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Program: Gradualism Returns

II. State Desertion: Myth or Reality  
in Hungary?

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Hungary's Loan Consolidation Program:

Gradualism Returns

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Abstract

The recently announced Hungarian loan consolidation program removes a significant portion of the nonperforming (bad) loans from the balance sheets of the three large state-owned commercial banks without the potential for excessive inflationary loan creation. The 1992 balance sheets of the banks are affected retroactively; capital adequacy ratios increase substantially and tax liabilities for 1992 and beyond also increase. The banks are partially recapitalized by a "combination" financial instrument that provides a stream of variable-return liquidity in exchange for a deferred balloon-payment liability at maturity in twenty years. We demonstrate that the instrument has positive net present value to the banks under reasonable forecasts for financial parameters. We also compute the impact of the program on the financial statements of Budapest Bank. A potential problem is identified as the deferred liability could affect the attractiveness of Hungarian commercial banks to new equity holders if bank privatization is delayed. Hence, the necessity to link bank privatization closely to any loan forgiveness program emerges as one lesson from the Hungarian experience. Since the financial instrument used is not a liquid asset, banks reserves are not increased significantly in the immediate period. Hence, the inflationary potential of bank recapitalization is minimized compared with programs that replace bad loans with government securities and, thus, create substantial excess reserves.



In an attempt to ease the bad debt burden on Hungarian commercial banks, the Ministry of Finance (MoF) and the Hungarian Investment and Development Rt (HID) announced the terms of a loan consolidation program to begin in March 1993. All commercial bank debt classified as "bad" by October 1, 1992 is eligible for participation.<sup>1</sup> The arrangement allows the banks to swap loans so classified for a special state financial instrument.<sup>2</sup> Upon removal from the balance sheets of the commercial banks, the bad loans are placed with HID which arranges the contractual terms for their workout.<sup>3</sup> The impact of cleaning up the balance sheets falls on the banks' 1992 profit and loss statements.<sup>4</sup> Whether

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<sup>1</sup> According to the Hungarian Banking Act, debt is qualified as "bad" if the loan is at least 360 days overdue or if the debtor is undergoing liquidation according to the Bankruptcy Act.

<sup>2</sup> Debt that was guaranteed by the government and certain types of bad loans (e.g., debt held from a company that is being bailed out by either the State Property Agency or the State Assets Holding Company) are swapped at 100% of their face value with the approval of the MoF. Other "old" debt, i.e., loans that were classified as bad as of December 1991, is swapped at 50% of face value. "New" bad loans, i.e., loans that were classified as bad in 1992 from January to October, are exchanged at 80% of face value. The capitalized accumulated interest arrears is treated differently from the principle of the loan in that only 50% of it is eligible for compensation with the above fractional replacement coefficients then applied.

<sup>3</sup> Although plans are not yet finalized, it is likely that a significant portion of the bad loans will be worked out under contract with HID by the banks that initially held them.

<sup>4</sup> The banks were allowed to determine the extent to which they would participate by designating the bad loans they wished to exclude from consideration by March 10, 1993. However, all eligible debt had been designated as "bad" according to the standards of the banking act before the loan consolidation scheme was announced. Hence, adverse selection problems were minimized. Furthermore, the government did announce that the loan consolidation program scheme is to be a once-only offer to avoid incentive (moral hazard) problems although "extensions" for a second phase in 1993 are now under consideration.

Hungary's loan consolidation program is sufficient to resolve the gridlock affecting Hungarian financial market depends crucially on the effect of the new financial instrument on the banks' balance sheets and the tax treatment of freed-up loan-loss reserves.

To eliminate bad debt from the commercial banks' balance sheets, the government is authorized by the 1993 budget law to issue special credit consolidation bonds (CCBs). The CCBs have a maturity of 20 years and bear interest equal to the average yield of 90-day Treasury bills (T-bill) payable in quarterly installments to the banks beginning in March 1994. However, the bank is assessed a participation fee of 50% of the income generated so that the net yield of the CCB is only 50% of the T-bill yield. In return for this stream of earnings, the bank is liable to pay the government the face value of the CCB at maturity. Hence, the CCB is a deferred liability for the bank with a balloon payment equal to its face value at maturity in exchange for an up-front variable interest payment. The loan consolidation program allows the banks to swap a non-performing asset (the bad loan) for increased current liquidity with an obligation to pay back the "loan" to the government twenty years later.

To determine the extent to which the program recapitalizes the commercial banks, we calculate the net discounted present value (NPV) of a HUF (forint-valued) 100 CCB to a participating bank for various specifications of the T-Bill yield ( $y$ ) and the

discount rate ( $r$ ) in Appendix A. For example, setting  $y = 14\%$  and  $r = 13\%$ , the NPV to the bank is HUF 39.78.<sup>5</sup> As the table indicates, the NPV of the CCB is positive from the bank's perspective for a wide range of parameter values and it increases as both the discount rate and T-bill yields increase. Since, increased inflation should be reflected in increases in both  $y$  and  $r$ , the bank stands to gain as inflation increases. On the other hand, the bank assumes the risk of significant decreases in inflation. As the table indicates, if  $y$  and  $r$  were to fall into the middle single digits, the NPV becomes negative as the balloon payment at the end of the term dominates the now lower stream of variable returns. As an interesting (and most likely unintended) corollary, the CCB imposes some financial discipline on policy makers since increases in inflation increase the state's obligation to the banks.

The immediate impact of the loan consolidation program is to improve dramatically the capital adequacy ratios of the Hungarian commercial banks for 1992. In Appendix B, we present an illustration of this effect using a stylized profit and loss statement based on 1992 data for Budapest Bank (BB), one of the four large state-owned commercial banks in Hungary. Without loan consolidation, the capital adequacy ratio would be 2.7%; with

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<sup>5</sup> In other words, if a competitive secondary market existed in which CCBs were transacted at a price equal to their NPV, the bank could recoup about 40% of the value of participating bad debt by immediately selling the CCB. However, the emergence of a competitive secondary market for this deferred liability is extremely unlikely.

loan consolidation, the same ratio is 11.8% well above the BIS target of 8% required by the Hungarian Banking Act. Some skeptics view the loan consolidation program as an accounting artifice to allow the currently insolvent commercial banks to satisfy these regulatory constraints.

Must the participating banks be better off after loan consolidation? The question arises because the agreement does not replace bad loans fully so that some write-offs from loan-loss reserves are necessary. Furthermore, accounting regulations treat any excess reserves released in loan consolidation as income in 1992 for the purpose of computing tax liability. Hence, some critics consider the program to be an attempt by the MoF to collect (much-needed) fiscal revenues from the banks. Taking the example of BB in Appendix B, we illustrate the effect of loan consolidation on its reserves and its 1992 tax liability. Removing the bad loans creates excess loan-loss reserves and BB's tax liability increases from zero (profits of negative HUF 2 billion without consolidation) to HUF 1 billion yielding HUF 0.4 billion in additional taxes for the fiscal budget. BB loses an additional HUF 3 billion of loan-loss reserves due to write-offs in consolidation for a total loss in 1992 of HUF 3.4 billion. If the CCBs are "worth" 40% of their face value as calculated above, the value to BB of the newly acquired HUF 14 billion in CCBs is HUF 5.6 billion for a net gain in real assets of HUF 2.2

billion.<sup>6</sup> From this figure, the bank's expected net recovery value from the working out the bad loans had they not been replaced must be subtracted. Hence, BB may not be significantly recapitalized by the loan consolidation program in the long run.

Furthermore, the prospects for bank privatization may not be improved as expected. Nonperforming assets with a highly uncertain, perhaps negligible value are replaced by CCBs with positive net value when issued. However, if privatization is delayed significantly, the deferred balloon-payment liability becomes more onerous to potential new equity holders. Hence, the CCBs in the bank's portfolio could become eventually a debt-impediment to bank privatization. On the other hand, judicious use of the initial interest returns should bolster the financial situation of the banks and improve their prospects for privatization. Nonetheless, we suggest that bank privatization should follow quickly on the heels of the loan consolidation program to avoid any negative impact from the deferred liability.

Why did the Ministry of Finance choose such an unusual financial instrument (really a combination of instruments) to replace the banks' bad loans? The likely answer lies in a

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<sup>6</sup> Not only are 1992 tax liabilities increased at a time when the fiscal budget is in serious deficit (7.1% of GDP), but the banks are no longer responsible for generating future loan-loss reserves against the "cleaned-up" bad loans (for BB, compare lines (i) and (y) in Appendix B). Since provisions are accumulated from pre-tax income, loan consolidation increases the banks' future tax liabilities as part of future income need no longer be set aside for provisioning against "old" bad debt. The future increase in tax liability was not considered in the calculation of the net benefit to BB of the program.

concern about the inflationary implications of recapitalizing the banks. If the banks were recapitalized by a highly liquid government security (as some have recommended), bank reserves would increase dramatically leading to the possibility for a rapid expansion of bank lending. However, the CCB is a deferred liability for the banks so the inflationary potential of the consolidation program is minimized. The injection of new capital to banks is more gradual as it equals the stream of variable returns per quarter over a twenty-year period plus the regular earnings freed-up in the next year or two because provisions need not be accumulated against the replaced bad loans. Furthermore, bank reserves do not increase immediately by the NPV of the CCB because the instrument is not negotiable. Hence, the potential for loan creation is phased in over time rather than increased in a one-shot expansion of reserves. Hungary's loan consolidation program follows in the gradualist tradition of its other transition policies.

Appendix A: Net Present Discounted Value to the Bank of a HUF 100 CCB at Alternative Values of Treasury Bill Yield ( $y$ ) and Discount Rate ( $r$ )

Table

T-Bill Yield (%)	Discount Rate (%)	NPV of HUF 100 CCB
5	5	-6.67
10	9	27.42
14	13	39.78
20	18	48.58
25	22	52.03

Note: In calculating the NPV of CCB we use the following income flows to reflect the actual arrangement: year 1; 0, year 2; T-Bill yield, years 3 to 19; one-half of the T-Bill yield, year 20; minus 100 plus one-half of the T-Bill yield.

## Appendix B: Loan consolidation: A numerical example

## Operative Assumptions:

- (i) Provisions from 1992 profits in excess of required provisions are put back into profits and taxed.
- (ii) The Banking Act considers required provisions in 1992 to be one-third of the difference between required reserves against bad debt and actual loan-loss reserves at the end of 1991.
- (iii) Corrected assets are calculated by applying the appropriate weights from the Hungarian Banking Act to adjust balance sheets assets for risk.
- (iv) Bad loans covered by state guarantees do not require loan-loss reserves.

Case 1: No loan consolidation

- a) Required loan-loss reserves against bad debt: HUF 25 Billions
- b) Write-offs for loan losses during 1992: 1
- c) Provisions set aside in 1992: 6
- d) Loan-loss reserves as of Dec. 31, 1991: 10
- e) Net Income (1992): 4
- f) Profits before provisions:

$$f = e - b = 4 - 1 = 3$$

- g) Revised profits corrected for provisioning due to required loan-loss reserves using assumptions (i) and (ii):

$$g = f - (a-d)/3 = 3 - 5 = -2$$

- h) Available loan-loss reserves on December 31, 1992:

$$h = d + c - b = 10 + 6 - 1 = 15$$

- i) Non-generated provisions:  $l = a - h = 25 - 15 = 10$
- j) Corrected assets using assumption (iii): 110
- k) Adjusted capital defined as share capital plus general reserves (13) minus non-generated provisions (10) = 3
- l) Capital adequacy:  $(k/j) = 2.7 \%$

Case 2: Effects of loan consolidation

- m) Bad loans placed with HID in exchange for CCBs: 17  
 n) - of which those not covered by state guarantee: 16  
 o) - of which those covered by state guarantee: 1  
 p) Required loan-loss reserves after consolidation using assumption (iv):

$$p = a - n = 25 - 16 = 9$$

- r) CCBs (excluding negligible cash payments = see below): 14  
 s) Loan write-offs in consolidation:  $s = m - r = 17 - 14 = 3$   
 t) Excess provisions after consolidation:

$$t = d + c - b - p - s = 10 + 6 - 1 - 9 - 3 = 3$$

- x) Revised profits:  $x = g + t = -2 + 3 = 1$   
 y) Non-generated provisions: 0  
 z) Capital adequacy:  $(13/110) = 11.8\%$  (see (k), (y) and (j))

The calculation of (r) in the loan consolidation scheme

According to the consolidation agreement, if a loan that was classified as bad prior to December 31, 1991 belongs to a company that the State Property Agency and the State Assets Holding Company chose to bail out, the bank is credited for the full face value. This category amounts to approximately 35% of HUF billion 17 in (m). For other loans which were classified as bad before December 31, 1991 (about 15% of the total), the bank is credited with only 50% of face value and it must write off the remaining 50%. For loans classified as bad during 1992 (as of October), the bank is credited with 80% of face value and it must write off 20% of their value. Since the majority of bad debt at BB is "new" by this definition, approximately half of the loans placed with HID fall into the 80% category. Applying the appropriate weights, HUF 17 billion in (m) becomes HUF 14 billion in (r). Furthermore, the agreement provides for a split between cash compensation and CCBs so that, for an HUF 10 million allocation to (r), the bank receives HUF 100 in cash plus HUF 999.999.900 in CCBs. Hence, HUF 14 billion in (r) means that BB receives 1.7 million in cash (which we consider negligible) and 13,998.3 million in CCBs.



## State Desertion: Myth or Reality in Hungary?

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### Abstract

The transition from a bureaucratically managed socialist economy to a market-oriented capitalist economy requires the state to withdraw from micro-managing the economy. Direct subsidies to both producers and consumers as a percent of GDP have decreased dramatically in the countries in transition. Immediately following these reductions, the economies of these countries were plunged into a deep recession. Did the state "desert" its dependent economic agents too rapidly? Aggregate data from Hungary indicates the government expenditures as a percent of GDP actually rose since 1990. However, as we show, if the figures are adjusted for the effects of the severe recession, aggregate expenditures as a percent of GDP fall by ten basis points from 1989 to 1992 moving Hungary from a ratio that was above any mixed market economy in 1989 to one that, in 1992, is at the high end of the middle-tier of such economies (e.g., the Scandinavian countries). Over the same period, aggregate support for the household sector dropped by two percent of GDP, a decrease approximately equal to the reduction in direct subsidies. Moreover, the composition of this support (measured as a percent of "corrected" GDP) changed as unemployment compensation increased (from zero), expenditures on health and education remained relatively constant and other categories decreased. Hungary's recent experience leaves open the question of what is the appropriate mix of state support and non-intervention (state desertion) that is necessary to nurture the emergence of both strong market institutions and properly behaving market players.

Most of the Central East European (CEE) countries in transition are entering the third year of a deep recession. The austerity programs pursued to stabilize these economies reduced private sector demand significantly. Liberalization of both prices and external trade added an inflationary shock to which the policy response was increased austerity. As the recession deepened, the tax base eroded and transfer payments increased plunging the fiscal budget into serious deficit. The budget deficit soaks up private savings that would be better channeled into financing the business expansion necessary to initiate and nurture the supply response to price liberalization. High and rising unemployment evokes pleas for stimulation that would increase further the budget deficit while the specter of "reinflation" hangs heavily over a fragile monetary balance. Given this scenario, what is the proper role of the state during the transition period?

Due to its predominant, almost all-embracing, past role in the socialist bureaucratically managed economy, the state must obviously withdraw from the micro-management of the economic sphere to orchestrate a successful transition to a mixed market economy. However, the crucial task for the government is to design the appropriate mix of support and non-intervention that will nurture the emergence of strong market institutions and players. The major difficulty facing policy makers is the lack of an historical precedence for such a radical restructuring of the state's role in so short a period of time. The main danger is that the state's withdrawal from economic activity is a

contributing cause to the recession that threatens further progress in the transition. As a working definition, we take state desertion to mean a rapid and continual decrease in the state's involvement in the aggregate economy. Since the institutional and behavioral preconditions for a well-functioning market mechanism are underdeveloped, state desertion creates a lacuna that may prove to be severely dysfunctional.

Janos Kornai documents the extent to which the new democratic systems have inherited large government bureaucracies.<sup>1</sup> The predominance of the state in economic activity is measured as the ratio of the general government budget to GDP. As Table 1 indicates, the Hungarian government redistributes about 60 percent of GDP whereas the typical proportion in market economies is between 40 and 50 percent (in the U.S. economy, it is significantly below 40 percent). In Table 2, consolidated general government expenditures and revenues as a percent of GDP are recorded for Hungary from 1985 to 1993 (target). Not only are both ratios inordinately high by international comparison, but expenditures as a percent of GDP have been increasing since 1990 after a significant drop in 1990. Given this aggregate data, should we conclude that in Hungary state desertion is a myth?

After having stagnated with low real growth in the second

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<sup>1</sup> Kornai, J, "The Postsocialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems" American Economic Review, Papers and Proceedings, Vol 82, No. 2, May 1992, pp. 1-21.

half of the eighties, the Hungarian economy slid into a recession in 1990 with real GDP falling by 3.5%. The recession deepened in 1991 and continued in 1992 as real GDP declined by 12% and 5% respectively. In market economies, recessions are accompanied by fiscal budget deterioration due to increased transfer payments and decreased taxable income. Might the recession be responsible for the increasing ratio of expenditure to GDP in Hungary? To "correct" the data in Table 2 for the effect of the Hungarian recession, we calculate the expenditure and revenue ratios for 1990, 1991, and 1992 as if GDP had been maintained at its 1989 level. Then, a starkly different picture emerges. Expenditures as a percent of 1989 GDP are 54.4, 50.8 and 51.4 for 1990, 1991, and 1992 respectively. For the same years, revenues as a percent of 1989 GDP are 55.6, 48.1, and 45.6. Therefore, after adjusting for the recession, the aggregate figures do support the "state desertion" hypothesis as the ratio of expenditures to non-recessionary GDP fell by ten points (or almost 18%) from 1989 to 1992. At 51.4% as the ratio of expenditures to GDP, Hungary would be placed in the upper tier of Western market economies.

Whether or not GDP is corrected for the recession, the state's withdrawal from micro-management of the economy is evident. In Table 2, subsidies to enterprises decline from 13.5% of GDP in 1987 to 4.4% of uncorrected GDP in 1992. In Table 3, consumer price subsidies as a percent of corrected GDP falls from 2.57 in 1989 to 0.56 in 1992. Table 3 also provides information on the changing composition of support for households. Although

expenditures on health and education remain roughly constant when corrected GDP is used, unemployment compensation which was nonexistent in 1989 grows to 3.1% of actual GDP in 1992 (with a projected value of almost 5% in 1993). However, total support to households corrected for the recession decreases from 34.87 to 32.73% for a decline of 2.14 percentage points. Consequently, aggregate state support of households is declining to reflect the decrease in direct subsidies while its composition is changing to reflect the new and growing social safety net expenditures for unemployment.

Eliminating the state's direct interference with markets through price subsidies to consumers (and firms) is a welcomed outcome. The transition to a market economy requires the state to withdraw from micro-managing the economy. However, an overly abrupt and continual decrease in state support of the aggregate economy may jeopardize the momentum of the transition. When adjusted for the effect of the recession on real GDP, aggregate expenditure to GDP falls by ten points in three years. The abruptness of state desertion then becomes apparent. Furthermore, support of the household sector decreases by two percent of GDP, approximately equal to the decline in direct subsidies. Resources devoted to health and education are maintained relatively constant while the rapidly increasing support provided as unemployment compensation crowds out other types of indirect support. Whether or not such a change is sufficiently dysfunctional to interfere with the transition requires an

analysis of the effects of state desertion on the major sectors of the economy.<sup>2</sup> However, the aggregate data does indicate that state desertion is more reality than myth!

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<sup>2</sup> The effects of state desertion on the financial sector are discussed in Istvan Abel and John P. Bonin, "State Desertion and Financial Market Failure: Is the Transition Stalled?" a paper prepared for the UN-WIDER conference on "The Role of State in Economic Change" in Cambridge, U.K., April 17-18, 1993.

Table 1  
Summary of General Government Operations:  
International Comparison  
(as Percentage of GDP)

Country	Revenues	Expenditures	Deficit (-) or Surplus (+)
Hungary (1987)	61.0	63.0	-2.0
Hungary (1989)	58.7	61.4	-2.7
Hungary (1991)	57.7	59.7	-2.0
Hungary (1992) <sup>1</sup>	56.5	63.6	-7.1
Hungary (1993) <sup>2</sup>	55.9	62.6	-6.7
Netherlands (1989)	51.1	56.6	-5.5
Sweden (1988)	59.1	56.9	2.2
Denmark (1989)	59.6	59.4	0.2
Belgium (1987)	47.8	54.7	-6.9
Austria (1989)	46.9	49.7	-2.8
France (1989)	46.2	47.8	-1.6
Germany (1987)	46.0	47.9	-1.9
Poland (1987)	47.4	47.6	-0.3
Rumania (1987)	52.8	45.5	7.3
Canada (1987)	40.3	44.7	-4.4
U.K. (1987)	42.7	44.0	-1.3
Finland (1987)	42.7	43.9	-1.2
Spain (1987)	35.0	38.6	-3.6
U.S.A. (1987)	34.9	36.9	-2.0

Source: Kornai (1992, p. 5) and Muraközi (1992, p. 1051 and 1053) for the data for countries other than Hungary. For Hungary data are revised and corrected by László Borbély of the Ministry of Finance.

<sup>1</sup> Expected for 1992 as of February 1993.

<sup>2</sup> Planned for 1993.

Table 2

Summary Table of Consolidated General Government  
Hungary, 1985-1993  
In Percentage of GDP

Year	Total Expenditures	Total Revenues	Surplus (+) Deficit (-)	Subsidies to Enterprises		
				Central Government	Extrabudgetary Funds	Total <sup>1</sup>
1985	60.9	60.3	-0.6	8.8	3.7	13.2
1986	64.6	61.5	-3.1	9.6	3.7	14.0
1987	63.0	61.0	-2.0	9.3	3.5	13.5
1988	61.6	61.5	-0.1	7.1	3.3	11.3
1989	61.4	58.7	-2.7	4.3	2.9	7.7
1990	56.4	57.6	+1.2	3.4	2.6	6.2
1991	59.7	57.7	-2.0	2.4	2.3	4.8
1992 <sup>2</sup>	63.6	56.5	-7.1	2.0	2.3	4.4
1993 <sup>3</sup>	62.6	55.9	-6.7	1.7	2.1	3.9

Source: Ministry of Finance Hungary. Consolidated data are revised and corrected by László Borbély.

<sup>1</sup> Total includes Central Government, Extrabudgetary Funds and Municipalities.

<sup>2</sup> Expected for 1992 as of February 1993.

<sup>3</sup> Target for 1993 in the budget plan.

Table 3

General Budgetary Expenditures for Households  
as a percentage of GDP

## Hungary

Year	Consumer Price Subsidy	Health	Education	Unemployment	Other <sup>1</sup>	Total
1985	4.85	3.80	6.37	-	13.25	28.27
1986	5.49	3.94	6.03	-	14.1	29.56
1987	5.44	3.74	5.73	-	13.58	28.49
1988	3.09	3.89	4.68	-	19.48	31.14
1989	2.57	4.56	5.49	-	22.25	34.87
1990	1.77	5.21	6.55	0.12	22.26	39.17
1990C	(1.70)	(5.02)	(6.32)	(0.11)	(21.48)	(37.79)
1991	1.83	5.85	7.39	0.84	24.65	40.56
1991C	(1.55)	(4.97)	(6.28)	(0.71)	(20.95)	(34.48)
1992 <sup>2</sup>	0.73	6.13	6.67	3.10	23.26	39.89
1992C	(0.59)	(4.95)	(5.38)	(2.50)	(18.78)	(32.21)
1993 <sup>3</sup>	0.68	5.67	5.88	4.95	22.01	39.19

Note: For the years 1990-1992 we corrected the data for the effect of the recession. Data in parentheses are ratios calculated by assuming no change in GDP.

Source: Ministry of Finance Hungary. Consolidated data are revised and corrected by László Borbély.

<sup>1</sup> This category includes expenditures on culture, sports, pensions, dependent care benefits and sick benefits.

<sup>2</sup> Expected for 1992 as of February 1993.

<sup>3</sup> Planned figure.