NBH's financing obligations to the budget. Despite efforts by the NBH to make interest rates on the passive facility attractive to banks, it has been little used.

80. Since 1992 the NBH has recognised that compulsory reserve requirements were effectively a tax on financial intermediation which helped to keep the margin between deposit and lending rates high.

81. Hungary lacks the institutional structure for the NBH to easily elicit bids for purchases of a given quantity of Treasury securities, in particular a network of primary dealers. The authorities and financial institutions are currently engaged in remedying this defect. However the authorities could at present purchase or sell securities directly to commercial banks, if they chose.

82. In 1994 this was accompanied by the development of an active and liquid forward foreign exchange market.

83. In June 1993 the NBH widened the band around the daily fixing from ±0.3 to 0.5 per cent, again in 1994 to ±1.25 percentage points, and in January 1995 to ±2.25 per cent.

84. At year-end 1994 nearly one quarter of the outstanding stock of enterprise loans was from owners.

85. The concept of international competitiveness and its usefulness in analysing certain economic problems is far from clear and has by now many meanings. See for example Bradford, C. *The new paradigm of systemic competitiveness: towards more integrated policies in Latin America*, OECD Development Centre, Paris, 1994; Krugman, P, "Competitiveness: a dangerous obsession", *Foreign Affairs*, 73, 1994.

86. For discussion of issues such as R&D policy, technology and human capital see *Review of industry and industrial policy in Hungary*, OECD, 1995.

87. Measured in terms of increased import penetration the most rapid areas of import growth were in machinery and equipment, office, accounting and computer machines, and medical and precision instruments.

88. For an extensive discussion of real exchange rate movements since 1988 see the *Economic Survey, op. cit.*, 1993.

89. Some studies indicate that Hungary produces a very different product mix than its neighbours, but this is clearly not the case in important areas like textiles or clothing and apparel.

90. There are severe problems in comparing levels of ULC due to the need to value output on a similar basis. For a critique of attempts to measure unit labour costs in level form see Oulton, N, "Labour productivity and unit labour costs in manufacturing: the UK and its competitors", *National Institute Economic Review*, May 1994. Havlik has attempted to avoid this problem by using an equivalent of purchasing power parities based on Austria and linking them to other countries. In 1994, the estimated level of unit labour cost was 37.9 per cent of the Austrian one. The respective figures for Poland, the Czech Republic and Slovakia are: 29.3 per cent, 23.3 per cent and 23.2 per cent. Havlik, P, *Exchange rates, wages and competitiveness of Central and Eastern Europe,* draft, Vienna, 1994.

91. The latter is only a proxy for prices of tradeable goods but the tendency does not change significantly when recalculated in terms of export prices.

92. This development reflects to some extent a tightening of financial discipline of Hungarian enterprises and with it the scrapping of uneconomical marginal capacity.

93. Ideally one would analyse the profitability of traded goods production, but no comparable data are presently available to analyse import-competing enterprises.

94. Data were analysed for all non-financial companies and for manufacturing companies. Exporting companies were defined as those having more than 25 per cent of total sales from exports: for non-financial and manufacturing firms the sample average was 58 and 60 per cent, respectively. For non-exporters the corresponding figures were 3.3 and 6.6 per cent, respectively. In both cases non-exporters, because of their much larger total size, still accounted for around 20 per cent of total exports.

95. For manufacturing firms, foreign-owned firms overall had a much higher export share of sales, and this was true even amongst export-oriented firms.

96. For manufacturing companies the wide difference in performance was also apparent, but non-exporters did improve substantially.

97. Evaluating the profitability of exports, and enterprise performance in general, may be skewed by the very large losses of these firms, some of which are important exporters. These large loss-making firms were members of the "dirty 12" (later increased to 14): state-owned companies which would normally have been subject to bankruptcy proceedings but which were instead subject to a special rescue programme. Debt write-offs for these firms may have artificially lowered losses in 1993; pre-tax losses of the 12 decreased from HUF –17.5 billion in 1992 to –6.6 billion in 1993, and showed positive profits of HUF 5.2 billion in 1994. Eight of these firms were among the largest of Hungary's exporters, each with exports over $100 million annually in 1994, accounting for over 50 per cent of

their sales, and collectively these firms accounted for over 16 per cent of total Hungarian exports.

98. The total number of loss-making exporters increased. This may have been partly caused by the transfer of some firms from the loss-making to profit-making group: sales of profitable firms increased by 30 per cent, though the value of the increase was greater than the decline in the sales of loss-makers. Another explanation is that some loss-makers disappeared from the sample due to liquidation.

99. This differential was particularly striking among manufacturing firms, where value-added per employee in exporting-firms increased by 40 per cent, compared to 15 per cent in non-exporters. However the level of value-added per employee remains over one-third higher in non-exporters. Interestingly enough, this differential is largely confined to foreign and state-owned firms: for the latter this measure was nearly double in non-exporters.

100. It is widely believed in Hungary that the tough bankruptcy law which went into effect in 1992 reduced export capacity by some 10 per cent, and initial studies by the Ministry of Finance supported this conclusion. A more careful follow-up study by the Ministry of Finance shows that the effect was somewhat smaller, and did not substantially affect larger firms. See Chapter IV for a further discussion of the bankruptcy law.

101. This figure is based on registered capital inflows through the banking systems. Estimates of additional foreign direct investment in-kind, in terms of imports of investment goods, range from $1.5 to 2 billion.

102. See National Bank of Hungary, "Direct foreign investment and privatisation in Hungary". *Monthly Bulletin*, August 1994. pp. 141-149.

103. Foreign-owned firms are defined here as any Hungarian firm with more than ten per cent foreign ownership, thus including joint-ventures.

104. Foreign-owned firms have dominant positions in frozen-food, vegetable oils, and sugar as well as tobacco, paper, publishing, detergents and cosmetics, and cement.

105. See Ádam Török. "Industrial Policy and Foreign Direct Investment in Hungary." *Institute for World Economics, Working Paper* No. 30, Hungarian Academy of Sciences, March 1994.

106. Foreign investors have generally not chosen Hungary as an export base to the European Union, but rather to the rest of Central Europe, and thus have not had to comply with the 50 per cent domestic content level necessary to qualify for benefits under the EU Association Agreement. Suzuki, which is the major exception, has experienced difficulty finding appropriate domestic suppliers; in a number of cases Suzuki's Japanese-based suppliers were required to transfer technology and know-how *gratis* to Hungarian firms to make up for local shortcomings.

107. Torok, *op. cit.*. This may be part of overall efficiency gains rather than switching to foreign suppliers.

108. This was not true for *industrial* firms, where foreign firms had a better profit performance than state-owned firms, but worse than domestic private firms. Pre-tax profits, and the level of taxes paid by foreign firms, are sensitive to start-up losses being experienced by several large firms.

109. GDP figures are in constant prices, for West Germany only. From OECD, *Quarterly National Accounts*, No. 4, 1994.

110. The Secretariat was not able to include in the decomposition the effects of enterprise bankruptcy and liquidation on export capacity, since no time series data exist on export capacity *per se*; nonetheless, the timing of these reductions does coincide with the period of real exchange rate appreciation, which may have led to an overestimate of its effect on exports.

111. In particular, only 11 quarters of data were available, and the results indicated that many of the estimates were quite unstable.

112. Proponents of the view that real exchange rate appreciation had an important effect on the trade balance begin their analysis earlier with the appreciation of 1989-1991, around 20 per cent. In this view, the "equilibrium" real exchange rate has been steadily depreciating since 1989 because of changes in relative prices and import liberalisation and, with the actual real exchange rate appreciating at the same time, substantial traded-goods production became unprofitable. In the wake of the implementation of the bankruptcy law in 1992 this capacity was shut down and lost, causing a permanent deterioration in the trade balance. As noted above and in Chapter IV, on balance the evidence indicates that some trade-goods capacity was shutdown in 1992/93, but no where near enough to explain the decline in the trade balance. The analysis presented in the Survey focuses only on the impact of real exchange rate movements during the review period, 1992/1994. The use of the first quarter of 1992 as a starting date does not imply that the real exchange rate was at an equilibrium at that time, even if the trade balance was in fact substantially positive for all but one month of period between June 1991 to June 1992. (The concept of an "equilibrium" real exchange rate is inherently a slippery one, and must be defined in the context of contemporaneous macroeconomic policy and full-employment.) Rather, this date was used because of the coverage of this review, and was the first date for which reliable trade data were available. For a more extended discussion of the early period, see the previous *Economic Survey of Hungary* (1993), pp. 59-66.

113. The sensitivity of reprocessing to exchange rate or unit labour costs is not surprising: anecdotal evidence concerning textile reprocessing indicates that purchasers easily switch to new suppliers as relative costs change, and that Hungary has been losing market share to countries to the east and south, such as the Ukraine, Belarus and Romania, which have lower labour costs.

114. The elasticities are derived holding demand constant. Exchange rate and other price changes may have an indirect effect via influencing the overall level of real money supply and demand. This would not be captured by the relatively simple regressions estimated here.

115. Very high and significant demand elasticity of exports and agricultural exports were estimated using non-seasonally adjusted agricultural exports and German GDP growth, in the range of 6-9. This was rejected as spurious correlation because of the highly seasonal nature of these two time series.

116. The regression results are confirmed by simple computations: the 23 per cent drop recorded in Hungarian exports to the European Union would require demand elasticities of eight given the fact that European Union total imports fell by 3.7 per cent.

117. These results differ somewhat from Hungarian estimates, perhaps because the OECD Secretariat did not explicitly model the effects of bankruptcy, as noted above. According to estimates by the NBH the decline of the trade balance can be attributed as follows: 45 per cent to the West European recession; 25 per cent to the drought and structural problems affecting agriculture; 5 per cent to the ban on meat exports; 5-8 per cent from the effects of bankruptcy and liquidation; and 15-20 per cent to a revival in domestic demand.

118. Hungarian tariff rates are low for raw materials and intermediate goods and relatively high on final goods. As a result the effective rate of protection is higher on final goods than on intermediates thereby discouraging production of the latter. See Chapter IV for more details.

119. SPA is the State Property Agency which had been charged with privatisation functions. HSHC is the Hungarian State Holding Company originally intended to manage state-owned companies which would remain in state ownership long term.

120. Under the Hungarian law, bankruptcy corresponds to what is called re-organisation (Chapter 11 procedure) in OECD countries. The debtor remains in possession and initiates the process. Liquidation corresponds better to the general concept of bankruptcy and includes receivership as well as liquidation. It is initiated at the request of the creditors and overseen by the courts. For a more detailed account of the Bankruptcy law see the *Economic Survey of Hungary, op. cit.*

121. Unless otherwise indicated, the statistics are drawn from information provided by the Financial Regulation Department of the Ministry of Finance.

122. The argument at the beginning was that an automatic trigger was the only way to improve financial discipline and to avoid creditor passivity. By mid 1993 the balance of Hungarian opinion had shifted toward the position that its application unnecessarily accelerated the process and was mixing creditor protection with debtor "punishment"(Cf., Szanyi, Miklós, "Bankruptcy procedures and enterprise restructuring in Hungary", Paper presented to the OECD Advising Group on Privatisation, September, 1994. For an alternative view arguing that the automatic trigger was from the very beginning inappropriate see "Policy recommendations on banks, capital markets and enterprise restructuring," Drafting Committee of the Comparative Privatisation Project, Institute for East West Studies, December, 1994, p. 17).

123. Hegedüs, Eva, *The Hungarian Framework for Bankruptcy and Reorganisation*, Paper presented at the Workshop on Corporate Bankruptcy and Reorganisation Proceedings in Central and Eastern Europe, OECD, Paris, 1993. Another study estimates that business entities which filed for bankruptcy or liquidation until the end of 1992, produced 10.3 per cent of output and 12 per cent of exports and employed 14 per cent of labour force in 1991 (Lamberger, Galina, "A csõdhullám hatásai a magyar iparban és mezõgazdaságban, különös tekintettel a külgazdasági hatásokra," *Research Report*, KOPINT-DATORG, Budapest, November 1993).

124. According to this data set compiled for the Ministry of Finance, bankruptcy and liquidation procedures concerned overwhelmingly registered companies which were in the lower end of this category. Out of the total number of bankruptcies and liquidations (3 457 and 6 582, respectively) published until September 1994, around 90 per cent affected double-entry bookkeeping firms. In the case of both bankruptcies and liquidations, 44 per cent of these

firms were "identified" in 1993, thus caution is required in comparing their balance sheet figures with the aggregated balance sheets of the 57.5 thousand double-entry bookkeeping companies.

125. Marsi, Erika and Judit Pap, "A csõdtörvény hatása a pénzintézetekre (The impact of the bankruptcy act on financial institutions)", *Bankszemle*, 1993:12.

126. The decline is in part a technical consequence of bankruptcy since the arrears of companies under liquidation are automatically taken out of the aggregate statistics. Methodological changes were also introduced.

127. Trade creditors, court trustee and conversions from bankruptcy have a combined share of 67.5 per cent, the firms themselves 18 per cent, and state creditors 13 per cent (Baer, Herbert L., and Cheryl W. Gray, *Debt as a control device in transitional economies: the experience of Hungary and Poland*, Paper presented to the conference "Corporate governance in Central Europe and Russia"). Recent data from the Ministry of Finance show an increase in the share of state creditors – mainly the tax office – in initiating liquidation proceedings.

128. Cf. "Az eltûnt csõdök nyomában (In search of disappeared bankruptcies)", *Figyelõ*, December 15, 1994.

129. Another factor is that banks earn revenue from clients not only from interest but from other sources such as foreign exchange transactions. As such they will tolerate some risk of bad debt. Szanyi, *op. cit.*

130. The bankruptcy law was amended in June 1995 forbidding enterprises under liquidation to raise wages without the permission of the creditors.

131. This applies particularly to the so called "dirty dozen" – 12 industrial firms chosen for support in 1992 because of their size and strategic position in the economy. Two additional industrial enterprises were added to the list later.

132. For one viewpoint Szanyi, M. *op. cit.*

133. These actions were often regarded as the equivalent of a "supply-side shock" to the Hungarian economy. The phrase was coined by Bokros, Lajos: "Privatisation and the banking system in Hungary", *Privatisation in the transition process*, UNCTAD, Geneva, 1994.

134. Existence loans (E-loans) involve the purchaser repaying the loan to the bank. From the perspective of the budget and the privatisation authorities they constitute a non-financial method, since the proceeds are immediately repaid to the NBH thereby reducing budget debt to the NBH.

135. For more detailed information on privatisation see *Privatisation Trends*, OECD, Paris (semiannual publication).

136. Compensation vouchers are tradeable bearer securities quoted on the stock exchange, usually at a substantial discount. They earned capitalised interest till the end of 1994, which was important if the voucher was used for privatisation or for conversion into a monthly life annuity.

137. Agricultural land must be allocated to land funds for this purpose. It is claimed that poor quality land in dispersed plots has been used for this purpose.

138. The privatisation of Gyortej dairy is a good example where one investor had an offer valued at the nominal value of vouchers but another, with a mixed cash/voucher offer, was not assessed by valuing the bid in terms of vouchers which could have been purchased with the cash part of the bid. The Deputy Director of the SPA was quoted as arguing that agricultural cooperatives and local authorities who were original holders should be preferred over "financial speculators".

139. In September 1994 the SPA reviewed in detail 150 sales approved between April and June 1994. Of these, violations of sales procedures or legal regulations occurred in 14 cases. An *ad hoc* body was also set up in September to review 43 sales and criminal proceedings were initiated in six of them.

140. The sale of a hotel chain – HungarHotels – is an example of the government overriding the results of a competitive tender conducted by the SPA.

141. *Privinfo,* Budapest, January 1994.

142. See, *The privatisation strategy of the government of Hungary*, 1994-1998, Budapest, November 11, 1994.

143. Under Hungarian company law a part holding of 75 per cent of the equity is entitled to control the firm directly like a subsidiary, rather than through the board of directors. A holding of 25 per cent plus one share prevents this but it is still unclear what real power the minority stake holder would in fact retain.

144. It was important that the new organisation take corporate form – like the existing HSHC – rather than an agency of state form such as the present SPA. The legal structure of the former allows debts to the state to be written off which cannot be done by an agency of the government. Privatisation of difficult companies would thereby be facilitated.

145. About 300 thousand hectares were fallow in 1992, 411 thousand in 1993 and 236 thousand in 1994. The causes of these movements are widely debated in Hungary, with some observers attributing them to (unnecessary) problems in farm restructuring, while others relate them to the changing profitability of farming. Input use appear to have been directly related to price movements caused largely by changes in government subsidies and loan programmes.

146. Agricultural output is split about 50-50 between plant crops and livestock products.

147. The remaining 27 – those farms occupied with seed propagation, animal stock breeding and research – are to remain under state control.

148. As part of the transition from collective to cooperative status assets were divided up into cooperative share and business shares. Cooperative shares essentially convey membership and have voting status: they have only a nominal value, are non-transferable, and must be sold back at face value to the cooperative upon departure. Business shares represent an equity interest in the value of the non-land assets of the cooperative, and were allotted to members (or their heirs) by the general assembly based on a normative measure of their contribution. Business shares are inheritable, fully negotiable, and may be held by non-members, but have no voting rights. Under the transition process, business shares could be exchanged for physical assets.

149. Hungary's Uruguay Round commitments place a binding limit on export subsidies.

150. Csermely, Ágnes, "Komparativ elõnyök a magyar gazdaságban," in: *A magyar feldolgozóipar versenyképessége, komparativ elõnyei.* Final report, GKI – KOPINT-DATORG – MTA IVKI, Budapest, 1994, pp. 19-35.

151. Table 5, page 33, *op. cit.*

152. As quoted in Sapir, A. "The Europe Agreements: implications for trade laws and institutions. Lessons from Hungary", *CEPR Discussion Paper Series*, No. 1024, 1994.

153. In response to pressures from foreign investors, tariffs on passenger cars, fertilisers, and colour television sets were raised in 1991.

154. For a review of the proposed regulatory structure, see *Review of Energy Policies*, International Energy Agency, Paris 1995.

Annex I

Debt dynamics in Hungary

This annex discusses the interrelationship between deficits, debt and interest payments.

Theoretical debt dynamics

Traditional analysis of the relationship between budget deficits and debt/GNP ratios starts from a framework of some very simple Domar-type dynamic models. Domar's Theorem about stability (in a mathematical sense, *i.e.* tends to some finite limit) is that, if the nominal rate of interest exceeds the nominal rate of GNP growth, the debt/GNP ratio will always explode for any sustained primary deficit. Hence deficits financed by debt cannot go on indefinitely. Only if the nominal interest rate equals or is less than the nominal rate of GNP growth will the debt/GNP ratio be stable. The first section derives this result and also shows that, for the debt/GNP ratio to decline when nominal interest rates exceed the rate of growth, the primary surplus must exceed the product of the debt/GNP ratio and the difference between the rate of interest and the rate of growth. Subsequent sections modify the result for the cases where: *i)* values change and *ii)* part of the deficit is met by printing money.

However, these limits apply only in the long run – and possibly the very long run: for policy analysis, the path of the debt/GNP ratio is more important. An interesting result here is that, for the debt/GNP ratio to decline, the primary surplus must exceed the product of the debt/GNP ratio and the difference between the rate of interest and the rate of growth.

The Domar method: standard version

The standard version assumes that GNP growth is consistent; that tax and non-interest expenditure by government are both constant proportions of GNP; and that all deficits are financed by issuing debt. This system can be described:

$$Y_t = Y_0 e^{gt} \tag{1}$$

$$T_t = sY_t \tag{2}$$

$$G_t = aY_t \tag{3}$$

$$G_t - T_t = (a - s)\, Y_t = pY_t \tag{3a}$$

$$\frac{dD_t}{dt} = G_t + rD_t - T_t \tag{4}$$

$$= pY_t + rD_t \tag{4a}$$

= Non-interest deficit + interest payments

where:

Y = nominal GNP, growing at constant rate g.
T = tax revenue
s = tax rate
G = non-interest expenditure by government
a = G, as share of GNP
p = non-interest or "primary" deficit
D = debt
r = nominal interest rate

Integrating this differential equation yields the general solution.

$$D_t = Ce^{rt} + \frac{pY_t}{g - r} \tag{5}$$

where C is the constant of integration [its actual value would depend on initial debt conditions as well as the other constants and would be given by writing $t = 0$ in (5)]. Dividing through by Y_t and using (1), yields.

$$\frac{D_t}{Y_t} = \frac{C}{Y_0}\, e^{(r-g)t} + \frac{p}{g - r} \tag{6}$$

The existence of a limit for D_t/Y_t generally requires strict inequality. If $g = r$ and $p = 0$ the second term on the right-hand side becomes indeterminate.

If $g > r$ [*i.e.* growth in Y exceeds the nominal interest rate], then

$$Lim\ t \to \infty \left[\frac{D_t}{Y_t} \right] = \frac{p}{g - r} \tag{7}$$

But if g is less than or equal to r, D_t/Y_t increases without limit (if $g = r$, second term is infinite). This proposition is Domar's Law. For instance, a primary deficit of 5 per cent of GNP and growth 2 per cent above the interest rate, would imply an ultimate debt/GNP ratio of 2.5.

To see how the debt/GNP changes, differentiate (6) with respect to t:

$$\frac{d}{dt} \left[\frac{D_t}{Y_t} \right] = (r - g)\ \frac{C}{Y_0}\ e^{(r-g)t} \tag{8}$$

$$= (r - g) \left[\frac{D_0}{Y_0} - \frac{P_0}{(g - r)} \right] e^{(r-g)t} \tag{9}$$

by writing $t = 0$ in (5) to define the constant of integration.

Examining the sign of (9), if $r > g$ (the normal case), then (9) is negative if and only if

$$-\frac{p}{r-g} > \frac{D_0}{Y_0} \quad (D_0 > 0) \tag{10}$$

That is, to get the debt/GNP ratio to decline, the primary surplus ($-p$) must exceed the product of the debt/GNP ratio and the difference between the rate of interest and the rate of growth of GNP. For instance, if the debt/GNP ratio is 0.8 and the rate of interest is four percentage points above the rate of growth of GNP, then a primary surplus equal to 3.2 per cent of GNP will be required. In Hungary in recent years, however, the gap between the rate of interest and growth has been much larger than in this example due to valuation effects.

Some important modifications

The above results can be modified in a number of ways. The value of existing debt might change due, for example, to exchange rate changes. This is a factor of considerable importance in Hungary.

If the value of debt outstanding rises by vD_t, where v is the revaluation effect, equation (4) is rewritten as:

$$\begin{aligned} \frac{dD_t}{dt} &= G_t + rD_t + vD_t - T_t \\ &= pY_t + (r + v)\, D_t \end{aligned} \tag{4'}$$

In this case, r must be replaced by $r + v$ in equation (5) yielding

$$D_t = Ce^{(r+v)t} + \frac{p}{g-(r+v)}\, Y_t \tag{5'}$$

The condition for D_t/Y_t having a limit is also changed, viz., $g > r + v$ (*i.e.* growth in Y must exceed the nominal interest rate plus the revaluation of previous debt). This is a harder condition to satisfy. The limit in this case is

$$\frac{p}{g-(r+v)}$$

As noted in the text, large foreign debt together with frequent devaluation of the exchange rate make revaluation effects particularly significant in Hungary. These revaluation effects have the effect of increasing the ultimate debt/GNP ratio.

Money financed borrowing

Part of the deficit in Hungary is financed by money creation rather than by issuing interest-bearing debt. For illustration purposes, a simple money demand equation may be added:

$$M_t = mY_t \text{ where } M \text{ is the stock of high-powered money} \tag{11}$$

so that

$$\frac{dD_t}{dt} = G_t + rD_t - T_t - \frac{dM_t}{dt} \qquad (4'')$$

Now $M_t = mY_0e^{gt}$ so that $\frac{dM_t}{dt} = gmY_0e^{gt} = gmY_t$

Using this and (2) and (3) gives

$$\frac{dD_t}{dt} = \{a - [s + gm]\}Y_t + rD_t$$

Note that high powered-money is equivalent to a tax in this equation. Replacing s by $[s + gm]$ in equation (5) gives the general solution

$$D_t = Ce^{rt} + \frac{a - [s + gm]}{g - r} Y_t \qquad (5'')$$

The stability condition $g > r$ is unchanged but the debt/GNP limit is reduced to

$$\frac{a - [s + gm]}{g - r}$$

and the condition for the debt/GNP ratio to decline is

$$\frac{-p + gm}{g - r} > \frac{D_0}{Y_0} \qquad (10')$$

In most countries the addition of monetary financing does not make a great difference to the above results because the ratio of high powered money, m, to GDP is quite small. This not true in Hungary as the ratio is around 0.25. With the nominal growth rate around 0.20, the left hand side of (10′) is transformed: seignorage and the inflation tax (gm) reduces the required primary surplus required for the debt/GDP ratio to decline by five percentage points. However, the effect has little policy relevance for several reasons:

i) a great deal of base money bears interest, in contrast to other countries. For example, bank reserves currently earn around 16 per cent. Thus greater use of monetary emissions would lead in effect to an increase in interest bearing debt and to a worsening of the consolidated (including NBH) primary budget surplus;

ii) the simple money demand function is not related to the rate of inflation. A systematic strategy of monetising the deficit so as to avoid interest payments is not viable since it would lead to a decline in the demand for high powered money, and thus to a decline in the base for the inflation tax. The preference of the Hungarian public for holding interest bearing foreign currency accounts indicates the empirical importance of this effect in the Hungarian context.

Annex II

Financial performance of enterprises

The financial performance of enterprises has improved considerably over the past two years: total pre-tax losses were around HUF 180 billion in 1992 and in 1993, and in 1994 they turned into pre-tax profits of HUF 98 billion. The non-financial sector began improving even earlier: pre-tax losses fell from HUF 179 billion in 1992 to HUF 39 billion in 1993, and in 1994 pre-tax profits of HUF 40 billion were realised. Relative to GDP, the overall non-financial profit ratio improved from –7.1 per cent in 1992 to –2.5 per cent in 1993 and +2.2 per cent in 1994.

The most frequently used data to indicate the development of the financial condition of firms derive from the tax authorities and cover the most important balance sheet and profit/loss items.[1] At the time of writing, tax returns were only available for 1992 and 1993. The data set covers only so-called double-entry book-keeping organisations. Thus, the sample does not include some of the smaller registered legal entities nor individual entrepreneurs. However, in terms of gross production (sales), value-added, and exports, the sample covers close to 50 per cent of the output of Hungarian economic organisations.

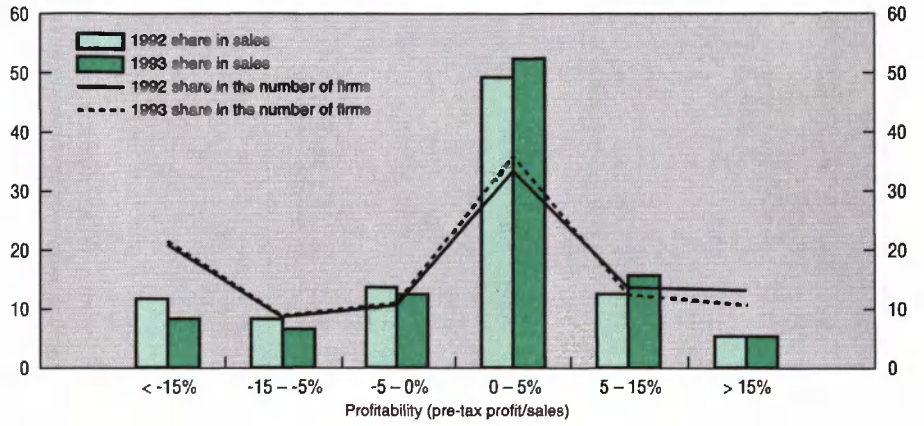
Year-on-year comparison of the processed tax files is rendered difficult by the changing number and, in the case of any breakdown, composition of the firms concerned. The number of companies in the data set increased from 57 247 to 70 718 in 1993. This was the net effect of 1 277 "exits" and 14 748 "entries". Exits from the sample are usually due to liquidations. Changes in balance sheet items also reflect one-off asset revaluations originating from the transformation of state firms into state-owned joint stock or limited liability companies.[2] In cases where the sample is decomposed into sub-categories, it is not possible to distinguish whether changes in indicators are due to individual companies shifting from one sub-group to another, new entrants and exits, or changes in actual performance.

The indicators

Tables A1-4 present selected indicators of financial and operational performance, covering size, profitability, financing (debt/equity), labour productivity and costs, and, where possible, a measure of "value-added".[3] To highlight aspects of enterprise adjust-

Figure A1. **DISTRIBUTION OF COMPANIES BY PROFITABILITY**

Percentage share



Note: 1992 average profitability = -3.44.
1993 average profitability = -1.17.
Source: Ministry of Finance.

ment, firms were divided into several groups covering profitability, ownership and export-orientation.

Overall Performance

Pre-tax profits for the enterprise sector as a whole deteriorated in 1993, but this was more than accounted for by the financial sector. Profits in the non-financial sector improved substantially, with all of the improvement coming in operating performance. Unit labour costs rose, especially in industry, but sales per employee rose even more rapidly. This was caused by a continued decline in employment combined with rising overall sales; in industry the former was more important than the latter, in non-industry it was the converse. Among profitable firms, little improvement was shown in profitability ratios, rather profits rose because of increased sales. Much of this improvement was concentrated in the most unprofitable firms, defined as those firms with pre-tax profit to sales ratios greater than –15 per cent in absolute terms. Though the number of these firms increased by over 3 000, their aggregate sales shrank by over 15 per cent as some firms were liquidated and others reduced capacity. Liquidation of the most indebted firms explains the improvement in the debt to equity ratio (Table A1), and in financial losses.

The large and growing number of loss-making firms, and their relatively small average size in terms of sales, conceals the fact that the majority of losses in this category

Table A1. **Financial performance of all double-entry enterprises**

	Total		Non-financial		Industry		Non-industrial		Highly unprofitable (non-financial)[1]		Other loss-makers (non-financial)	
	1992	1993	1992	1993	1992	1993	1992	1993	1992	1993	1992	1993
Number of firms (thousands)	57.9	71.5	57.2	70.7	12.0	14.4	45.3	56.3	11.9	15.1	10.9	14.0
Size												
Employees/firm	38.9	28.4	38.3	27.8	80.3	58.0	27.3	20.1	48.5	25.8	42.9	28.9
Sales/firm (HUF millions)	98.8	95.0	98.0	94.5	197.0	189.7	71.8	70.2	54.3	36.3	112.4	90.0
Profitability (per cent)												
PBT/sales[2]	–3.4	–3.2	–3.4	–1.2	–4.6	–1.1	–2.6	–1.3	–48.6	–47.2	–4.8	–4.4
PBT/equity[2]	–4.0	–4.4	–4.1	–1.7	–4.7	–1.2	–3.6	–2.2	–54.4	–29.1	–6.6	–8.1
OP/sales[2]	–3.3	–3.7	–0.8	1.2	–0.9	1.5	–0.8	1.0	–31.4	–28.3	–2.5	–2.2
OP/equity[2]	–3.8	–5.1	–1.0	1.7	–0.9	1.7	–1.0	1.7	–35.1	–17.4	–3.4	–4.1
Productivity (thousands)												
Sales/employee	2 540.2	3 343.1	2 555.8	3 394.8	2 452.4	3 269.4	2 636.3	3 487.8	1 119.9	1 408.4	2 621.8	3 112.2
Wages/employee	250.0	330.0	240.0	320.0	240.0	340.0	250.0	300.0	220.0	270.0	220.0	309.3
Unit labour costs (per cent)	16.5	18.9	16.0	18.0	16.3	19.2	16.3	17.0	32.1	36.4	14.6	18.6
Debt (in per cent)												
Total debt/equity	144.6	182.2	51.7	60.9	42.4	45.2	60.7	78.2	123.3	84.7	46.1	69.2
Short-term/total liabilities	64.7	62.9	81.8	80.0	77.9	77.2	84.3	81.7	80.5	75.4	85.1	84.8
Other (in per cent)												
Exports/sales	13.9	13.2	14.1	13.3	19.4	19.3	10.3	9.1	23.6	19.6	13.1	11.8
Foreign equity share	10.1	15.8	9.5	15.9	11.6	16.5	7.4	15.2	12.1	19.6	8.6	15.2
State and local equity share	59.2	53.6	60.1	52.9	68.6	61.0	51.5	43.4	52.9	50.7	54.0	46.1
	Billions of forints											
Sales	5 716.5	6 793.5	5 609.7	6 683.6	2 356.1	2 728.4	3 253.5	3 955.1	647.3	549.4	1 226.5	1 258.0
Operating profit	–188.1	–252.0	–44.3	80.2	–20.0	42.0	–24.4	38.4	–203.1	–155.2	–30.4	–27.9
Financial profit	20.6	53.7	–126.2	–139.7	–74.0	–68.5	–51.7	–70.8	–78.7	–66.7	–29.3	–27.5
Extraordinary profits	–26.3	–17.0	–23.0	–14.7	–13.9	–1.1	–8.8	–13.4	–32.6	–32.9	0.2	0.7
Pre-tax profits	–194.4	–219.4	–193.0	–78.2	–108.1	–28.9	–85.2	–49.4	–314.3	–259.4	–59.5	–55.3
Exports	795.7	893.3	789.9	887.6	456.1	526.9	333.8	361.1	152.9	107.9	160.8	148.6
Employees ('000s)	2 250.4	2 032.1	2 194.9	1 968.8	960.7	834.5	1 234.1	1 134.0	578.1	390.1	467.8	404.2

1. Highly unprofitable firms were those with pre-tax profit/sales ratios above –15 per cent in absolute terms.
2. OP = operating profits; PBT = profits before tax.
Source: Ministry of Finance, tax records.

Table A2. **Financial performance of non-financial enterprises**

	Foreign[1]		State and local[1]		Private domestic[1]	
	1992	1993	1992	1993	1992	1993
Number of firms (thousands)	12.3	16.2	4.5	3.5	40.5	51.1
Size						
Employees/firm (thousands)	26.6	23.8	222.6	222.4	21.4	15.9
Sales/firm (HUF millions)	107.4	130.7	528.9	627.6	47.2	46.7
Profitability (per cent)						
PBT/sales[3]	–2.3	–0.8	–4.8	–2.8	–2.6	–0.0
PBT/equity[3]	–4.8	–1.5	–3.7	–2.2	–5.1	–0.1
OP/sales[3]	–0.2	1.6	–1.4	–0.1	–0.5	2.0
OP/equity[3]	–0.4	3.2	–1.0	–0.0	–1.0	5.4
Productivity (thousands)						
Sales/employee	4 037.6	5 491.6	2 376.0	2 821.9	2 205.6	2 937.1
Unit labour costs (per cent)	12.6	14.4	17.3	22	17.1	17.4
Wages/employee	297.5	409.7	251.8	335.5	215.1	255.3
Debt (per cent)						
Total debt/equity	118.9	107.2	30.0	29.0	77.8	104.4
Short-term/total liabilities	75.8	75.5	82.9	82.2	86.1	83.7
Other (per cent)						
Exports/sales	22.2	20.6	12.8	10.7	10.1	9.2
Foreign equity share	56.9	62.6	0.0	0.0	0.0	0.0
State and local equity share	16.6	17.8	95.1	90.9	0.4	1.0
	Billions of forints					
Sales	1 316.0	2 112.1	2 384.8	2 184.7	1 910.9	2 385.3
Operating profit	–2.6	34.0	–32.2	–1.1	–9.6	47.2
Financial profit	–22.1	–44.8	–69.6	–54.8	–34.2	–39.6
Extraordinary profit	–5.1	–3.2	–11.4	–5.7	–6.3	–5.7
Pre-tax profits	–29.9	–16.1	–113.3	–61.8	–50.1	–0.7
Exports	292.0	434.5	305.7	233.8	192.6	219.2
Employees (thousands)	325.9	384.6	1 003.7	774.2	866.4	812.1

Table A2. **Financial performance of non-financial enterprises** *(cont.)*

	Low export[2]	Low export	High export		Firms making operating losses		Firms making operating profits	
	1992	1993	1992	1993	1992	1993	1992	1993
Number of firms (thousands)	52.1	65.0	5.2	5.7	22.8	29.1	34.4	41.6
Size								
Employees/firm (thousands)	30.7	24.1	115.6	69.8	45.8	27.3	33.4	28.2
Sales/firm (HUF millions)	85.5	84.0	223.9	213.8	82.0	62.1	108.6	117.3
Profitability (per cent)								
PBT/sales[3]	–2.5	–1.2	–6.9	–1.0	–20.0	–17.4	4.8	4.8
PBT/equity[3]	–2.8	–1.6	–12.9	–2.1	–25.2	–20.0	5.7	7.5
OP/sales[3]	–0.2	1.2	–2.9	1.1	–12.5	–10.1	5.1	5.4
OP/equity[3]	–0.3	1.6	–5.4	2.3	–15.7	–11.6	5.9	8.4
Productivity (HUF thousands)								
Sales/employee	2 782.0	3 480.4	1 937.2	3 060.8	1 791.7	2 275.4	3 251.9	4 153.4
Unit labour costs (per cent)	14.9	17.2	20.8	21.4	20.9	24.2	13.8	15.7
Wages/employee	247.9	314.6	232.5	325.0	220.0	290.0	260.0	340.0
Debt (per cent)								
Total debt/equity	43.1	53.6	107.4	113.9	76.2	78.0	40.3	52.3
Short-term/total liabilities	81.2	80.2	16.9	20.8	82.2	79.0	81.3	80.7
Other (per cent)								
Export/sales	3.5	3.3	55.0	58.2	16.7	14.2	12.8	13.0
Foreign equity share	8.4	13.5	15.2	31.7	10.1	17.6	9.0	14.8
State and local equity share	60.0	54.7	60.3	41.1	54.5	49.5	67.7	55.2
	Billions of forints							
Sales	4 452.8	5 463.7	1 157.0	1 220.1	1 873.8	1 807.4	3 736.0	4 876.4
Operating profit	–10.8	67.1	–33.6	13.0	–233.5	–183.1	189.0	263.3
Financial profit	–80.3	–105.4	–45.7	–34.0	–107.9	–94.2	–17.9	–45.4
Extraordinary profit	–22.0	–24.4	–0.8	9.9	–32.4	–32.2	9.7	17.6
Pre-tax profits	–113.1	–66.3	–80.1	–12.1	–373.9	–314.7	180.6	236.3
Exports	154.2	178.2	635.9	709.6	313.7	256.5	476.3	631.5
Employees (thousands)	1 600.6	1 569.9	597.2	398.0	1 045.8	794.3	1 148.9	1 174.1

1. For ownership definitions, see text.
2. High exporters defined as enterprises with export/sales ratio greater than 25 per cent. Low-exporters are below 25 per cent.
3. OP = operating profits; PBT = profits before tax.

Source: Ministry of Finance, tax records.

were caused by a very small number of very large firms. Separate analysis by GEII – using retained earnings rather than pre-tax profits – shows that around 1 per cent of non-financial enterprises had losses per firm averaging over HUF 100 million. There were 603 such companies in 1992, and 541 in 1993, producing 68 and 61 per cent of total losses of the enterprise sector, respectively. In 1993 about 18 per cent of these companies had material costs greater than sales, indicating that they might have negative value-added, and for another 39 per cent material and labour costs combined were greater than sales.

Another aspect of the concentration of loss-making activities is the concentration of non-performing loans.[4] In 1992, 132 large loss-making companies – those with losses above HUF 100 million – had 85.1 per cent of the total amount of problem loans, altogether worth HUF 55 billion, with 21 companies accounting for 40 per cent alone. For these 21 companies, the net loss in 1992 was HUF 48.3 billion. In 1993 the stock of problem loans in this sample had risen to HUF 88.4 billion, with large loss-makers accounting for 70.9 per cent.

Ownership and performance

For the purpose of analysis, a somewhat "unorthodox" definition of ownership was used. In Table A2-4, those firms in which foreigners had *any* stake in the registered capital in 1992 and/or 1993, are treated as foreign-owned firms or joint ventures (Foreign). All those companies where the combined share of the state and the local government was at least 25 per cent were defined as state-owned enterprises (State and Local). The rest of the companies (*i.e.* firms without foreign participation and with less than 25 per cent combined share of the state and the local government) are termed private domestic firms.[5]

The evidence presented in Table A2 shows that the improvement in financial performance was across ownership type, though the greatest improvement was found in domestically-owned firms. Operating profitability was much higher in private firms than the state-owned sector; among non-financial firms there was little difference in performance between foreign and private domestic firms, but this was not true for the manufacturing sector where foreign firms outperformed domestic firms. In terms of levels, performance was generally significantly better in foreign firms: sales per employee were nearly double those found in domestic firms, more than compensating for higher wages. In terms of capitalisation, state-owned firms had substantially lower equity to sales ratios than private firms, and all domestic firms had much lower debt to equity ratios than foreign firms, with a higher proportion of longer-term debt.

Export performance

Tables A3-4 present financial performance figures for a subset of the sample – manufacturing firms. The sub-sample was split into firms with low-export shares, defined as those firms with a ratio of exports to total sales of less than 25 per cent, and high-export firms, those with export shares above 25 per cent. Foreign firms accounted for over half

Table A3. **Financial performance of manufacturing exporters**

	Foreign		State and local		Private domestic		Total	
	1992	1993	1992	1993	1992	1993	1992	1993
Number of firms	788	1 022	277	178	668	767	1 733	1 967
Size								
Employees/firm	169.0	129.8	608.3	577.1	128.9	103.1	223.8	159.9
Sales/firm (HUF millions)	311.6	389.1	975.3	1 338.4	224.8	198.8	384.2	400.8
Profitability (per cent)								
PBT/sales[1]	–3.45	–0.33	–10.79	–4.41	–16.21	–1.18	–9.31	–1.72
PBT/equity[1]	–5.64	–0.59	–16.45	–6.67	–46.80	–3.33	–16.33	–3.17
OP/sales[1]	2.00	3.02	–4.84	–2.53	–9.60	1.69	–3.39	1.09
OP/equity[1]	3.27	5.51	–7.37	–3.82	–27.71	4.77	–5.95	1.99
Productivity (HUF thousands)								
Sales/employee	1 843.8	2 691.1	1 603.3	2 081.8	1 744.1	1 731.2	1 717.2	2250.7
"Value-added"/employee	595.2	914.8	422.9	566.3	485.7	506.6	496.0	698.3
Wages/employee	219.6	355.5	206.5	310.6	229.4	246.4	216.1	313.4
Unit labour costs (per cent)	19.3	21.4	20.5	23.6	23.2	24.3	20.7	22.6
Debt (in per cent)								
Total debt/equity	101.4	107.9	87.2	90.7	173.9	114.9	104.7	102.5
Short-term/total liabilities	67.3	71.1	80.9	73.8	93.7	91.8	78.6	74.9
Other (per cent)								
Exports/sales	60.1	59.8	48.5	47.2	55.0	52.5	54.2	54.6
Foreign equity share	49.3	61.9	0.0	0.0	0.0	0.0	19.7	33.9
State and local equity share	28.7	20.7	92.9	90.6	0.5	1.0	53.0	40.9

Table A3. **Financial performance of manufacturing exporters** *(cont.)*

	Foreign		State and local		Private domestic		Total	
	1992	1993	1992	1993	1992	1993	1992	1993
	Billions of forints							
Sales	245.6	397.7	270.2	238.2	150.1	152.5	665.9	788.5
Operating profit	4.9	12.0	–13.1	–6.0	–14.4	2.6	–22.6	8.6
Financial profit	–12.9	–13.6	–19.3	–13.8	–8.1	–4.0	–40.3	–31.4
Extraordinary profits	–0.5	0.7	3.2	9.4	–1.9	–0.3	0.9	9.8
Pre-tax profits	–8.5	–1.3	–29.2	–10.5	–24.3	–1.8	–62.0	–13.6
Exports	147.5	238.0	130.9	112.5	82.6	80.0	361.0	430.5
Employees (thousands)	133.2	132.7	168.5	102.7	86.1	79.1	387.8	314.5
	With operating profit							
Number of firms	402	534	93	73	357	453	852	1060
Sales	168.6	304.8	118.6	123.8	72.4	104.4	359.5	533.0
Operating profit	16.8	29.6	7.8	8.3	4.6	6.7	29.2	44.5
Financial profit	–6.2	–9.2	–6.3	–6.4	–2.4	–2.8	–15.0	–18.3
Extraordinary profits	–0.5	0.1	–0.1	–1.9	0.2	–0.9	–0.3	–2.7
Pre-tax profits	10.1	20.1	1.4	–0.0	2.3	2.9	13.8	22.9
Exports	99.0	178.2	54.9	61.3	38.1	54.7	192.0	294.2
Employees (thousands)	68.8	91.8	66.2	50.9	40.0	50.6	174.9	193.4
	With operating loss							
Number of firms	386	488	184	105	311	314	881	907
Sales	77.9	92.9	151.6	114.4	77.8	48.2	306.4	255.5
Operating profit	–11.9	–17.6	–20.8	–14.3	–19.0	–4.1	–51.7	–35.9
Financial profit	–6.7	–4.4	–13.0	–7.4	–5.6	–1.3	–25.3	–13.1
Extraordinary profits	0.0	0.7	3.3	11.2	–2.1	0.7	1.2	12.6
Pre-tax profits	–18.6	–21.4	–30.5	–10.5	–26.7	–4.7	–75.8	–36.5
Exports	48.5	59.8	76.1	51.2	44.5	25.3	169.1	136.3
Employees (thousands)	64.4	40.8	102.3	51.8	46.1	28.4	212.8	121.1

1. OP = operating profits; PBT = profits before tax.
Source: Ministry of Finance, tax records.

Table A4. **Financial performance of manufacturing non-exporters**

	Foreign		State and local		Private domestic		Total	
	1992	1993	1992	1993	1992	1993	1992	1993
Number of firms	1 760	2 347	1 087	740	7 090	8 928	9 937	12 015
Size								
Employees/firm	40.8	40.7	204.7	189.1	21.9	19.2	45.3	33.9
Sales/firm (HUF million)	163.4	210.7	589.5	701.5	34.1	43.7	117.8	116.8
Profitability (per cent)								
PBT/sales[1]	–3.7	–0.1	–3.5	–2.4	–2.5	–0.1	–3.4	–0.9
PBT/equity[1]	–5.5	–0.2	–4.3	–2.8	–61.4	–0.3	–4.8	–1.5
OP/sales[1]	–0.9	2.3	–0.1	2.0	–0.0	1.7	–0.2	2.0
OP/equity[1]	–1.3	3.8	–0.1	2.4	–0.0	4.9	–0.3	3.3
Productivity (HUF thousands)								
Sales/employee	4 006.3	4 648.6	2 880.1	3 329.4	1 554.2	2 042.7	2 601.5	3 097.3
"Value-added"/employee	1 262.1	1 423.9	927.1	1 082.9	475.0	578.8	824.3	950.7
Wages/employee	352.8	427.5	259.3	355.5	188.4	264.3	249.7	334.0
Unit labour costs (per cent)	14.6	15.1	14.6	17.2	20.8	21.7	15.9	17.7
Debt (in per cent)								
Total debt/equity	81.1	74.3	42.1	43.0	105.2	104.7	58.7	63.4
Short-term/total liabilities	68.8	79.0	81.0	77.3	88.1	84.7	78.4	79.9
Other (per cent)								
Exports/sales	6.9	5.7	10.2	10.3	3.5	3.0	8.0	6.7
Foreign equity share	65.6	72.0	0.0	0.0	0.0	0.0	21.0	29.0
State and local equity share	16.5	10.2	96.2	96.2	0.2	2.0	56.5	41.6

Table A4. **Financial performance of manufacturing non-exporters** *(cont.)*

	Foreign		State and local		Private domestic		Total	
	1992	1993	1992	1993	1992	1993	1992	1993
	Billions of forints							
Sales	287.7	494.6	640.8	519.1	241.6	389.8	1 170.1	1 403.4
Operating profit	–2.5	11.3	–0.3	10.4	–0.0	6.8	–2.8	28.5
Financial profit	–4.2	–9.1	–21.2	–19.2	–5.0	–6.3	–30.4	–34.6
Extraordinary profits	–4.0	–2.2	–1.1	–3.3	–0.9	–0.8	–6.0	–6.3
Pre-tax profits	–10.8	–0.6	–22.6	–12.2	–6.0	–0.4	–39.3	–13.2
Exports	19.9	28.1	65.2	53.4	8.4	11.8	93.5	93.4
Employees (thousands)	71.8	95.5	222.5	140.0	155.5	171.3	449.8	406.7
	With operating profit							
Number of firms	732	1 005	506	319	3 628	4 581	4 866	5 905
Sales	195.5	361.7	519.5	460.1	168.8	299.6	883.9	1 121.4
Operating profit	17.7	34.2	22.6	24.0	14.2	21.7	54.5	79.9
Financial profit	–1.7	–4.1	–13.2	–11.7	–2.1	–4.1	–17.0	–19.8
Extraordinary profits	–0.6	–1.9	0.0	–4.4	–0.3	–0.8	–0.9	–7.1
Pre-tax profits	15.4	27.6	9.4	7.8	11.8	16.6	36.6	52.0
Exports	12.5	18.8	53.0	49.3	4.9	8.6	70.4	76.6
Employees (thousands)	46.3	65.1	142.1	97.4	83.6	107.1	272.0	269.6
	With operating loss							
Number of firms	1 028	1 342	581	421	3 462	4 347	5 071	6 110
Sales	92.2	132.9	121.3	59.0	72.8	90.1	286.3	282.0
Operating profit	–20.2	–22.9	–22.9	–13.5	–14.2	–14.9	–57.3	–51.4
Financial profit	–2.6	–5.0	–8.0	–7.6	–2.9	–2.2	–13.4	–14.8
Extraordinary profits	–3.4	–0.3	–1.1	1.0	–0.7	0.0	–5.2	0.8
Pre-tax profits	–26.2	–28.3	–32.0	–20.1	–17.8	–16.9	–75.9	–65.3
Exports	7.4	9.3	12.2	4.1	3.5	3.3	23.1	16.7
Employees (thousands)	25.5	30.4	80.4	42.6	71.8	64.2	177.8	137.1

1. OP = operating profits; PBT = profits before tax.
Source: Ministry of Finance, tax records.

of all high-export manufacturing firms, as oppose to about 20 per cent of the total. Examination of the table yields several interesting insights. First is the relatively few number of highly export-oriented manufacturing firms: about 2 000 out of 14 000 total, accounting for 85 per cent of manufacturing exports. Second, exporting firms are much larger, two or three times the size of low-exporters either in terms of employees or average sales. Third, exporting firms were much more highly leveraged, presumably having better access to credit, especially foreign credit.

Perhaps most striking is the difference in productivity and profitability. Productivity was much higher among non-exporters, regardless of ownership. While not presented in the tables because of data problems, this difference in favour of non-exporters also showed up in estimates of value-added (total sales less material costs); this is probably consistent with an interpretation that exporting firms have a much higher import content. Profitability was higher for domestic non-exporters as compared to domestic exporters, though not foreign firms, indicating that foreign firms may find it more profitable to export than compete in local markets, while for domestic firms it is the converse. Finally, the export/ownership breakdown shows the large share of loss-makers among state-owned high-export firms, especially in 1992.

Notes

1. The tax files have been processed by GEII, the Institute of Economic Analysis and Informatics of the Ministry of Finance.
2. This may have been the case with MAV (Hungarian Railways) which, as a state firm, was registered in the 1992 data set with equity valued according to previous practice. Due to the revaluation changes, however, in 1993 MAV's equity amounted already to HUF 400 billion, making up more than 8 per cent of the total equity of firms covered by the statistics.
3. "Valued added" is defined as sales (net of VAT and excise taxes) less material-related costs.
4. Based on a survey conducted by the National Bank of Hungary. The coverage of this survey may be narrower than that of the Office of Banking Supervision.
5. While it seems that these definitions are in sharp contrast with the traditional way of determining the owners (those who had a simple majority in the registered capital), their viability may be confirmed by the fact that in 1992: *a)* the average share of foreign capital in Foreign firms was 57 per cent; *b)* the average share of state and local government equity in the capital of State and Local was 95 per cent; and *c)* the average share of owners other than the state and the local governments in the capital of the domestic private firms was almost 100 per cent. Further, a comparison of the State and Local with the companies with majority state ownership of the same sample shows that both in terms of per centage share in the total of almost all available balance sheet items and, hence, in the performance indicators, there was a very substantial similarity between the two definitions of "state firms" in 1992. In 1993 a remarkable differentiation occurred in the sense that the share of firms with majority state ownership dropped more slowly than that of firms with more than 25 per cent state and local government ownership. Nevertheless, the declining trend in the share of state firms within the total was clear in both sets of figures (the second data set is from GEII (MoF), "Az adóskonszolidációs és a világbanki EFSAL program keretében készült számitások, computations made within the framework of the debtor reconciliation and World Bank EFSAL program/", Budapest, 1994).

Annex III

Decomposing the trade balance

The Secretariat estimated a simple model of the Hungarian trade balance to help assess the overall competitiveness of the Hungarian economy. The model was also used to conduct some counterfactual simulations to measure the effects of various shocks on Hungarian trade performance. Given the severe limitations of the data and numerous econometric problems encountered the simulation results and the model itself must be interpreted with extreme caution, and treated as a simple exercise and not a rigorous econometric estimation of a structural model.

The model

The model consists of 6 equations, three each for exports and imports. Exports were split into four groups: total agricultural exports;[1] non-agricultural exports to developed market economies net of reprocessing; total reprocessing exports; and non-agricultural exports to all other economies. Equations were estimated for the first three categories of exports, the fourth was simply taken as exogenous for simulation purposes given the lack of any reliable measures of either foreign demand or the effective exchange rate. Imports were separated into agricultural, reprocessing, and non-agricultural imports net of reprocessing, with no geographic breakdown.

Exports (X) were modelled as a function of foreign demand (FD), the real exchange rate (R), domestic supply measures (for agriculture) (DS), and domestic demand (DD). The anticipated signs are presented in Eq. 1. Domestic sales were included because anecdotal information, and experience in other countries similar to Hungary indicated that there might be some crowding-out effects of domestic demand on export sales. It was expected in the case of agriculture that the small country assumption would hold, and that therefore external demand would not effect the level of agricultural exports.

$$X_t = x(\overset{+}{FD}_t, \overset{-}{R}_t, \overset{+}{DS}_t, \overset{-}{DD}_t) \qquad (1)$$

Imports were modelled simply as a function of domestic demand, domestic supply (for agriculture) and the real exchange rate.

$$M_t = m(\overset{+}{R}_t, \overset{-}{DS}_t, \overset{+}{DD}_t) \qquad (2)$$

Data Sources

All trade data was taken from a geographic and commodity breakdown of quarterly customs statistics made available by the Hungarian Central Statistical Office (CSO). The data was converted into US dollars using average quarterly exchange rates supplied by the same source. Non-agricultural trade figures were adjusted to take out the effect of MiG, natural gas and imports for repairs, as well as reprocessing which was treated separately. The data was not corrected for seasonality effects, which appear to be quite strong in Hungary.

A number of sources for external demand were tried. These were all in constant prices and included: OECD GDP, European Union GDP, and West German GDP, seasonally-adjusted and not adjusted. All data were taken from the OECD publication *Quarterly National Accounts*.

Domestic demand and supply are difficult to proxy in Hungary. For demand, quarterly national accounts figures are not yet available, and retail sales, despite several recent improvements, remain unreliable. As an alternative, domestic sales of industrial products was used, in constant (1985) prices. Domestic agricultural production was proxied using two sources: tons of bony meat produced, and tons of cereals harvested.[2] All of this data was drawn from the CSO's *Monthly Statistical Bulletin*.

Real exchange rate measures were calculated in terms of producer prices, against the ecu, the US dollar and a weighted average of the two. Exchange rate data was taken from the National Bank of Hungary's *Monthly Bulletins*; external producer prices were for the European Union and United States, from OECD sources.

Model estimation

All data were converted into constant price indices (where necessary) with 1992 Q1 = 100. The model was estimated in logarithmic form over 11 quarters, 1992 Q1 to 1994 Q3 using Ordinary Least Squares.[3] In general, several econometric problems were present in most of the estimations. Because of the small sample size, many coefficients could only be estimated approximately, resulting in large standard deviations and low t-statistics. This problem was reinforced by multicollinearity between many of the variables, so that coefficient estimates were unstable: the addition or substraction of regressors often caused large swings in coefficients. This was particularly the case because of the presence of strong seasonal trends, which in several cases showed up in spurious correlations and unbelievably high coefficient estimates; attempts were made to correct for this using deseasonalised independent variables. Given the smallness of the sample and crudeness of the data, more sophisticated time series techniques were not utilised.

Estimation of the export equations produced several interesting results. Of all the demand variables tried, West German GDP (not seasonally adjusted) was the most robust and produced the most reasonable estimates. Similarly, of the several real exchange rate variables, it was the Ecu measure which was the most significant; dollar-based measures

Table A5. **Trade equation estimates**[1]

	German GDP	REER ECU	Domestic sales	Cereals	Meat	R^2
Exports						
Non-agriculture, net of reprocessing	2.51 (1.59)[3] [0.37]	–1.87 (–2.45)[2] [–0.57]	–0.71 (–0.99)[4] [–0.21]			0.70
Reprocessing		–2.19 (–2.64) [2]				0.44
Agriculture		–1.94 (–1.34)[4] [–0.41]		0.13 (1.58)[3] [0.55]	0.29 (0.45)[4] [0.18]	0.68
	Reprocessing exports					
Imports						
Non-agriculture			1.97 (3.65)[2]			0.59
Reprocessing	0.72 (3.08)[2] [0.65]		2.04 (3.34)[2] [0.71]			0.66
Agriculture			1.82 (1.94)[3] [0.62]	–0.08 (–1.52)[4] [–0.46]	–0.40 (–0.94) [–0.33]	0.56

1. Estimated in logarithms using OLSQ on quarterly data 92 Q1-94 Q3. Beta statistics contained in brackets. Student's t-statistics in parentheses.
2. Significant at 5 per cent level in a one-tailed test.
3. Significant at 20 per cent level in a one-tailed test.
4. Significant at 40 per cent level in a one-tailed test.

Source: OECD Secretariat calculations.

showed little explanatory power. Real exchange rate coefficients ranged between –1.8 and –2.2, with the strongest effects showing up in reprocessing exports. Domestic demand did show up as a negative influence on both agricultural and non-agricultural exports, but not reprocessing. A foreign demand variable was found to be insignificant in agricultural exports, consistent with the *a priori* assumption that Hungary faces an infinitely elastic demand for commodity exports, and giving weight to the assumptions that EC agricultural restrictions are generally not binding. Neither foreign nor domestic demand variables were significant for reprocessing exports. These results confirmed the widespread belief in Hungary that reprocessing exports are very price sensitive. Regressions in which unit labour costs in foreign currency replaced real exchange rate measures provided even better results, but were not used for sake of simplicity. Equation estimates are presented in Table A5.

The major surprise on import equations was that coefficients on the real exchange rate were either the wrong sign (negative) or very close to zero and insignificant. This may be indicative of high price inelasticity of import demand, *i.e.* that many important are ''necessary'', raw materials and other inputs for which there are no domestic substitutes. In general, the coefficient on import demand ranged between 1.8 and 2.0.

Counterfactual simulations

Simple simulations of the six trade equations were conducted to assess the impact of the various external shocks and policy changes during the period on the trade balance.[4] In all cases non-agricultural exports to lesser developed market economies and economies and transition were set at the levels actually recorded from 1992-1994. The counterfactual assumptions and how they were modeled are:

- European recession: German GDP would have grown by 2.6 per cent annually, beginning with 1992 Q4.
- Real exchange rate appreciation: the real exchange rate is held constant at 1992 Q1 levels.[5]
- Agricultural drought and restructuring: cereals harvests would have remained at 1991 levels; meat production would have remained constant at 1992 Q1 levels;
- Domestic demand: constant at 1992 real levels.

The results (Table A6) show that the major causes of the large trade deficits in 1993 and 1994 was domestic demand and, to a lesser extent, the real exchange rate. Their relative role changed over the course of the two years. In 1993 both factors were important, with the real exchange rate effect being slightly larger. In 1994, domestic demand was the major reason the trade balance remained high as the real exchange rate returned to 1992 levels. (As is discussed in Chapter III, the strong demand response may be interpreted equivalently as a weak domestic supply response.) By contrast, the effects of the West European recession and agricultural problems were relatively small, each around $500 million annually. The simulations indicated that the drop in agricultural supply only explained about half of the deterioration of the agricultural trade balance; the other half was due to exchange rate movements and increased domestic demand. The

Table A6. **Trade balance[1] simulations**

All figures in millions of US$

	1992	1993	1994[2]	Cumulative
Trade balance				
Actual level	–387	–3 639	–3 521	
Actual change		–3 252	+118	
Base simulation level	–893	–3 045	–3 673	
Base simulation change		–2 152	–628	
Effects on trade balance[3]				
Agricultural problems				
Low coefficients	213	314	322	849
High coefficients	323	512	601	1 436
Real exchange rates	391	1 474	808	2 673
Domestic demand	44	1 140	2 452	3 636
European recession	20	446	553	1 019
Total				
Arithmetic (with low agri. estimates)	668	3 374	4 135	8 177
Interaction effects	679	3 582	4 338	8 600

1. All figures net of imports of MIGs, repairs and natural gas, imports.
2. Based on projections for first three quarters.
3. See text for definitions.

Source: OECD Secretariat calculations.

effect of lower West European demand played an even smaller role in explaining changes in Hungarian exports to that region.

Overall, the simulation showed that if all four negative effects had been reversed, the trade balance would have shown surpluses in 1993 and 1994 of $5-600 million. Put another way, removal of the effects of the real exchange rate and domestic demand would have left the trade balance in rough balance.

Notes

1. Agricultural exports (and imports) included processed food products.
2. The CSO does calculate a number of volume indices for agricultural production. These were not used because all of them are based on growth relative to the same period of the previous year, and are cumulative.
3. Lags were tried for most of the exogenous variables without improving the results.
4. Note that the model is a partial equilibrium approach and therefore has no feedback effects. For example, there is no relationship between the constant real exchange rate and inflation in the model, or between exports sales and domestic demand growth.
5. As such, the model does not give any insights as to the effects of the real exchange rate appreciation which occurred between 1989 and 1992.

Annex IV

Poverty and income distribution

Data sources

There are two sources for data on poverty and income distribution in Hungary. The first are annual household panel surveys conducted by TARKI, a private research institute, in conjunction with the Central Statistical Office (CSO) and Budapest Economic University. The panel survey has a relatively small sample size, but allows for annual comparisons and contains information on income distribution. Comparison of the panel survey results with household income estimates in the national accounts shows that the panel survey underreports overall income, particularly in areas like entrepreneurial income.

The other source is the household budget survey carried out annually (since 1991) by the CSO. This survey is based on a wider sample, contains expenditure as well as income data, and is much more detailed in measuring poverty by household type, especially with respect to household size. Using the budget survey data, Péter Szivós[1] has constructed three different measures of poverty: share of households below a measure of basic subsistence; share of households below the minimum pension level; and share of households below half the mean income level. Each of these definitions is problematic: the subsistence measure has the advantage of being an absolute measure, but yields estimates which seem too large, around half of the population; the other two are relative measures and generate very low (single-digit) estimates. Furthermore, the relative ranking between groups changes with the definition.

Income distribution became more differentiated

Income distribution[2] in Hungary, became more dispersed between 1982 and 1992, and this trend continued during the survey period. Between 1992 and 1994,[3] the growth rate of nominal household incomes[4] was directly correlated with income distribution: incomes of the top decile grew by 36.0 per cent whereas the bottom decile grew by 23.2 per cent (Table A7). As a result, the ratio of the top to bottom decile increased from 6.67 to 7.37.[5] There is also evidence that the income distribution became more dispersed, that larger extremes of poor and the rich at the ends of the distribution[6] (Figure A2). The changing income distribution does not necessarily reflect the status of individual households, since households move between different income groups over time. Between

Table A7. **Income distribution and factors affecting**[1]

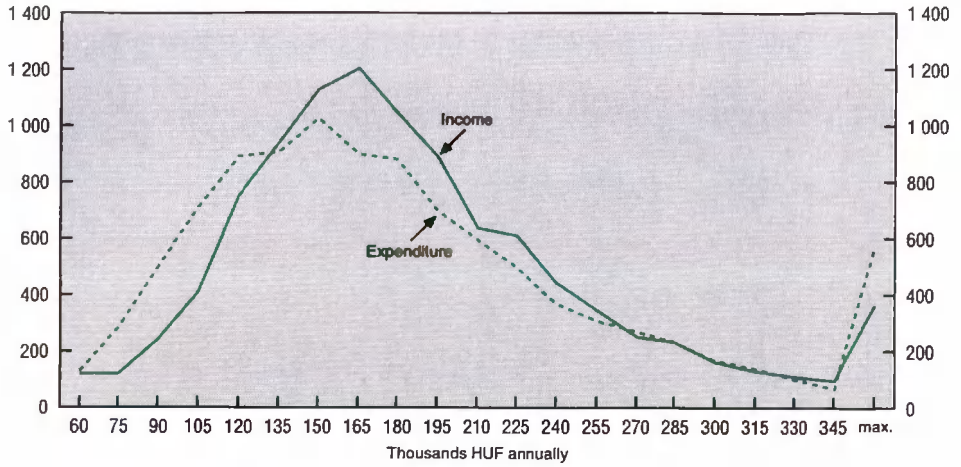
	1	2	3	4	5	6	7	8	9	10
Decile shares of income by income type:										
Total labour income	1.5	2.5	2.9	3.9	5.7	7.9	9.8	13.8	18.5	33.6
of which:										
Wages	1.5	2.5	2.9	3.9	5.7	8.0	9.9	13.9	18.5	33.3
Entrepreneurs incomes	4.7	1.1	0.0	0.0	1.8	1.4	5.8	8.8	20.4	56.2
Social benefits	5.4	9.8	11.7	12.1	12.0	10.9	11.1	9.2	9.2	8.4
of which:										
Pensions	4.9	9.5	12.1	12.6	12.1	11.0	11.0	9.0	9.0	8.7
Unemployment	15.0	18.1	9.4	9.4	9.3	11.5	10.7	5.6	8.8	2.3
Child support	6.7	12.5	11.9	7.8	15.6	9.8	14.9	10.3	6.6	3.9
Social assistance	12.9	9.4	8.4	10.2	9.2	10.3	9.9	11.2	9.6	9.1
of which:										
Welfare	24.4	7.9	8.1	19.2	8.5	15.5	5.8	4.4	6.1	0.2
Family allowances	10.0	10.2	7.9	9.5	9.7	10.6	11.0	12.0	10.8	8.4
Share of income types in decile's total income										
Wage income	21.7	24.3	24.7	29.3	37.8	47.7	52.2	62.7	67.5	72.0
Entrepreneurs	0.9	0.1	0.0	0.0	0.2	0.1	0.4	0.5	1.0	1.6
Social benefits	54.2	64.5	66.2	60.8	53.4	43.5	39.5	27.9	22.4	12.3
Social assistance	21.0	10.0	7.7	8.3	6.6	6.7	5.7	5.5	3.8	2.1

1. Household equivalent basis, per individual per million.

Source: Household panel Surveys, CSO and TARKI, 1994. Data covers April 1993-March 1994 or similar periods in previous years.

Figure A2. **DISTRIBUTION OF INCOME AND EXPENDITURE**

Thousands



Source: Hungarian Central Statistics Office.

1992 and 1994 mobility in Hungary was fairly high across income groups, except amongst the rich: 60 per cent of those in the upper quintile were still in that quintile two years later.[7]

The widening of income distribution was directly related with increased returns to education and job skills. Between 1992 and 1994, nominal incomes of the highly educated increased by around 50 per cent. This difference tended to decline directly with lower skilled jobs: incomes of clerical and unskilled workers increased at around half the rate of the highly educated. The exception was skilled and semi-skilled workers, in which case incomes of the latter grew more rapidly, consistent with the shift away from heavy industry.

Poverty is highest among the unemployed and in rural areas

As noted earlier, poverty measures in Hungary appear to either grossly under or over-estimate actual incidence, but all show a rising trend.[8] The largest numbers of the poor in Hungary are found among skilled and semi-skilled workers and pensioners primarily because of their large size in the population, though they also have slightly higher than average incidences of poverty. The unemployed account for an equally large share of the poor, but this is because of very high incidence. The incidence of poverty is also high among the disabled, those with low levels of education, and those living in rural

areas, especially in the eastern half of the country. According to the panel and budget surveys, respectively, 37.6 per cent of unemployed individuals were in the bottom quintile in 1994, and 25.8 per cent of unemployed households earned less than half of the mean income. The figures are only slightly better for the disabled. While poverty tends to correlate directly with job skills and education, one of the exceptions in Hungary is fairly high poverty levels amongst skilled workers, indicating the extensive dislocations which have occurred in much of heavy industry since the transition. Unemployment correlates with structural poverty: 18.6 per cent of the unemployed were in poverty for all three years covered in the panel survey.

Poverty is highest in rural areas and eastern Hungary, both in absolute and relative terms. Income levels in Budapest, which often impress the foreign visitor, are not representative of the country as a whole. In Budapest the income distribution is quite skewed: over 40 per cent of the population are in the upper quintile of the national income distribution, and two-thirds in the upper two quintiles, while only 8.6 per cent in the bottom quintile. While the income distribution is relatively flat in the rest of the country, the incidence of poverty rises steadily as one moves from provincial capitals to smaller cities to villages. This is reinforced by the regional disparities between East and West: the budget survey data show the incidence of poverty in the East to be double the rate in the West and North Transdanubia regions along the Austrian and Czech borders.

Evidence on the incidence of poverty amongst children and the elderly is very difficult to assess because it is affected by the problem of adjusting for household size.[9] In general, the results on family size are unclear and depend on the measure used: it appears that families with 3 or more children have high incidences of poverty, but this may reflect the effect of Gipsy families which are usually quite large. For pensioners, the budget survey results show that pensioners generally have incidence of poverty lower than the employed, but again this is sensitive to the equivalence scale used.

The chance of falling into poverty for a brief spell is very high

The problem of poverty in Hungary is not simply one of levels, but of high economic insecurity among the same elements of the population which tend to be poor. The panel survey includes statistics on the number of people who have been in the bottom quintile at any time during the last three years. These results (Table A8) reveal that for the unemployed and disabled, rural residents, *et al.*, the probability of having fallen into the bottom quintile over the last three years was between 40-50 per cent. However, even the fairly well-off or well-educated *e.g.* secondary school graduates, the probability of falling into poverty over the last few years was nearly 20 per cent.

The welfare system does little to improve the situation

The Hungarian social welfare system,[10] broadly defined, has done little to alleviate relative poverty despite its generous nature. Because of the emphasis on universal benefits and the large number of pensioners in the Hungarian system, a very high per centage of households – 75 per cent – receive some form of social insurance benefits and 40 per

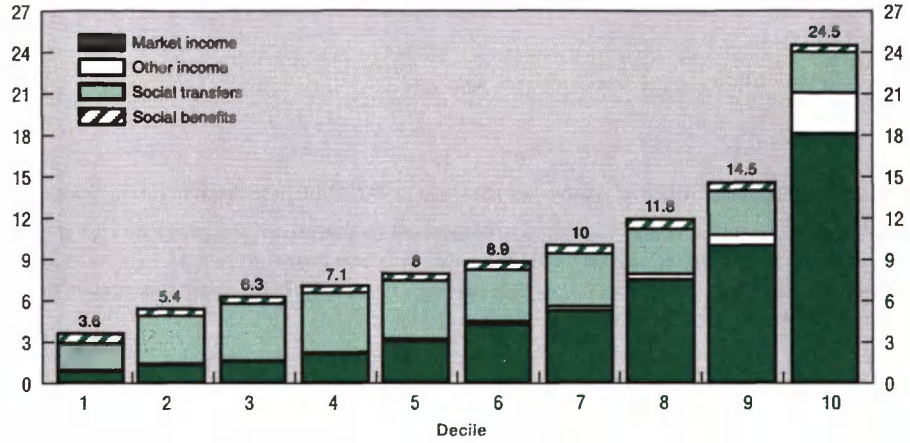
Table A8. **Poverty statistics by household type**

	Probability of ever being in poverty during 4/91-3/94[1]	In poverty for 4/91-3/94[1]	In poverty in 1994	
			CSO[2]	TARKI[1]
By education				
Less than primary education	35.6	8.0	9.4	18.5
Primary education	39.9	8.8	7.9	24.7
Vocational graduate	33.1	6.7	4.4	17.8
Secondary graduate	19.4	2.1	1.9	9.8
University graduate	11.1	0.3	2.0	2.9
Not employed population				
Old age pensioners	18.0	1.5	4.39	7.8
Old age pensioners with jobs	16.2	1.6	4.39	3.2
Maternity benefits	54.2	2.5	8.48	27.2
Unemployed	53.1	18.6	25.8	37.1
By occupational status				
High + medium-level managers	10.2	2.0	1.5	6.2
Clerical workers	20.2	1.8	1.6	9.1
Skilled workers	25.1	2.8	2.2	11.6
Unskilled workers	16.4	4.5	7.9	18.6
Agricultural workers	43.3	5.5	..	28.1
Self-employed	41.1	6.3	7.4	23.6
By location				
Budapest	18.5	1.2	3.0	7.8
Provincial capitals	29.5	5.5	4.66	14.8
Small cities and towns	33.3	6.3	4.66	19.5
Villages	40.3	10.4	6.3	24.2
By region				
Central			3.9	
North Hungary			6.5	
North plain			7.6	
South plain			6.4	
West Transdanubia			2.6	
North Transdanubia			3.1	
South Transdanubia			4.6	
South Transdanubia			5.0	
Gypsies	85.6	57.1		68.7

1. TARKI defines poverty as being in the bottom 20 per cent of the income distribution. Year defined as April-March.
2. CSO definition of poverty as half mean income, on calendar year basis.

Source: TARKI, Central Statistical Office.

Figure A3. **DISTRIBUTION OF MARKET INCOMES, SOCIAL BENEFITS AND TRANSFERS**
Per cent



Source: Hungarian Central Statistics Office.

cent receive some form of social transfer. More importantly, these programs have only a limited impact on ameliorating the income distribution as their distribution is fairly flat across income levels. As can be seen in Figure A3 (household panel survey basis), social insurance benefits tend to go toward the middle and upper deciles, with the four middle deciles receiving 46 per cent of total insurance. Social transfers are only moderately better, with the top and bottom three deciles receiving exactly the same level of benefits –30 per cent. This is largely the result of the impact of family allowances, which are by far the largest social benefit program and account for 4 per cent of total household income (based on the panel survey data). The changes in family allowances announced as part of the government's March 1995 programme should result in better targeting.

Notes

1. See Péter Szivós, *Profile of poverty in Hungary, 1993*, Budapest, March 1995, processed.
2. All references in the text to income distribution are to analysis of the panel surveys in articles by Andonka and Spéder, and by Tóth, in *Social transformation – Report of the results of the III wave of the Hungarian household panel survey*. The analysis of poverty is drawn from the work of Péter Szivós, *op. cit.* using the budget survey data.
3. Figures for given years refer to the year ending in March of that year, *i.e.* 1994 refers to the year of April 1993 to March 1994.
4. Calculated based on income per capita by decile, on a household-equivalent basis.
5. It is likely that the panel survey data understates the deterioration because of the underreporting of non-wage market incomes: 75 per cent of reported non-wage market incomes accrue to the top quintile of the income distribution.
6. See Péter Szivós, Income distribution in Hungary in the Early 1990's, Budapest, processed.
7. On per capita basis, unadjusted.
8. The incidence of poverty on a minimum subsistence basis has soared from 10.1 per cent in 1987 to 55.3 per cent of the population in 1993. Measures based on the minimum pension or half of the mean income, which both give levels of under 5 per cent, show increases of 66 and 42 per cent, respectively.
9. The panel survey data indicates that poverty is inversely correlated with age (poor children, rich pensioners), but this does not make adjustment for household size. Most of these calculations are based on per capita household incomes, so that large families with many children are classified as low-income, whereas the elderly, with smaller households, are shown to be relatively well-off. Nor is the implicit assumption that the poor tend to have larger families in fact correct: there is a large grouping of large families at both high and low income levels. Péter Szivós' analysis of the budget survey data, which uses what is referred to (incorrectly) as the "standard OECD" equivalence scale adjustment, can be used to analyse households based on number of children, or across household categories holding household size constant.
10. The system divides social programs into two types of benefits: social insurance and social transfers. Social insurance includes old age pensions, disability pensions, unemployment benefits, maternity benefits, and sick pay. Social transfers are, in theory, more targeted to helping disadvantaged households. These programs include unemployment assistance (after unemployment insurance expires), family allowances, and social assistance (or welfare).

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