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INTERNATIONAL MONETARY FUND

HUNGARY

Recent Economic Developments and Background Issues

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Approved by the European I Department

March 10, 1995

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Hungary - Basic Data

Population (end-1993)	10.3 million				
GDP per capita (1993)	US$3,707				

	1990	1991	1992	1993	Estimate 1994
Real economy (change in percent)					
Real GDP	-3.5	-11.9	-4.3	-2.3	2.6
Real domestic demand 1/	-3.1	-9.4	-6.1	7.0	5.3
Of which:					
Private consumption	-3.6	-5.8	-1.3	1.4	1.6
Gross fixed investment	-5.2	-0.6	-2.8	-0.7	13.8
CPI (end-year)	34.6	31.0	24.7	21.1	21.2
GDP deflator	26.0	26.0	21.7	24.2	20.0
Employment	-0.6	-3.1	-9.6	-9.3	-1.8
Unemployment rate (in percent of labor force)	1.4	7.5	12.3	12.1	10.9
Public finance (percent of GDP)					
Consolidated state budget balance (GFS) 2/	0.9	-4.0	-6.6	-7.5	-6.0
(Excluding privatization receipts)	0.9	-4.0	-7.3	-7.5	-6.8
Public debt					
General government	63.3	75.9	80.8	91.1	88.4
Consolidated public sector 3/	56.5	67.7	66.5	84.5	82.5
Money and credit (end of year, percent change)					
Domestic credit	...	8.0	10.3	16.8	13.8
Broad money (M2)	...	29.4	27.3	16.8	13.6
Interest rate (90-day treasury bills, end-December)	33.7	32.4	14.7	24.3	31.8
Gross national saving 4/	27.3	17.8	14.4	9.2	12.4
Gross investment 4/	25.4	20.4	15.2	19.7	21.3
Balance of payments					
Current account (percent of GDP) 4/	1.2	0.9	0.9	-9.6	-9.5
(Billions of U.S. dollars)	0.3	0.4	0.3	-3.5	-3.9
Reserves in convertible currencies					
(National valuation of gold, billions of U.S. dollars)	1.2	4.0	4.4	6.7	6.8
(In months of merchandise imports)	2.3	5.3	5.2	7.1	7.2
Gross external debt in convertible currencies					
In percent of GDP	64.6	73.3	63.4	64.4	69.5
In billions of U.S. dollars	21.3	22.7	21.4	24.5	27.7 5/
Public and publicly guaranteed debt	18.0	18.9	17.8	20.4	21.5 5/
Of which: private creditors	15.3	15.1	14.0	16.5	17.4 5/
Of which: bonds	4.7	6.0	6.8	10.6	12.5 5/
Short-term debt	2.9	2.2	2.3	2.0	2.2 5/
Net external debt in convertible currencies					
In percent of GDP	48.4	47.1	35.7	41.4	46.3
In billions of U.S. dollars	15.9	14.6	13.1	15.0	19.0
Debt service ratio 6/	52.3	35.0	38.6	47.4	60.8
Exchange rate					
Nominal effective rate (1985 = 100)	58.5	51.9	49.1	47.6	40.8 7/
Real effective rate (1985 = 100)	87.1	98.7	106.5	117.4	117.4 7/

Sources: Data provided by the authorities; and official and staff estimates.

1/ Excludes in 1993 imports of military equipment from Russia in lieu of outstanding claims by Hungary.
2/ Includes the activities of the State Development Institution; in 1990, adjustments are made to both revenues and expenditures relating to the financing of local councils to render these comparable with later data.
3/ Consolidation of general government and central bank debt.
4/ Current account deficit is on a settlements basis and differs from the saving-investment balance which is on a national accounts basis.
5/ End-September 1994.
6/ In percent of exports of goods and nonfactor services.
7/ November 1994.

I. Introduction

The downward trend in measured aggregate output that had begun in 1990 reached its trough during 1993 and Hungary recorded its first positive GDP growth in five years in 1994, estimated at about 2 1/2 percent. At the same time, progress with respect to inflation remained slow and the annual increase in consumer prices, after some decline early in the year, stood at about 21 percent at end-1994, little changed from 1993. Overall, macroeconomic developments in Hungary during 1993-94 were overshadowed by large fiscal and external imbalances. The deficit of the consolidated state sector budget averaged about 6 3/4 percent of GDP during 1993-94, and the external current account deficit swung from a small surplus in earlier years to a deficit of nearly 10 percent of GDP in 1993-94, notwithstanding a substantial tightening of monetary policy from mid-1993 onward. The external deficits resulted in a sharp increase in external debt, with the level of net external debt reaching about US$19 billion at the end of 1994 (some 46 percent of GDP and US$6 billion higher than in 1992). However, foreign reserves also increased in 1993 and marginally further in 1994; at about US$6.8 billion at end-1994, they covered 7 1/4 months of imports.

These macroeconomic developments are discussed in some detail in Chapter II, with particular focus on the reasons for the large deterioration in the external position during 1993-94. As well as reviewing in this context the evolution of fiscal, monetary and exchange rate policies over this period, the chapter also includes a brief analysis of the 1995 Budget.

Following the discussion of recent economic developments, five chapters provide more detailed background information on selected issues.

Chapter III discusses the large decline in the compensation of capital relative to that of labor during the recent transition toward a market economy. This experience in Hungary is compared with that in other countries--including other economies in transition. The chapter also reviews changes in the structure of the labor market and the wage determination system, as well as progress with enterprise reform. It suggests that a possible explanation for the shift in factor incomes during this period was the persistence of soft budget constraints together with inadequate governance in the enterprise sector, which has weakened management's resistance to increases in labor costs. Also contributing to higher real labor costs was the multilevel system of wage determination that is geared towards the maintenance of real consumption wages.

Chapter IV reviews the main developments in household saving over the past decade and attempts to isolate some of their main determinants. A particular conclusion is that the temporary boom in household saving in 1990-91, which cushioned the economy during that period against a decline in saving by other sectors, was probably to a large extent the result of a rise in economic uncertainty at the beginning of the transition period. Preliminary econometric work suggests that real interest rates may also have played some role in raising household financial saving; the impact of interest rates on total household saving, however, was probably relatively small.

The fiscal sector is at the center of many of the economic challenges that Hungary is presently facing. Chapter V reviews key features of the present system, outlining the size of the present fiscal sector and placing it in the context of other transforming economies in Central Europe. The present revenue and expenditure systems of the general government are reviewed in detail, with special focus on welfare programs, which account for a substantial proportion of total general government outlays. The operations of different levels of government are also examined.

Hungary's progress with banking reform between 1987 and 1994 is reviewed in Chapter VI. Following the establishment of a two-tier system in 1987, a number of measures were introduced in order to improve competitiveness in the banking sector. Nevertheless, individual bank lending remained heavily concentrated, and enterprises with major shareholdings in banks were often their largest borrowers. Major legislative reforms introduced in 1992--including mandatory provisioning against nonperforming loans and a new bankruptcy law--substantially improved the transparency of banking operations. As a result, the reported financial position of the banks deteriorated sharply. In order to shore up the state-owned banks, the authorities undertook several programs to improve the balance sheets of the banks, including swapping government bonds for bad debt, and bank recapitalization. The chapter concludes with a discussion of the current state of Hungary's banking system, including the emergence of a group of dynamic small and medium-sized banks, which have recently made significant inroads in the domestic banking sector.

Finally, Chapter VII describes Hungary's foreign trade and payments system. It indicates, inter alia, the considerable liberalization of external trade that has taken place in recent years, a process that continued in 1995 with the implementation of agreements with the EC, CEFTA, and EFTA and under the Uruguay Round.

II Recent economic developments

1. Domestic economy

a. Macroeconomic developments during 1993-94

Measured output fell by 2.3 percent in 1993, taking the cumulative decline in real GDP over 1990-93 to 19 percent. However, output bottomed out during the course of 1993, and GDP growth in 1994 turned positive for the first time in five years. 1/ In 1993, developments were characterized by very asymmetric behavior of domestic and foreign demand--with a large negative growth contribution from the external sector as exports collapsed while import growth remained robust. In 1994, import and export growth were more balanced and strong investment demand led the growth in GDP, estimated at around 2 1/2 percent (Chart 1).

Demand developments during 1993 showed a rebound in domestic demand with real demand increasing by 10 percent, led by sharply higher public consumption and investment. 2/ The growth in public consumption was dominated by an exceptional purchase of military equipment from Russia to settle outstanding claims by Hungary; however, even excluding these exceptional transactions, public consumption increased by about 3 percent in real terms. The growth in investment in 1993 reflected an end of the downsizing of stocks that occurred over the previous two years, as sharply higher stock-building contributed an estimated 6 percent to GDP in 1993 (the rise in stock building may also reflect some measurement errors in other demand components that are captured residually in this item). At the same time, fixed investment demand declined further in 1993, though by less than 1 percent. Household consumption increased by 1 1/2 percent in real terms and, with a further fall in real disposable incomes, this reflected a sharp decline in the household saving rate. This was possibly facilitated by negative real interest rates on financial saving instruments during most of the year, and precautionary savings may also have declined in 1993 as the income and employment outlook began to stabilize. 3/

Despite the increase in domestic demand, GDP growth was still negative in 1993 as a wide gap emerged between imports and exports. Exports fell sharply and the factors contributing to the fall, which are discussed in more detail in Section II.4, included possibly lagged effects from the

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1/ Tables 1-17 summarize developments in the domestic economy. As in other transition economies, considerable weaknesses exist in the national accounts and other statistical data series and the discussion below is subject to these limitations.

2/ The attached tables include within public consumption and imports for 1993 the import of military equipment from Russia as part of the settlement of outstanding claims. On a national accounts basis, these imports amounted to some Ft 72 billion (over 2 percent of GDP) and, excluding these transactions, domestic demand increased by 7 percent in real terms in 1993.

3/ For a more detailed analysis of household saving, see Chapter IV.

earlier sharp appreciation of the forint in real terms; demand weakness in major trading partners; and some exogenous factors, such as the continued drought and its effects on agricultural exports and UN sanctions on the Federal Republic of Yugoslavia (Serbia/Montenegro). Some of these factors also contributed to the rise in imports. But a key factor in the 18 1/2 percent increase of imports in volume terms was also the strong expansion of domestic demand, discussed previously. The overall policy stance facilitated the acceleration in domestic demand with a positive impulse from the fiscal side and an easing of monetary policy early in the year, prior to a tightening in the face of the widening external gaps (see below).

In 1994, developments were more balanced across different demand components. The highest growth rate--some 14 percent in real terms--is estimated for gross fixed investment. This occurred despite sharply rising real interest rates for market-based domestic enterprise credits, and reflected improvements in the profit situation of some enterprises (including in the industrial sector); follow-up investments to earlier foreign direct investment; and also the overall improvement in domestic and external demand. Private consumption increased in 1994 by about 1 1/2 percent in real terms, about the same rate as in the previous year. Nevertheless, with considerable growth in household incomes in real terms, the household saving rate increased in 1994. This may have partly reflected cyclical factors as well as the higher returns on some financial instruments (see Chapter IV).

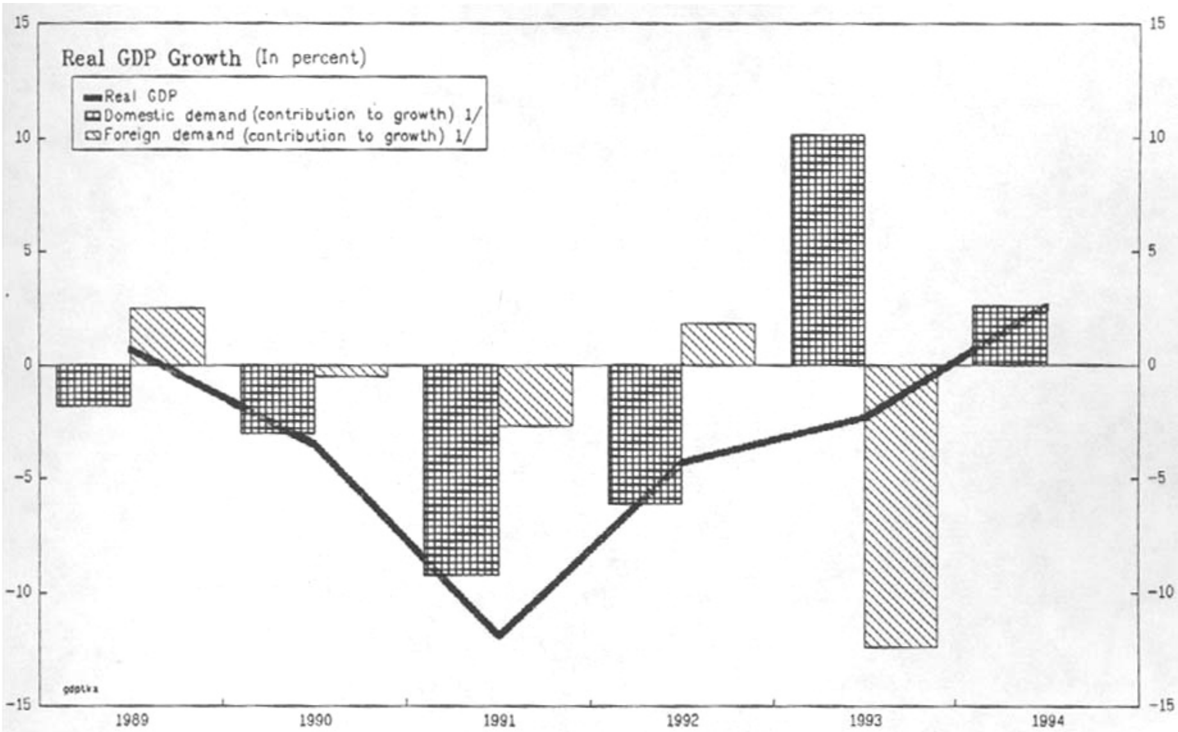
The sectoral performance in 1993 was characterized by stabilization or only small reductions in value-added in most sectors compared to the previous year, with the notable exception of the agricultural sector. The latter contracted by about 15 percent reflecting foremost the fourth consecutive year of drought conditions. Financial difficulties and the lack of a well-functioning credit system for the agricultural sector in the wake of property transfers also contributed to a further reduction in livestock and area under cultivation, and the share of agriculture in total GDP fell below 10 percent in 1993. On the other hand, a recovery took hold in the manufacturing sector and in several service areas, and the rebound gained momentum in 1994. Industrial production increased by 9 1/2 percent in 1994, accompanied by strong gains in productivity. At the same time, weather conditions also improved and the agricultural sector is expected to record its first year of positive growth since the recent transformation process began in 1989.

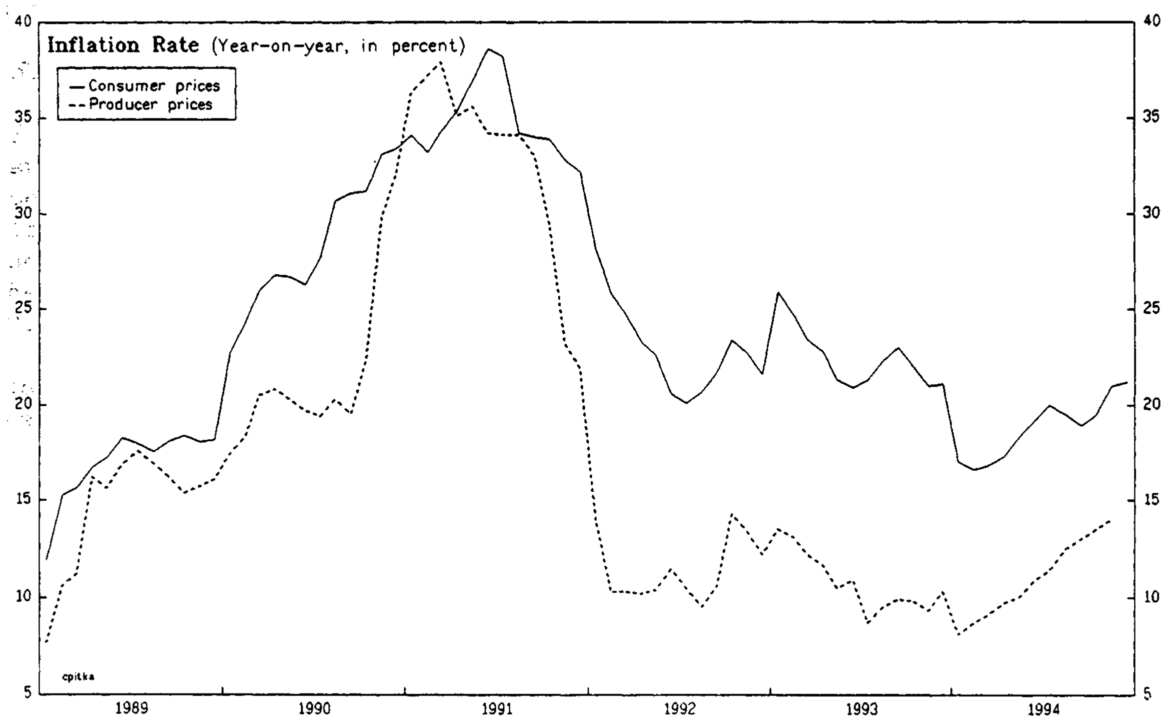
The turnaround in output during 1993/94 was, with some lag, also reflected in the labor market. Based on labor force survey data, the year-on-year decline in employment was only 1 1/2 percent in the second half of 1994 compared to an almost 10 percent decline at the beginning of 1993. A substantial share of the reduction in employment was accompanied by outflows from the labor force, partly into early retirement and also as a result of discouraged worker effects. In the event, the official unemployment rate peaked in the first quarter of 1993 at 13.6 percent and gradually declined to 10.4 percent by end-1994.

Chart 1

HUNGARY

GDP GROWTH AND INFLATION, 1989-94





Sources: Hungarian Statistical Office; and authorities' estimates.

1/ Includes in 1993 the import of military equipment from Russia.

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In contrast to several other transition economies, wage developments in Hungary have shown little responsiveness to the fundamental worsening of labor market conditions in the transition period. 1/ With a fairly centralized bargaining system, relatively ineffective representation of employers' interests--partly due to still soft budget constraints in the public sector, including public enterprises--and an orientation of general wage developments on the centrally agreed minimum wage, real wages (deflated by consumer prices) declined very little in 1990-93 even as employment fell sharply. With output also falling--and despite the sizable decline in employment--this led to a considerable redistribution in the income shares in favor of labor incomes (especially when incomes in kind and fringe benefits are included; see Chapter III). In 1993, net real wages remained essentially unchanged as higher increases in the gross wage were offset by a widening of the tax wedge. However, in 1994 when the deterioration in labor market conditions began to bottom out, net real wages increased by an estimated 5 1/2 percent, led by higher public sector wages. Most tradeable sector firms were able to offset the wage increases in 1994 with gains in productivity, reflecting advances in output and, in many cases, further labor shedding.

Consumer price inflation in 1993 remained at about the same rate (22 1/2 percent) as in the previous year (Chart 1). This reflected several factors, including a loosening of monetary conditions early in 1993, indirect tax measures (notably increases of the VAT), and an acceleration of food prices in the face of the drought. In 1994, consumer price inflation decelerated at first, reaching a low of 16.6 percent in February on a year-on-year basis, as the 1994 budget contained relatively few measures with direct price effects. However, the progress in reducing inflation was short-lived. With the external position requiring repeated adjustments of the exchange rate in 1994--by a cumulative 16.8 percent (in terms of domestic currency) against the basket, including an 8 percent devaluation in August--tradeable prices accelerated. Moreover, from the cost side, rapidly rising wages affected especially those sheltered sectors that could not achieve commensurate productivity gains, and world market prices of raw materials increased also faster than in previous years. Under these circumstances, annual consumer price inflation accelerated to 21.2 percent by December 1994. However, with the relatively low 12-month inflation rates recorded earlier, average annual inflation in 1994 was less than 19 percent, the lowest rate since 1989.

Price increases at the producer level have been well below those of consumer prices, averaging about 11 percent in 1993-1994. The difference reflects primarily the impact of tax and other administrative price measures and the relatively larger weight of the service sector in the consumer price index. With services starting the transition with low price levels by international comparison, and being also more insulated from international competition, they have recorded persistently above average inflation rates in recent years. More recently, though, with the strong impact of the

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1/ This issue is discussed in more detail in Chapter III.

larger depreciations of the forint on producer prices, the gap between consumer and producer price inflation rates has narrowed falling to some 6 1/2 percentage points by end-1994 from about 11 1/2 percent in 1992-93.

b. Structural reforms

Even though many reforms were introduced relatively gradually in Hungary, the role of the private sector expanded significantly, accounting for more than 50 percent of measured GDP in 1994. The private sector expanded in part through the creation of new private enterprises. By end-1993, almost 700,000 individual entrepreneurs were registered and the number of incorporated enterprises had increased more than five-fold since 1989 to over 85,000, increasing further to 95,000 by August 1994.

A second avenue for increasing the role of the private sector has been the privatization of existing enterprises. In the past, the authorities have pursued a mixture of privatization techniques--including outright sales, auctions, compensation vouchers, spontaneous privatization, and privatization through subsidized loans. By August 1994, the main agency initially charged with privatization, the State Property Agency, had completely or partially sold off 810 of the over 1,800 companies in its initial portfolio, with an additional 433 companies entering into liquidation proceedings. The largest single privatization to date involved the partial privatization of the telecommunications company, with revenues of US$875 million. In general, though, net revenues to the budget from privatization have been limited, with a considerable proportion of gross receipts expended on maintaining the companies still in state ownership, recapitalizing companies to be sold, and on costs associated with the privatization process itself.

During 1994, little progress was made in the area of privatization, partly as a result of the Parliamentary elections in May. As a consequence, the privatization process remains far from complete with about 40 percent of value-added in the economy still produced by the state. The new government, which took office in July 1994, has developed a strategy for the acceleration of privatization, and a revised privatization law is currently before parliament. The new privatization strategy is to emphasize cash sales, with revenues accruing to the budget rather than being used for enterprise restructuring; open-bidding procedures; speed of sales with privatization to be largely completed by 1998; and would sharply curtail the areas where the state would want to reserve for itself a long-term stake. It is envisaged that for small state-owned companies privatization could be initiated at the company level; but the majority of revenues are expected from the sale of several large enterprises in the energy sector (electricity, gas, and oil), telecommunications, and, to a lesser extent, from the banking sector.

Aside from privatization, bankruptcy and liquidation proceedings have formed a second pillar of enterprise restructuring. The bankruptcy law introduced in 1992 initially included strict regulations under which firms automatically entered into bankruptcy if they were more than 90 days overdue on their debt service. This may have forced some economically viable firms into bankruptcy. At the same time, bankruptcy proceedings for some firms were excessively protracted. Modifications to the law were introduced in 1993 to address these deficiencies. In all, the courts have accepted close to 3,500 bankruptcy applications over the period from 1992 through September 1994, with about 1/3 of the cases ending in an agreement between debtor and creditors. Over the same period, declared enterprise liquidations amounted to almost 21,000, but as in the case of bankruptcies, the number of applications for liquidation proceedings has fallen sharply since 1992. However, many enterprises, especially in the public sector, have been shielded from the bankruptcy procedures, partly through the continued provision of bank credit, and have continued to remain loss makers. In parallel to the bankruptcy and liquidation procedures, a new debt reconciliation scheme was introduced in late 1993 which is to allow some greater flexibility for out-of-court settlements, and some 2,000 debtors have applied to the various options offered under this scheme. 1/

c. Social indicators and poverty

Many social indicators, including measures of the incidence of poverty, have deteriorated since the late 1980s. This reflected the general decline in economic activity and the associated sharp fall in overall income and rise in unemployment; an increase in income disparity between richer and poorer households has also been a factor. Moreover, many government programs intended to offset some of these effects are not well targeted and, per forint spent on them, relatively unsuccessful in addressing the situation of the poorest segments of the population.

Only approximate estimates are available for most poverty indicators. Measured as the share of the population receiving less than the minimum subsistence level as calculated by the Hungarian Central Statistical Office (CSO), poverty affected some 1.5 to 2 million people in 1992, or at least 15 percent of the population. The poverty incidence based on this measure may have doubled since the late 1980s. However, the CSO's measure of the subsistence level is quite high in relation to the general income level of the economy, amounting to between 50 percent and 85 percent of the average net wage in 1994. 2/ While the absolute size of poverty may be overstated by this measure, the trend that emerges from various indicators would point in the same direction, indicating a significant increase in recent years. On the other hand, income disparities within the poorer segments of the population are relatively small in Hungary.

1/ For further details, see Chapter III.

2/ The CSO distinguishes for the subsistence level between different types of households. For example, the per capita subsistence level ranged from as low as Ft 11,435 per month for a household with 3 adults and 4 children to as high as Ft 18,620 for a one-person household.

The deterioration in recent years is not confined to the incidence of poverty, but extends also to a variety of other social indicators, especially in the health area. For example, life expectancy at birth has declined considerably, especially for males where it amounted to less than 65 years in 1992 compared to 73 years in neighboring Austria. At the same time, death rates have increased while the birth rate declined from already low levels. Public health expenditures have also declined in real terms since the late 1980s; however, with an even faster decline in GDP, their share in GDP has increased considerably. The new government emphasizes that better expenditure targeting and a fundamental reorientation of some services is needed to reverse the past deterioration in this area and achieve a more efficient use of health care expenditure.

2. Public finance

a. Structure of the public sector

The structure of the public sector in Hungary is relatively decentralized and complex. The general government comprises the consolidated central government and the local government sector (LGs). The consolidated central budget, in turn, contains the state budget (SB), the activities of the 31 budgetary chapters (which are, for the most part, spending ministries) and 1,395 central budgetary institutions (CBIs) they administer, 29 extra-budgetary funds (EBFs) and two social security funds (SSFs). The local government sector comprises 8 regional bodies, 19 county governments and about 3,155 municipalities. 1/ The activities of these various entities are intertwined with a multitude of financial flows between them--including transfers from the state budget to the CBIs, EBFs, SSFs and the LGs; transfers from the EBFs to CBIs, the SB, LGs, and other EBFs; and transfers among the CBIs.

As comprehensive data on the general government sector for 1994 is not yet available, the present section is focussed on a more narrow definition of the government sector--the so-called consolidated state budget sector. 2/ This definition subsumes the net operations of the state budget and the social security funds and two EBFs (the Employment and Solidarity Funds) plus transfers made to CBIs, the remaining EBFs and the LGs.

The consolidated state budget sector covers most of the main taxes--the profits tax (CIT), personal income tax (PIT), social security levies, customs duties, the VAT, and a number of excise and turnover taxes. However, a share of the personal income tax is paid directly to the LGs and

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1/ All figures on numbers of organizations are quoted as at the end of 1993.
2/ Chapter V presents some preliminary staff estimates for the general government.

a number of earmarked taxes are collected by the EBFs. EBFs, CBIs and the LGs also collect substantial own account revenues which are not included in the consolidated budget presentation.

The consolidated state budget also covers the bulk of spending made directly by the central government itself (including on subsidies, centrally directed investment, debt service and international transactions) and transfers to the CBIs and the EBFs and LGs. However, as each of these other levels of government have their own sources of revenue, the concept understates the true size of general government spending. Based on information prepared for the period 1990 to 1993, it appears that the state consolidated public sector may understate general government revenues by about 5-8 percent of GDP and general government expenditures by a similar amount.

b. Developments during 1990 to 1993

The consolidated state budget moved from a surplus equivalent to almost 1 percent of GDP in 1990 to a deficit of 7.5 percent of GDP in 1993 (Tables 18-19, and Chart 2). Much of this deterioration can be traced to the substantial decline in real output in this period--directly affecting both revenues and, to a lesser extent, expenditures--and to reform measures taken to deal with the transition. Measures falling within this latter category included the issuance of debt to finance recapitalization of commercial banks (Chapter VI); the introduction of a bankruptcy law which initially required enterprises with overdue payments of more than 90 days to place themselves under court protection and allowed them to suspend all payments, including tax and social security liabilities; the take-over of subsidized loans for housing from the National Savings Bank; and the switch to financing budget deficits by issuing securities at market-related interest rates from 1991.

The decline in GDP tended to mask the extent of fiscal effort undertaken by the authorities. Thus revenues were held at between 46 percent and 48 percent of GDP during this period despite the substantial decline in real activity which eroded tax bases. Revenues were sustained by strong increases in personal income taxes and social security contributions (as the relative share of wages in GDP rose and real effective income tax rates increased as rate scales were held relatively constant in the face of rising inflation) and by substantially increased contributions from VAT, excises and taxes on foreign trade (as the bases for these taxes expanded relative to GDP).

Meanwhile, there was a rise in the ratio of expenditure to GDP from around 48 percent to 55 percent. This increase was explained entirely by increases in current expenditures. Although subsides were reduced substantially, this effort was more than offset by increased expenditure on goods and services and on social security (including substantial increases in unemployment related payments) as well as rising interest payments.

Although the fiscal situation had begun to deteriorate already in 1991, it worsened sharply in the middle of 1992--with corporate revenues collapsing and unemployment rising--initially catching the authorities by surprise. The original budget for 1993 projected a deficit of Ft 230 billion or 6.2 percent of GDP. However, substantial overruns in expenditure became evident as the year progressed. Midyear wage increases, drought-related assistance and additional spending on CBIs, including the defence forces, together with prospective shortfalls in some revenues, contributed to a deteriorating budget outlook. By midyear, it appeared likely that the deficit could approach 7 percent of GDP.

In the face of this deterioration, a fiscal adjustment package was announced in mid-1993 that, together with the measures contained in the original budget, amounted to about 4 percent of GDP on a full-year basis. On the revenue side, the measures included an increase in the preferential VAT rate from zero to 6 percent and a reclassification of some items; a freezing of the personal income tax brackets and some broadening of the tax base; a reduction from 50 percent to 30 percent of the share of the personal income tax transferred to local authorities; and an increase of unemployment contributions by employers and employees. On the expenditure side, the main measures proposed included a partial freeze in nominal expenditure on goods and services, a cut in pharmaceutical subsidies, a partial indexation of pensions, and tightening of eligibility requirements for unemployment benefits.

Additional measures designed to affect primarily the 1994 budget were also announced at that time including further limits on VAT exemptions and another increase on the VAT minimum rate from 6 percent to 10 percent (yielding Ft 10.7 billion in 1993 and Ft 21 billion in a full year); further broadening of the PIT and CIT tax base; and introduction of a minimum tax under the PIT and CIT. On the expenditure side, the main measures included elimination of a number of central budgetary institutions and an improved targeting of family allowances. To limit the deficit of the social security administration, measures were taken to broaden the base for social security contributions, reform the sickness payments system, lower subsidy rates on pharmaceuticals, and introduce health care copayments for some services.

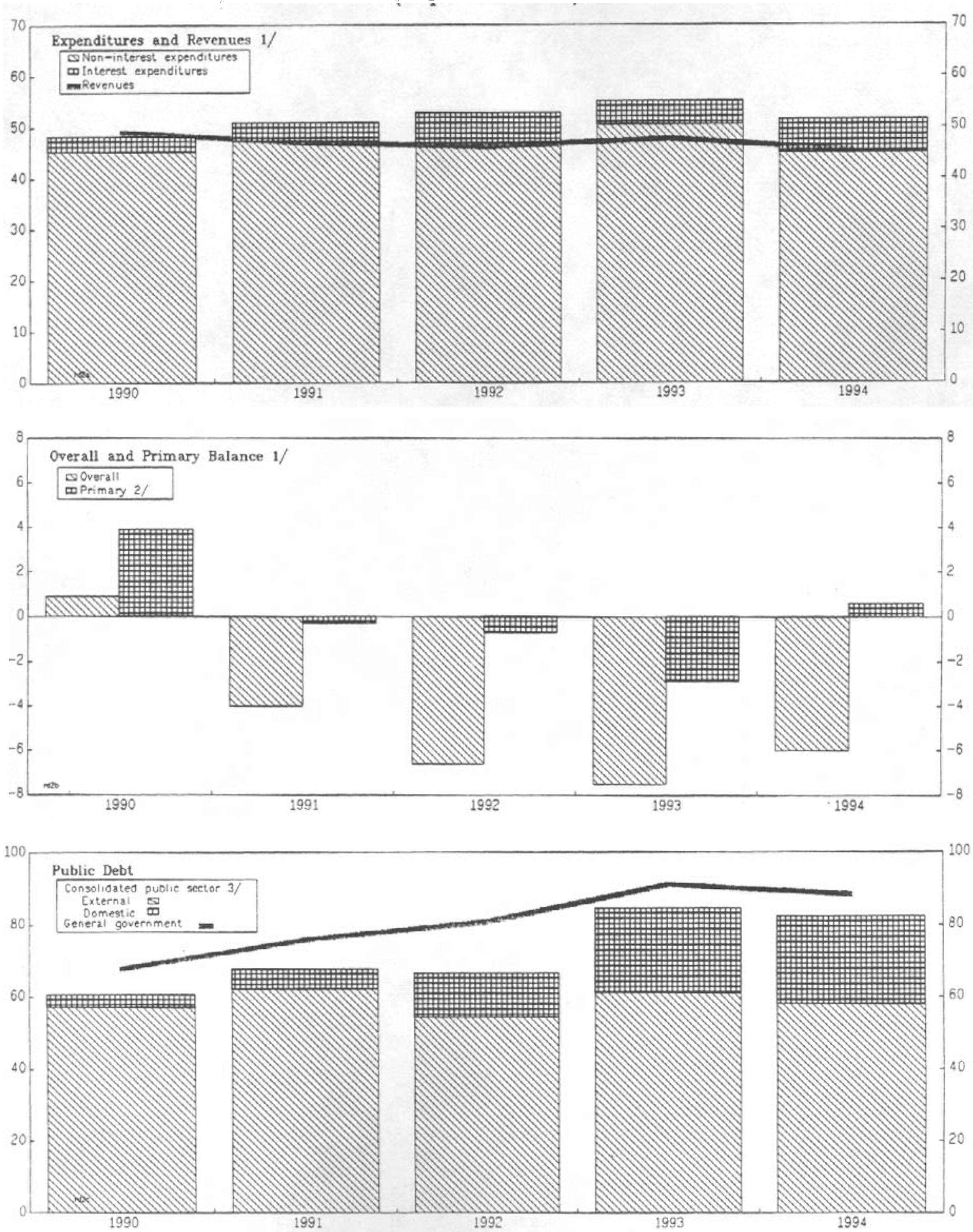
Subsequent to the announcement of this package of measures, substantial progress was made in reducing the deficit in the last five months of 1993 and the final outcome would have been 5.4 percent of GDP but for the special defence items discussed below.

The budget outturn for 1993 included a special defence purchase of Russian military aircraft which added Ft 70.5 billion or 2 percent of GDP, bringing the budget deficit to Ft 262.8 billion or 7.5 percent of GDP. The transaction was part of an intergovernment agreement with the Russian Federation involving the exchange of aircraft in return for cancellation of debt obligations of US$800 million incurred by the former Soviet Union. Under this arrangement, the authorities made expenditures totalling

Chart 2

HUNGARY

SELECTED FISCAL INDICATORS, 1990-94
(In percent of GDP)



Sources: National Bank of Hungary; and Ministry of Finance.

1/ Consolidated state budget.
2/ Overall balance excluding interest payments.
3/ Consolidated debt of general government and National Bank of Hungary (NBH).

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Ft 101.5 billion in 1993 and received revenues (mainly VAT and other taxes levied on the import of the aircraft) of Ft 31 billion in 1993, resulting in a net increase in the measured deficit of Ft 70.5 billion in 1993. 1/

c. Developments in 1994

The original consolidated state budget for 1994 projected a deficit of Ft 246 billion or 5.8 percent of GDP. These estimates reflected a projected resumption in output growth and took account of the substantial full-year effect of the supplementary fiscal measures presented in 1993. However, the impact of the originally announced 1993 package was reduced by the failure to fully implement some measures (particularly the tax base broadening and social security measures). Moreover, the 1994 budget incorporated some discrete tax measures that lowered the revenue outlook, including a 4 percent reduction in the CIT, and introduction of deductions for social security contributions to the PIT. Large privatization revenues were also assumed and sizeable asset transfers and arrears collection were expected to assist the finances of the social security funds. In the absence of such privatization revenues, the projected deficit was equivalent to 7.5 percent of GDP--broadly comparable with the equivalent deficit outcome in 1993.

During the course of the year, there was again concern that the deficit would come in well above the budget estimate. This concern largely reflected prospective shortfalls in company profits and turnover taxes; faster than expected increases in interest costs, subsidy payments and other current expenditures, including wage increases to government workers; 2/ and shortfalls in privatization revenues. A larger than-expected deficit in the social security funds also seemed likely as a result of a retroactive pension increase, and the failure to meet targets for the transfer of state assets and collection of contribution arrears.

Against this background, a supplementary budget was formulated which included measures designed to raise about 1 1/4 percent of GDP on a full-year basis. On the revenue side, it included an increase in excise taxes on alcohol and tobacco, petroleum products, and motor vehicles. Measures with respect to the VAT--in particular, an increase in the preferred rate from 10 percent to 12 percent, and the reclassification of telecommunication services to the 25 percent rate--were included in the supplementary budget, but would take effect only from the beginning of 1995. The measures on the revenue side were supplemented by expenditure reductions, concentrated on the CBIs and EBFs, agricultural subsidies (where substantial overruns occurred relative to the originally budgeted amounts), investment spending, and political compensation payments.

1/ The additional residual impact of this transaction in 1994 and 1995 is discussed in Chapter V.

2/ The overall increase in the public sector wage bill is estimated at 19 1/2 percent in 1994 while public sector employment fell by 4 percent.

The savings outlined in the supplementary budget together with revenue gains associated with the faster than originally anticipated pace of devaluations (which boosted the domestic value of import duty collections), higher demand and income growth in the second half of 1994 and general restraint on expenditures led to an improvement in the financial position notwithstanding several subsequent fiscal measures which acted to increase the deficit. 1/ Estimates of the final outcome for 1994 suggest that the deficit will be about 6 percent of GDP, only slightly above that projected in the initial budget and some 1 1/2 percent of GDP lower than in 1993.

For the year as a whole, revenues fell as a share of GDP by about 2 percent compared to 1993, with substantial reductions in both PIT and social security contributions relative to GDP. The reduction in PIT collections reflected the budget measures, including the decision to make social security contributions deductible. The fall in social security contributions in relation to GDP reflected mainly collection difficulties, including a further increase in arrears.

Meanwhile, expenditures fell by about 3 1/2 percent of GDP notwithstanding a 2 percentage point increase in interest expenditure. The fall was concentrated in goods and services expenditures (which fell by over 4 percentage points) and social security spending (which fell by 2 percentage points). The decline in unemployment-related expenses, the nonrecurrence of special defence related transactions, and a reduction in the public sector wage bill on account of the estimated decline in public employment contributed to these developments. However, preliminary data for the general government indicate that the expenditure reductions at the consolidated state level were partly offset by expenditure increases at other levels of government (see Chapter V).

Defence department spending in 1994 is estimated to be Ft 71.5 billion or 1.6 percent of GSP including an amount of Ft 11.6 billion carry over costs of the 1993 purchase of military equipment from Russia (see above). This compares to an estimated spending equivalent to about 4.5 percent of GDP in 1993 (or about 1.6 percent of GDP excluding the military equipment from Russia). Defence department employment in 1994 totalled about 90,000 plus 57,000 enlisted men.

d. The 1995 budget

The consolidated state budget deficit in 1995 is projected to fall slightly to 5.8 percent of GDP. However, that estimate includes expected revenues of Ft 150 billion from privatization; excluding such revenues, the budget deficit would rise from 6.8 percent to 8.7 percent of GDP. This deterioration reflects both a sharp fall in the ratio of tax revenues to

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1/ These measures included additional subsidies to Hungarian railways (MAV) to clear social security contribution arrears (Ft 16.2 billion) and costs incurred in the reorganization of a major regional metallurgy plant (Ft 1.3 billion in 1994 and Ft 4.3 billion in 1995).

GDP, while expenditures remain at over 50 percent of GDP--less than 1 percent below estimated 1994 levels. The composition of expenditures will change sharply with interest payments projected to rise by almost 2 percent of GDP and a somewhat larger drop in noninterest expenditures. The macroeconomic projections underlying the 1995 Budget envisage stagnation in real GDP, a rise in the GDP deflator of about 20 percent, and a considerable redistribution of incomes towards the enterprise sector, associated with a projected decline in real wages.

Tax revenues are estimated to fall relative to GDP as a result of three main factors. First, the authorities introduced a number of new tax measures (for details see Chapter V) which are estimated to lead to a net reduction in revenue of about Ft 35 billion. Second, customs duties are expected to decline mainly as a result of a reduction in tariffs and fees associated with international trading agreements. Third, the projected stagnation in output and fall in real wages will impact on both direct and indirect taxes.

The main discrete tax measures were with respect to the corporate profit tax, including a reduction in the rate on reinvested profits from 36 percent to 18 percent, and with respect to the personal income tax. The changes to the personal income tax included a replacement of the former tax deductions by a more equitable system of tax credits; and introduction of a fringe benefits tax on the personal use of business cars. Other measures included in the budget were the abolition of the interest withholding tax; a halving in the dividend withholding tax rate to 10 percent; and an increase in the road fund levy. Changes to the coverage of social security levies are also proposed and collections in this area are expected to benefit from measures to improve compliance and reduce arrears.

The budgeted decline in customs revenue reflects a number of factors. The growth in imports is projected to slow sharply; statistical fees will be reduced as part of agreements associated with the Uruguay Round; and there will be substantial reductions in tariffs under the association agreements with the EU, CEFTA, and EFTA, as well as in connection with the Uruguay Round agreement.

The projected zero growth in real GDP and decline in real wages will have a broad-based negative impact on revenues in 1995. However, the impact on excise and VAT collections is masked by the full-year effect of higher rates introduced in the 1994 supplementary budget package. This applies particularly to the VAT as the changes announced in the 1994 package were not introduced until January 1, 1995.

As noted earlier, the growth in expenditures in 1995 is dominated by a projected 56 percent increase in interest payments. The growth in this item reflects both an increase in central government debt and a rise in effective interest rates. The increase in public debt reflects both the cumulative effect of state budget deficits in the period to 1994 as well as debt issued to fund specific off-budget measures, such as bank recapitalization and the conversion of foreign exchange losses incurred by the NBH into interest bearing government securities (see below). The 1995 Budget assumed an average interest rate on market-based domestic debt of 26-28.5 percent. While this is higher than the average rates prevailing in 1994, the sharp rise in interest rates in the second half of 1994 and in early 1995 may still make this assumption overly optimistic. On the other hand, the budgeted interest projections assumed substantial savings from the direct marketing of public debt instruments to households that was to increase in 1995 as new venues, including post offices and saving cooperatives, were to be used for this purpose.

Noninterest expenditures are estimated to fall by about 7 percent in real terms. This projected outcome reflects restraint in most categories: the wage bill is to be held to a nominal increase of only 6 1/2 percent in the public sector; social security spending policies are to be tightened, particularly in the health area; family allowances are to be held constant in nominal terms; producer subsidies, particularly to agriculture, are to be reduced; centrally-decided and state enterprise capital expenditures will be tightly controlled; and the grants to the LGs are to be held virtually unchanged in nominal terms. Defence spending is projected at Ft 76 billion or 1.5 percent of GDP.

e. Public sector debt

The debt of the general government increased by almost 25 percent of GDP to over 90 percent in the three-year period 1990-93, before falling moderately to an estimated 88.4 percent of GDP at the end of 1994 (Table 20). Despite the previously described sharp increase in the fiscal deficits over this period, the underlying debt dynamics were generally favorable and would have led to a decline in the debt-to-GDP ratio. However, movements in this ratio have been dominated in recent years by nondeficit related security issues of the state, mainly related to enterprise and banking sector support.

The generally favorable underlying debt dynamics reflect that a considerable portion of the domestic debt still carries below market interest rates. In this regard, the most important items concern historical debt held by the NBH, and debt linked to devaluation-related losses of the NBH. The latter are securitized with government debt in recognition that these largely reflect quasi-fiscal deficits of the NBH, the sovereign external borrower in the case of Hungary. However, this debt carries a zero interest, and the related debt stock amounted to about 1/3 of GDP at end-1993. 1/

1/ New regulations came into effect at end-1993 according to which at least 5 percent of the total outstanding stock at end-year of devaluation related claims must be converted into interest bearing government securities. The first conversion took place in 1994 when Ft 59.1 billion were issued based on the end-1993 debt stock. The first interest payments on the converted debt are due in 1995.

With the effective interest payments substantially below the nominal growth of GDP, the rise in the debt-to-GDP ratio was primarily due to a sharp increase in nondeficit related debt operations. Over the past years, the main factors in this context were the replacement of subsidized housing loans by treasury bonds in 1992; and the issuance of bank consolidation bonds in 1993/94 totaling an estimated Ft 324 billion.

Since much of the government debt that carries below-market rates is domestic debt and principally held by the central bank, a clearer picture of the underlying debt dynamics emerges when the debts of the general government and the central bank are consolidated. This consolidated debt of the public sector amounted to an estimated 82.5 percent of GDP at the end of 1994, with the largest share--70 percent of the total or 58 percent of GDP--consisting of external debt obligations. However, the fastest growing component in recent years has been domestic debt, which has increased from about 5 1/2 percent of GDP in 1991 (or 8 percent of total consolidated public sector debt) to almost 25 percent of GDP in 1994. This reflected several of the previously discussed nonrelated security issues of the state, and also the increasing reliance by the state on other domestic sources than the NBH for its large deficit financing needs.

3. Monetary policy and developments

Since 1993, monetary policy in Hungary has been characterized by two distinct phases. The first half of 1993 saw a continuation of the easing that began in mid-1992 that was intended to stimulate domestic demand through lower interest rates. However, following a sharp deterioration in the external current account balance in mid-1993 and a growing budgetary financing requirement, monetary tightening was initiated beginning in the third quarter of 1993. This relatively tight stance of monetary policy was maintained throughout 1994 and early 1995 as the external position continued to deteriorate.

a. Developments in 1993

In the first half of 1993, Hungary's monetary policy sought to boost domestic demand and secure economic recovery mainly by lowering domestic interest rates. Given the extent of slack in the domestic economy, the monetary policy stance was not seen as compromising the underlying primary policy objective of lowering inflation. Monetary policy conditions were eased at the beginning of 1993 when, on January 1, the NBH lowered its basic refinancing rate by 1 percentage point to 20 percent (following a similar reduction in October 1992), and reduced the mandatory reserve ratio from 16 percent to 14 percent.

The effect of these changes should be viewed alongside the increase in household demand for precautionary savings in 1992 and early 1993 in response to the downturn in economic activity. These savings were held primarily in the form of bank deposits and, as a result, household bank deposits increased by 37 percent in the 12 months to June 1993. Due to the lower cost of central bank refinancing and the sharp increase in the volume of deposits, the banks' cost of funds declined significantly, and this was reflected in a reduction in enterprise deposit rates of nearly 15 percentage points between May 1992 and June 1993.

Even though banks typically had excess reserves, they were in general reluctant to lend to enterprises out of concern for potential further deteriorations in the quality of their loan portfolios. Instead, they opted to use their reserves to purchase lower-risk assets, including treasury bills. Reflecting this switch towards government securities, bank credit to enterprises declined by 3 percent in nominal terms during the 12 months to June 1993, and credit to government grew by some 23 percent over the same period. 1/ The pickup in demand for government securities contributed to a sharp decline in their yield, with average rates on 90-day Treasury bills falling from 25 percent in June 1992 to 10 1/2 percent in April 1993.

The easing of monetary policy in early 1993 resulted in smaller reductions in lending rates than in deposit rates. For example, by June 1993, enterprise credit rates had declined on average by about 10 percentage points (relative to May 1992), while deposit rates had fallen by about 15 percentage points over the same period. This differential response is attributable to two main factors. First, banks were required to accumulate provisions against their nonperforming loans which created incentives to increase intermediation spreads so as to boost bank profitability. Second, the structure of the Hungarian banking system remained highly segmented so that, in practice, little competition existed among banks for the bulk of corporate clients. As a result, banks did not fully pass on to their corporate debtors the lower cost of funds. 2/ These two factors contributed to the persistence of very large intermediation spreads from mid-1992 to mid-1993. 3/

In part reflecting the easing of monetary policy and the central bank financing of the state budget, inflation remained at about 21 percent in mid-1993, relatively unchanged from its average level in 1992. Consistent

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1/ The observed decline in the stock of bank credit to enterprises reflects also the 1992 credit consolidation operation which led to substitution within the asset side of the banks' balance sheets from enterprise to government credits. Correcting for these effects, the observed growth in enterprise credits was nearly 8 percent.

2/ Lack of competition on the deposit side would tend to depress deposit rates paid by the banks.

3/ Relatively high intermediation spreads in Hungary also reflected the fact that intermediation *costs* for banks operating in Hungary remained well above those for banks operating abroad. This reflected (i) relatively high mandatory reserve requirements in Hungary, and (ii) relatively low rates of remuneration on required reserves. For example, reserves held against forint-denominated liabilities were remunerated at 2 percent per annum in 1993, whereas reserves held against foreign-denominated liabilities--payable in forint--received 11 percent.

with the policy of maintaining the existing level of external competitiveness through small, periodic adjustments in the exchange rate, the NBH devalued the forint five times in 1993 by a cumulative 15 percent.

In combination with the reductions in nominal interest rates in the first half of 1993, the failure of inflation to decline caused real enterprise deposit rates and real yields on government paper to fall sharply. 1/ Based on the producer price deflator, real enterprise deposit rates declined to low but positive levels in mid-1993. However, based on the consumer price deflator, real enterprise deposit rates turned sharply negative. In contrast, reflecting stickiness of lending rates, real enterprise credit rates (based on either the consumer or producer price deflator) remained significantly positive (see Chart 3). 2/ In summary, therefore, the main impact of the monetary policy measures enacted since the second half of 1992 was to depress the real return on financial savings. This may have played a role in the sharp deterioration in economy-wide saving, and with it the external current account balance, in mid-1993.

In response to the significant deterioration in the external position, the National Bank raised interest rates on its key repurchase agreements in both June and October, 1993. As the structure of interest rates moved upwards, the yield on Treasury bills increased sharply, reaching 24 1/2 percent for 90-day bills by the end of the year, up from a low of 10 1/2 percent in April. 3/

The progressive tightening of monetary policy in the second half of 1993 was reflected in a slowdown in monetary growth. The year-on-year growth rate of broad money declined from 24 percent in June to less than 17 percent in December. Reflecting the increase in interest rates on non-monetary assets, the (end-year) velocity of broad money increased in 1993, following several years of decline.

1/ The appropriate deflator for calculating real enterprise deposit is an open question. On the one hand, the accumulation of inventories may be viewed as the alternative to holding enterprise deposits, thereby justifying the use of the producer-price deflator. Alternatively, since funds used to constitute enterprise deposits could be paid out as shareholders' dividends, the consumer price index may also be used to calculate real enterprise deposit rates.

2/ The producer price index would seem to be the most appropriate deflator for enterprise lending rates; however, in the case of lending to households and the service sector, the consumer price index might be the more appropriate deflator for calculating real interest rates.

3/ In the last quarter of 1993, the yield on 90-day Treasury bills actually exceeded the interest rate on three-month repurchase agreements. This led commercial banks to purchase government securities with refinancing credits from the NBH, thereby raising *de facto* central bank financing of the fiscal deficit.

As to the implementation of monetary policy, the NBH continued to strengthen its instruments of indirect monetary control in 1993. Beginning in 1990 and continuing through 1993, direct refinancing of the banking sector (including for export prefinancing) by the NBH decreased substantially, although the NBH maintained several long-term refinancing facilities related to specific subsidized activities. Also, the NBH launched in January 1993 repurchase and reverse repurchase facilities based on government securities. This step provided the NBH with a wider range of instruments with which to conduct open market operations. By the end of the first quarter of 1993, repurchase agreements had become the primary source of short-term central bank refinancing, and by the end of the year represented about one third of total lending by the NBH to financial institutions. In addition, the National Bank also introduced refinancing through foreign-exchange deposit swaps at the beginning of 1993, with the NBH bearing the exchange rate risk.

b. Developments in 1994 and early 1995

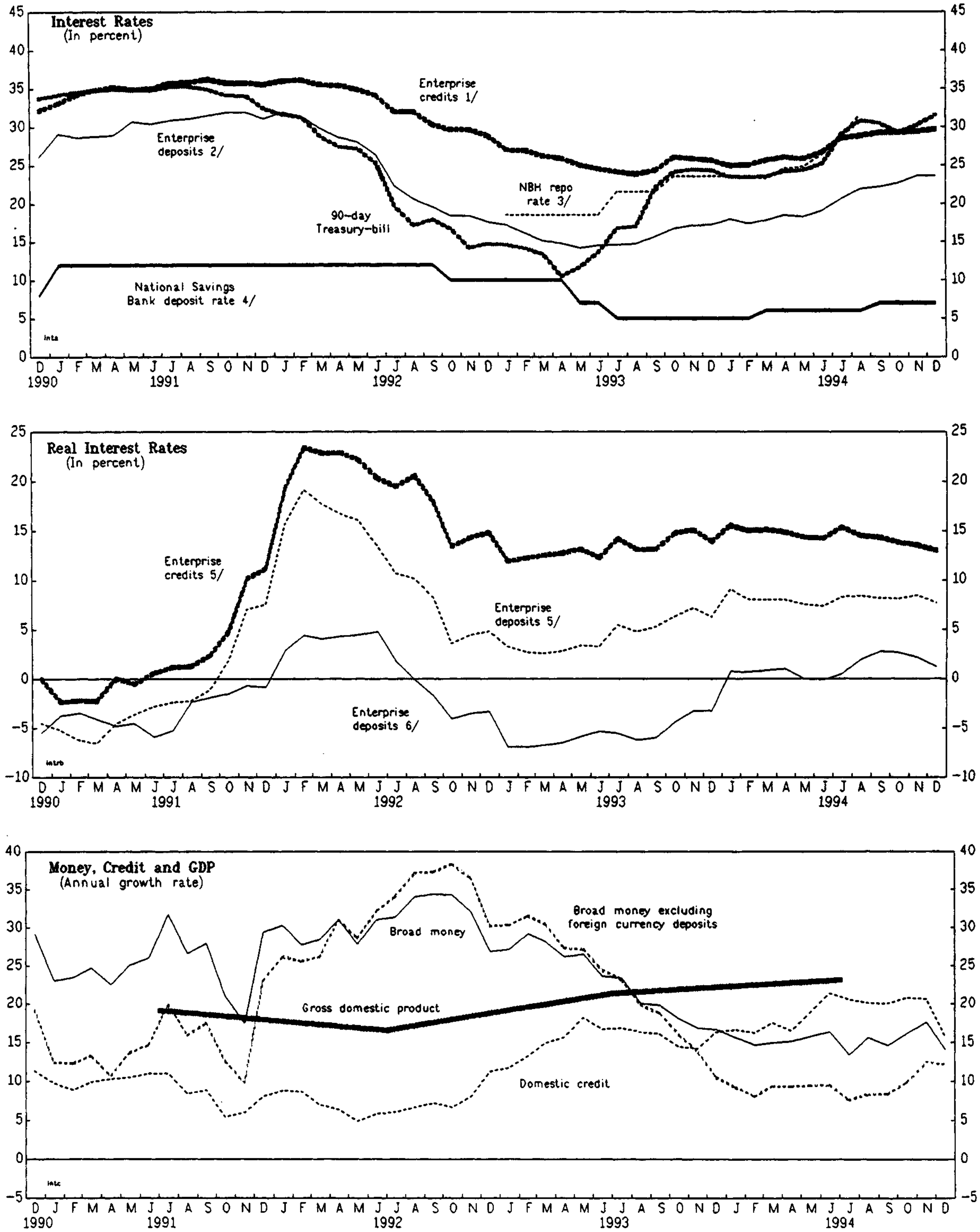
Against the background of a sharply deteriorating external position and an annual inflation rate above 20 percent, the National Bank continued to tighten monetary policy throughout 1994. Interest rates on repurchase agreements were raised in several steps during the year, and by the end of 1994 rates on one-month agreements had reached 31 1/4 percent. Furthermore, the NBH's base rate--which applies to credits for the state budget and also to loans (with maturities in excess of one year) to financial institutions--was increased from 22 percent to 25 percent in mid-1994, remaining at that level for the rest of the year. The base rate was subsequently increased to 28 percent on February 1, 1995. In addition, interest rates on repurchase agreements were raised by 1 3/4 percentage points to 3 3/4 percentage points, depending on the maturity, on February 22, 1995. As concerns the exchange rate instrument, the NBH maintained its policy of periodic devaluations of the forint in 1994, in line with its objective of preventing an erosion of international competitiveness (see Section II.4 below).

The tightening of monetary conditions in 1994 was not confined to upward movements in official interest rates. In 1994 and early 1995, the NBH modified its set of refinancing instruments in order to strengthen control of bank liquidity and shorten the maturity structure of its refinancing credits. On February 14, 1994 the NBH terminated its two-week, six-month, and one-year active repurchase facilities, while simultaneously introducing a one-week passive facility. Additional adjustments to the set of instruments were made on September 5, 1994, when the NBH eliminated its three-month active and passive repurchase facilities and its three-month foreign-exchange deposit swaps, and again on December 20, 1994, when the NBH terminated all foreign-exchange swap facilities, and eliminated the use of one-month active and passive repurchase agreements. As a result of these steps, only overnight and one-week active repurchase facilities and the one-

Chart 3

HUNGARY

SELECTED MONETARY INDICATORS, 1990-94



Sources: National Bank of Hungary; IMF, International Financial Statistics; and staff estimates.

1/ Less than one year maturity.
2/ Less than one year, more than one month maturity.
3/ Three-month active repo rate. Facility terminated September 5, 1994.
4/ Sight deposit rate.
5/ Deflated by the producer price index.
6/ Deflated by the consumer price index.

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week passive facility remain. In order to further restrict bank liquidity, the NBH raised mandatory reserve requirements by 2 percentage points (to 14 percent) in February 1995. 1/

Taken together, the objectives of these monetary policy measures were to secure a marked improvement in the external balance by compressing interest-rate sensitive domestic demand and boosting domestic saving, and to reduce inflation from its entrenched level of above 20 percent a year. However, a number of structural features of Hungary's economy served to weaken the link between the instruments and targets of monetary policy. First, the increasing openness of the economy to foreign capital inflows limited the ability of the NBH to control the volume of liquidity in the economy since domestic borrowers could turn to international capital markets for financing. Reflecting this tendency, the stock of foreign-financed business sector loans grew from about US$1 billion (5 1/2 percent of broad money) at end-1992 to about US$2.2 billion (12 percent of broad money) by mid-1994. 2/ As Hungarian firms were increasingly able to obtain loans from abroad, the transmission of monetary policy instruments (particularly interest rates) to macroeconomic variables, including the level of activity and saving and investment flows, was dampened.

A second structural characteristic that weakened the linkages between monetary policy instruments and the real economy related to the rapid growth of credits allocated on preferential or nonmarket terms. Credits with preferential interest rates or state guarantees accounted for about 20 percent of the total outstanding stock of enterprise credits at end-1994 and about two thirds of the total increase in credit to enterprises during the

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1/ Simultaneously, in order to mitigate the effect on intermediation costs of the increase in reserve requirements, the remuneration rate on required reserves was raised from 8 percent to 12 percent for domestic currency deposits and from 18 percent to 24 percent for foreign currency deposits.

2/ In part, the increasing role of foreign capital in the domestic economy is a reflection of the growing number of joint venture firms operating in Hungary. About one quarter of foreign private sector debt outstanding at mid-1994 was extended by nonresident owners to local subsidiaries.

year. 1/ The extent of lending on nonmarket terms implied that a large part of the economy was insulated from the effects of increases in official lending rates, and that the burden of macroeconomic adjustment was concentrated on a relatively small segment of the economy, including to a significant degree the emerging private sector.

In addition, for those credits that *were* on commercial terms, the effectiveness of monetary policy was hampered by the less than full transmission of changes in *official* interest rates to *market* lending rates. Whereas enterprise deposit rates increased by about 8 percentage points between mid-1993 and October 1994, enterprise lending rates rose by only 5 percentage points during this period. Greater upward rigidity in lending rates than in deposit rates reflected previously-mentioned factors such as the increasing openness of the economy to capital inflows, which limited the extent to which banks could raise their lending rates for creditworthy enterprises above those prevailing abroad. 2/ In addition, because the financial performance of the banking sector improved markedly in 1994 owing to the implementation of programs to recapitalize the banks, there was some *downward* pressure on intermediation spreads and lending rates. 3/ This tendency to lower lending rates as a result of the improved financial position of the banks (in an environment in which official rates were rising) also served to weaken the extent to which changes in official rates were transmitted to market lending rates.

1/ Loans at preferential interest rates, which accounted for about one third of the increase in credit to enterprises in 1994, fall into two categories: those with fixed interest rates and those where the rate is tied to the NBH's base rate. The first group includes loans provided by the NBH to promote privatization of state assets and employee buyouts of state firms. These loans carry an interest rate of 3 percent. The second group of credits includes loans extended through the NBH on behalf of the Japanese Export-Import bank, at 75 percent of the NBH's base rate, designed to encourage the establishment of new businesses. Credits with state guarantees, which accounted for one third of enterprise borrowing in the first 11 months of 1994, have been used to finance the operating costs of large state-owned enterprises, including the State Railway. In 1994, the increase in guaranteed credits was subject to an annual ceiling of 3 percent of state budget revenues. This ceiling has been reduced to 2 1/2 percent in 1995.

2/ However, as the banks tended to differentiate among their clients on the basis of creditworthiness, considerable variability in market lending rates emerged.

3/ Also contributing to improved profitability in the banking sector were: (i) a one percentage point reduction in the mandatory reserve requirement on April 1, 1994 and again on May 1, 1994 to 12 percent; (ii) an increase in the remuneration rate on mandatory reserves held against foreign exchange deposits from 11 percent to 18 percent in February, 1994; and (iii) an increase in the remuneration rate from 2 percent to 6 percent on reserves held against forint deposits in June, 1994, and a further increase to 8 percent in October, 1994.

As regards the development of the monetary aggregates, significant reliance on direct sales of securities to the nonbank public to finance the state budget led to a sharp reduction in real money demand in 1994 as private savings were channeled away from relatively low-yielding bank deposits. Specifically, broad money increased by about 13 1/2 percent during the year, lagging growth in nominal GDP by nearly 10 percentage points, resulting in a further increase in velocity. Including holdings of government securities by the nonbank public, which are estimated to have grown from some Ft 100 billion (5 3/4 percent of broad money) at end-1993 to Ft 250 billion (12 1/2 percent of broad money) at end-1994, however, the ratio of M4 (broad money plus holdings of government securities by the nonbank public) to nominal income remained relatively constant during the year.

As regards the components of broad money, foreign currency deposits (FCDs) grew by about 23 percent in the 12 months to end-1994, resulting in a small increase in the share of FCDs in total enterprise and household deposits to about one quarter. Household FCDs, which accounted for 70 percent of total foreign currency deposits in December 1994, increased by 34 percent in 1993 and by 42 percent in 1994, reflecting an increased desire by households to safeguard the real value of their financial assets in a period of heightened macroeconomic uncertainty. 1/ 2/

Despite increases in the cost of borrowing, domestic credit of the banking sector expanded by more than 16 percent in 1994, about the same rate as in the previous year. Lending to enterprises (including small enterprises) and to the state government each accounted for about 22 percent of the total increase in domestic credit. Reflecting the importance of noninterest rate sensitive enterprise borrowing during the year, credit to enterprises grew by nearly 15 percent in 1994, compared to a decline of about 1 percent in the previous year. 3/ Credit to the consolidated state government increased by more than 10 percent, in part reflecting the

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1/ Growth in household FCDs was constrained over this period by a yearly limit on foreign exchange purchases, currently US$800 per person.

2/ The behavior of enterprise FCDs has been erratic over this period, and even declined sharply in January, 1993, as foreign investors drew down their FCDs in order to purchase shares in the telecommunications company. The erratic behavior of enterprise FCDs reflects the fact that only foreign enterprises or enterprises with foreign partners are permitted to open such accounts, and then only to deposit their foreign capital. Withdrawals, however, are unrestricted and, if used to purchase imports, the resulting goods are subject to import duties at reduced or zero rates.

3/ Excluding the effects of loan consolidation growth in enterprise borrowing was about 20 percent in 1994.

increase in government debt in the form of consolidation bonds issued in connection with bank recapitalization and enterprise debt reduction schemes. 1/ 2/

4. Balance of payments and external debt

The balance of payments in Hungary deteriorated markedly in 1993-94. Following small surpluses during the preceding three years, the current account deficit averaged about US$3 3/4 billion (nearly 10 percent of GDP) in 1993-94 (Chart 4). The current account deficit was financed to a considerable extent by official and enterprise borrowing and external debt and debt service indicators deteriorated; in particular, the net external debt to GDP ratio increased by over 10 percentage points to 46 percent over the two year period to end-1994. At the same time, foreign exchange reserves reached record levels, also supported by sizable inflows of foreign direct investment.

a. External trade developments during 1993-94

The external trade balance in 1993 widened sharply to US$2.9 billion (8.1 percent of GDP), after a deficit of US$0.4 billion in 1992, as exports declined markedly while imports accelerated. 3/ The decline in exports by an estimated 16.8 percent reflected to some extent factors unrelated to the conduct of domestic economic policy, especially the continued drought and its detrimental impact on agricultural supply conditions, and the effects of the implementation of UN sanctions against the Federal Republic of Yugoslavia (Serbia/Montenegro). In addition, the recession in Western Europe, and especially in Germany, Hungary's main trading partner, hampered export activity. It is also likely that the base, the 1992 level of exports, was somewhat exceptional as enterprises in the early stages of restructuring after the collapse of the CMEA sought to export their products even if it entailed significant losses, a situation that was not sustainable and eventually corrected following the implementation of the new bankruptcy regulations in 1992. Even so, Hungary's export performance in 1993 also lagged behind that of several other transforming economies in Central and Eastern Europe, and this points also to the importance of domestic factors in the trade performance. Among these factors, external competitiveness as measured by price and labor cost indicators had deteriorated considerably in earlier years, with real effective exchange rates appreciating by over 25 percent based on consumer prices and almost 30 percent based on unit

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1/ In accordance with the provisions of the 1993 Amendment to the Act on the National Bank of Hungary, the *composition* of government debt was affected by the replacement in May 1994 of nearly Ft 60 billion in outstanding interest-free debt to the National Bank arising from past foreign-exchange valuation losses with market-interest bearing securities.

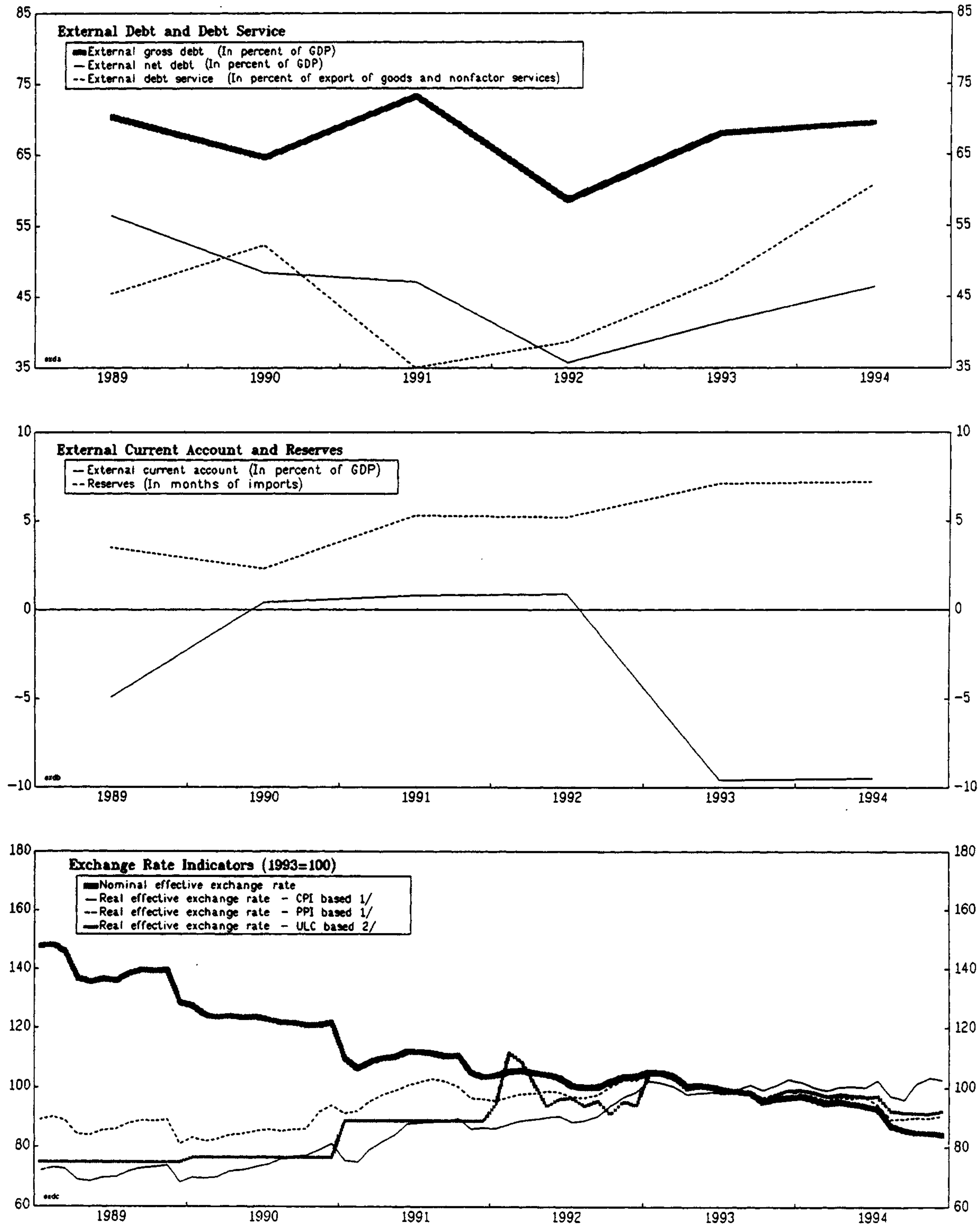
2/ More than one quarter of government debt to the banking system is in the form of consolidation bonds.

3/ The following analysis of trade developments is based on customs data; a brief comparison with settlement data is provided later in this section.

Chart 4

HUNGARY

SELECTED EXTERNAL INDICATORS, 1989-94



Sources: National Bank of Hungary; IMF, International Financial Statistics; and staff estimates.

1/ Data from October onward are staff projections.
2/ ULC = Annual average prior to January 1992. Data from October 1994 onward are projections.

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labor costs between end-1990 and end-1993. 1/ While there was only a relatively small further appreciation during 1993 itself--and the producer price based index even depreciated--it is likely that the trade performance in 1993 reflected some lagged response to the earlier appreciation, especially as concerns the highly cost elastic commissioned works, which declined by US$0.5 billion. Moreover, as the external imbalances widened, many market participants may have expected a larger discrete exchange rate adjustment, and this likely contributed to an underinvoicing of exports at the time. Further contributing to the decline in exports was the domestic macroeconomic policy setting, notably on the fiscal side, where the resource absorption of the public sector remained large favoring the nongoods sector.

Hungary. Contributions to the export decline in 1993

(In millions of US dollars)

Change in total exports, customs basis	-1,798
Contributions by:	
Exogenous factors 1/	-740
Drought effects on agricultural exports	-340
UN sanctions on the Federal Republic of Yugoslavia (Serbia/Montenegro)	-400
Other factors	-1,058
Underinvoicing	-391
Other	-667

Source: staff estimates.

1/ Defined here as directly related to weather conditions and international sanctions, but excluding, for example, business cycle movements in partner countries.

1/ In view of underlying data problems, uncertainty concerning the lag length of the trade response to relative cost changes, and structural changes in the economy, it is difficult to interpret the importance of these exchange rate movements and historical data are likely to provide only limited information; see below.

The growth of imports in 1993 was largely influenced by similar factors as the export developments, including the earlier deterioration in competitiveness and the negative supply shock in the domestic agricultural sector. Furthermore, the acceleration of domestic demand with a positive fiscal impulse, the deterioration in private saving and the ensuing rise in domestic consumption, and an end to the downsizing of enterprise inventories, contributed importantly to the growth in imports.

The interpretation of external trade developments in 1994 is hampered by a considerable divergence between information based on customs and settlement statistics. While these two sources had also shown quantitatively somewhat different trends in 1993, the differences were more marked in 1994; settlement data indicate a further decline in exports and essentially flat imports in US dollar terms, while customs data point to double digit growth in exports as well as imports with the latter growing at a somewhat faster pace. While it is possible to reconcile part of these differences, it is nevertheless rather difficult to provide a fully consistent analysis of the trends in 1994. 1/

Hungary. External trade indicators on a settlement and customs basis, 1992-94 1/

(In billions of US dollars, except when indicated otherwise)

	1992		1993				1994			
	Settlement Basis	Customs Basis	Settlement Basis Level	Settlement Basis Percent Change	Customs Basis Level	Customs Basis Percent Change	Settlement Basis Level	Settlement Basis Percent Change	Customs Basis Level	Customs Basis Percent Change
Exports	10,028	10,705	8,094	-19.3	8,907	-16.8	7,613	-5.9	10,701	20.1
Imports 1/	10,077	11,079	11,341	12.5	11,817	6.7	11,248	0.8	14,554	23.2
Trade balance	-50	-374	-3,247	...	-2,910	...	-3,635	...	-3,853	...
(In percent of GDP)	(-0.1)	(-1.0)	(-9.0)	...	(-8.1)	...	(-8.9)	...	(-9.4)	...

Source: National Bank of Hungary.

1/ Excludes in 1993 import of military equipment from Russia in lieu of outstanding debt obligations.

1/ The gap between customs data and settlement data, which are on a payments basis, includes as important items goods for processing (commissioned work); leasing items; repairs of aircraft; and Jamburg gas deliveries that have no payment counterparts. However, even after these adjustments are identified there remain significant differences between the two data sources, reflecting differences in coverage and leads and lags in the timing of payments.

Based on customs data, exports are estimated to have increased by 20 percent in U.S. dollar terms in 1994, led by a strong increase in exports of manufactured consumer goods. They benefitted from some gains in cost competitiveness with strong productivity growth more than compensating for rapidly rising wages in the tradable sector. Export demand expanded with the economic rebound in Western Europe, and the share of exports to EU countries recovered from the losses in the previous year, accounting for over 50 percent of total exports. On the import side, the growth in customs values was supported by strong growth in imports of machinery goods, in parallel with the rebound in domestic investment activity. Furthermore, rising disposable incomes contributed to a rapid expansion in consumer durable and food imports. Somewhat less than half of the imports originated in EU countries, while the share of the former socialist economies, which has fallen substantially since the end of the CMEA trade system, accounted for less than one quarter of total imports.

The main policy instruments employed to address the widening current account deficit were a tightening of the monetary stance in terms of increases in official interest rates (discussed in Section II.3), and discrete adjustments of the nominal exchange rate vis-à-vis the currency basket. In the event, the forint was devalued five times in 1993 and seven times in 1994 by a cumulative 13 percent and by 14.4 percent, respectively, including a 7 1/2 percent depreciation in August 1994. 1/

With these exchange rate adjustments, the real effective exchange rate based on unit labor cost regained some of the earlier losses and was, at end-1994, slightly under its level at end-1992. Taking a longer perspective, the unit-labor cost based real exchange rate at end-1994 was still some 20 percent higher than early in the transition process in 1990. Assessments of competitiveness, however, are complicated by external shocks and ongoing structural change that the Hungarian economy has experienced in recent years. Other indicators that shed some light on competitiveness include direct observations on enterprise profitability, which show large and persistent losses in many enterprises and sectors; however, they suggest that profitability of exporters, although relatively low on average, may exceed the level in the rest of the economy, and preliminary data point to some improvement in the firms' profit situations in 1994. The external current and trade accounts themselves also provide some indication of the competitive position of Hungary, as do the market shares of Hungarian products on domestic and foreign markets, which have declined considerably, in particular in 1993.

b. Other current account transactions

Among major service account items, receipts from tourism are estimated to have increased by over 20 percent in 1994 in U.S. dollar terms, following a slight decrease in the previous year. Cyclical conditions in the countries of origin contributed to these developments. Moreover, with the

1/ Further details on the exchange system are contained in Chapter VII.

number of tourist arrivals declining in 1994, the increase in receipts reflected a rise in per capita expenditure, as more tourists utilized relatively higher priced hotels as opposed to private accommodations. Expenditures by Hungarian tourists abroad have steadily increased in recent years and the net tourism surplus averaged about US$0.5 billion in 1993-94.

Interest expenditure in 1993-94 rose in line with the increase in external debt levels, but lower long-term interest rates, especially on capital markets in Europe in 1993, mitigated the increase. Under these circumstances, interest expenditure increased from US$1.6 billion in 1993 to almost US$2 billion in 1994.

In all, the service account deficit added more than US$1 billion to the gap in the trade balance in 1993-94 and, with fairly stable and relatively small net transfer inflows, the current account recorded deficits of US$3.5 billion in 1993 and an estimated US$3.9 billion in 1994 (around 9 1/2 percent of GDP).

c. Capital flows and international reserves

The sharp deterioration in the external current account in 1993-94 was more than offset by large capital inflows. Access to international capital improved in 1993 for many emerging market borrowers, and the NBH undertook an extensive borrowing program, especially on private bond markets. In all, 16 bond issues were placed during 1993, mostly in a variety of European bond markets and in Japan, with yield spreads generally averaging some 250 basis points over benchmark instruments. Following general market trends, the situation became more difficult in early 1994. However, this proved to be temporary and, for the year as a whole, the NBH was still able to place the same number of issues on international markets at broadly similar terms than in the previous year, though at smaller amounts per placement. The average maturity of the foreign borrowing by the NBH exceeded seven years in 1993/94.

Enterprise borrowing also accelerated in 1993-94 and averaged about US$1 billion, partly in response to the tightening of domestic monetary conditions since mid-1993. In addition, borrowing abroad was facilitated by the increasing presence of subsidiaries of foreign-owned companies and joint venture companies with relatively easier access to foreign capital markets.

Hungary continued to attract a large share of the foreign direct investment flows into the region. In 1993, total inflows reached US$2.3 billion (about 6 1/2 percent of GDP), strongly influenced by the partial privatization of the telecommunications company. In 1994, inflows declined to about US$1.1 billion, their lowest level in four years, partly due to the earlier discussed slowdown in privatization, and increasing competition from other countries in the region that were able to attract a larger share. Even so, Hungary's share of total inflows into the region was still above 50 percent for the period since 1990.

Short-term capital inflows have played a relatively minor role in Hungary--with the stock remaining broadly stable at somewhat over US$2 billion--as portfolio inflows have been restricted (see Chapter VII). On the other hand, balance of payments estimates for 1994 showed a strong inflow of short-term capital including errors and omissions; while some of this is likely to reflect unrecorded trade flows, it could also include some unrecorded short-term capital flows.

The large net inflows outweighed not only the sizable amortization payments--of US$3.3 million and US$4.3 billion in 1993 and 1994, respectively--but allowed also for a build-up in international reserves to record levels. The build-up occurred mainly in 1993, as reserves remained broadly unchanged in 1994; by end-1994, reserves of US$6.8 billion covered 7.2 months of merchandise imports.

d. External debt and debt service

The current account deficits and reserve accumulation in 1993-94 was financed to a considerable extent by debt-creating capital inflows. During this two-year period (and including valuation changes), Hungary's net debt increased by almost US$6 billion to US$19 billion (about 46 percent of GDP). With the concurrent increase in foreign exchange reserves and other assets, gross debt increased even faster over the same period reaching an estimated US$28.5 billion at end-1994.

Hungary's external obligations are largely medium- and long-term, with average maturity of total external debt, including short-term debt, of about 4 1/2 years. As mentioned above, the stock of short-term debt has remained fairly stable at somewhat over US$2 billion, and amounted to about 8 1/2 percent of total external debt at end-1994. This relatively small level of short-term debt reflects restrictions on private portfolio inflows; in particular, nonresidents are prohibited from purchasing most government securities. Debt management has been geared at lengthening maturities and smoothing amortization payments, and the NBH seldom borrows at maturities below seven years. To smooth amortization payments, the NBH pre-paid amortizations due in 1995-96 of about US$0.9 billion in the first half of 1994. With favorable long-term interest rates on the more recent borrowing, this also reduced the interest bill for 1994 and future years.

With the recent switch in the borrowing program from commercial bank borrowing to bond financing, the share of bonds in total debt rose from an insignificant amount in 1990 to about 3/4 of total public debt extended by private creditors to Hungary by end-September 1994, or about 45 percent of total external debt.

At present, Hungary's external debt and debt service burden exceeds the levels observed at the beginning of the transition period in 1989/90, with the gross debt-to-GDP ratio at almost 70 percent and the debt-to-export ratio at about 280 percent. While these ratios are high even by the standards of heavily indebted countries, 1/ Hungary compares favorably in terms of its level of reserves, with import coverage exceeding 50 percent, and in terms of its access to international financial markets.

Reflecting the recent increase in the external debt stock, debt service indicators deteriorated during 1993/94. In 1994, debt service reached 53 percent of exports of goods and nonfactor services; 2/ interest payments alone amounted to 19 percent of exports of goods and nonfactor services.

1/ Comparisons are based on IMF, World Economic Outlook (various issues); see also Table 42.

2/ Excluding early debt repayments by the NBH; excluding such repayments, the debt service ratio was about 61 percent.

Table 1. Hungary: Gross Domestic Product and Aggregate Demand, 1989-94 1/

	1989	1990	1991	1992	1993	Estimate 1994
			(In billions of forint)			
Domestic demand	1,653.4	2,003.5	2,503.6	3,872.5	3,817.3	4,640.6
Consumption	1,207.3	1,504.3	1,997.3	2,433.6	3,127.6	3,719.8
Individual 2/	1,029.6	1,282.5	1,699.3	2,085.3	2,614.6	3,190.3
Collective 3/ 4/	177.7	221.8	233.6	290.5	450.0	455.8
Other 5/	...	...	64.4	57.8	63.0	73.7
Investment	446.1	499.2	506.3	438.9	689.7	920.8
Gross fixed capital	347.8	369.6	515.8	576.1	643.8	843.8
Stockbuilding	98.3	129.6	-9.5	-137.2	45.9	77.0
Net exports	57.4	76.0	-26.9	13.1	-314.7	-326.6
Exports	620.9	669.0	925.3	1,077.8	1,048.2	1,407.6
Imports 4/	563.5	593.0	952.2	1,064.7	1,362.9	1,734.1
GDP	1,710.8	2,079.5	2,476.7	2,885.6	3,502.6	4,314.1
			(In percent of GDP)			
Domestic demand	96.6	96.3	101.1	99.5	109.0	107.6
Consumption	70.6	72.3	80.6	84.3	89.3	86.2
Individual 2/	60.2	61.7	68.6	72.3	74.6	74.0
Collective 3 4/	10.4	10.7	9.4	10.1	12.8	10.6
Other	...	...	2.6	2.0	1.8	1.7
Investment	26.1	24.0	20.4	15.2	19.7	21.3
Gross fixed capital	20.3	17.8	20.8	20.0	18.4	19.6
Stockbuilding	5.7	6.2	-0.4	-4.8	1.3	1.8
Net exports	3.4	3.7	-1.1	0.5	-9.0	-7.6
Exports	36.3	32.2	37.4	37.4	29.9	32.6
Imports 4/	32.9	28.5	38.4	36.9	38.9	40.2
GDP	100.0	100.0	100.0	100.0	100.0	100.0

Sources: CSO; and data provided by the Hungarian authorities.

1/ The data series have a break in 1991: for 1991-94, the data are based on the new System of National Accounts (SNA); earlier data are based on the old SNA (see also the following footnotes).
2/ Under the new SNA: household consumption, including social transfers in kind; under the old SNA: private consumption.
3/ Under the new SNA: government final consumption expenditure, excluding social transfers in kind by the government; under the old SNA: public consumption.
4/ Includes in 1993 Ft 72 billion in imports of military equipment from Russia.
5/ No data for this category are available under the old SNA.

Table 2. Hungary: Aggregate Demand - Real Growth and Inflation, 1989-94 1/

	1989	1990	1991	1992	1993	Estimate 1994
			(Real growth rate, in percent)			
Domestic demand	-1.6	-3.1	-9.4	-6.1	10.0	2.4
Consumption	-0.3	-2.7	-5.4	-1.4	5.0	-1.7
Of which:						
Individual 2/	-0.3	-3.6	-5.8	-1.3	1.4	1.6
Collective 3/ 4/	0.2	2.6	-2.7	3.9	30.5	-17.5
Investment	-5.8	-4.3	-22.2	-24.7	37.0	18.9
Gross fixed capital	-5.0	-5.2	-0.6	-2.8	-0.7	13.8
Stockbuilding 5/	-0.6	0.1	-5.1	-4.4	5.9	1.3
Net exports 5/	2.5	-0.5	-2.6	1.8	-12.2	--
Exports	8.6	-5.3	-15.3	5.4	-11.9	13.3
Imports 4/	1.8	-4.3	-8.8	0.5	18.6	10.2
GDP	0.7	-3.5	-11.9	-4.3	-2.3	2.6
			(Implicit deflator growth, in percent)			
Domestic demand	20.4	25.1	30.6	22.2	20.8	18.7
Of which:						
Consumption	16.7	28.1	33.0	23.6	22.4	20.9
Of which:						
Individual 2/	19.0	29.2	32.9	24.3	23.7	20.1
Collective 3/ 4/	5.2	21.6	34.0	19.7	18.7	22.8
Gross fixed capital	23.9	12.1	20.0	14.9	12.5	12.3
Exports	7.8	13.8	47.3	10.5	10.4	18.5
Imports 4/	12.5	10.0	66.8	11.3	7.9	15.5
GDP	18.4	26.0	26.0	21.8	24.2	20.0

Sources: CSO; and data provided by the Hungarian authorities.

1/ The data series have a break in 1991: for 1991-94, the data are based on the new System of National Accounts (SNA); earlier data are based on the old SNA (see also the following footnotes).

2/ Under the new SNA: household consumption, including social transfers in kind; under the old SNA: private consumption.

3/ Under the new SNA: government final consumption expenditure, excluding social transfer in kind by the government; under the old SNA: public consumption.

4/ Includes in 1993 Ft 72 billion imports of military equipment from Russia. Excluding these imports, real growth in collective consumption and imports was 4.0 percent and 11.1 percent, respectively, in 1993 and 3.5 percent and 17.7 percent in 1994.

5/ Contribution to growth.

Table 3. Hungary: Gross Value Added by Industries, 1990-93 1/

	In Billions of Forint at Current Prices	In Percent of GDP	Annual Percentage Change, at Constant Prices			
	1991		1990	1991	1992	1993
Agriculture, hunting, forestry and fishing	197.1	8.0	-7.7	-17.9	-13.9	-14.7
Industry	793.0	32.0	-3.9	-10.2	-7.8	-0.3
Mining and quarrying 2/	81.8	3.3	...	...	-63.1	-11.2
Manufacturing 2/	494.3	20.0	...	...	0.1	1.2
Electricity, gas, steam and water supply	90.5	3.7	...	...	-1.3	-4.8
Construction	126.4	5.1	-4.7	-8.2	-0.8	-3.9
Transport, storage and communication	192.3	7.8	-7.3	-11.4	-4.7	-7.4
Other services	1,107.2	44.7	6.4	-4.7	-5.8	-1.5
Wholesale and retail trade; repair of motor vehicles and household goods	307.2	12.4	...	...	-22.9	1.7
Hotels and restaurants	51.1	2.1	...	...	-11.3	-2.1
Financial intermediation	179.2	7.2	...	...	-22.7	-9.0
Real estate, renting and other	222.5	9.0	...	...	9.5	3.6
Public administration and defence, and compulsory social security	124.6	5.0	...	...	6.1	0.6
Education	84.5	3.4	...	...	6.0	0.6
Health and social work	82.6	3.3	...	...	3.0	-6.3
Other community, social and personal service activities	55.5	2.2	...	...	30.3	-14.6
Total	2,289.6	92.4	...	...	-6.7	-2.8
Imputed bank charges	-107.7	-4.3	...	...	...	...
GDP at basic prices	2,181.9	88.1	...	...	-5.7	-2.9
Net taxes on products	294.8	11.9	...	...	6.1	1.2
GDP at market prices	2,476.7	100.0	-3.5	-11.9	-4.3	-2.3

Sources: CSO, National Accounts Hungary, 1991-93; data provided by the authorities; and staff estimates

1/ Growth rates after 1991 (and the forint values of 1991) are based on the new System of National Accounts (SNA); data for earlier periods are based on the old SNA methodology and not directly comparable.
2/ From 1992, all activities of the Hungarian Oil Company (MOL Rt) are classified as manufacturing.

Table 4. Hungary: Developments in Industry, 1985-94 1/

	Percentage Share			Percentage Share of Sales, 1993 3/		Percentage Change at Constant Prices						
	Gross Production 2/		Employment			Industrial Production	Productivity	Gross Production				
	1985	1993	1993	Domestic	Exports	1985-93	1993	1990	1991	1992	1993	Jan-Nov. 1994
Mining and quarrying	2.4	2.0	3.6	94.7	5.3	-42.4	39.6	-11.8	-10.5	-17.9	-1.0	-13.2
Manufacturing	86.9	84.3	85.7	71.2	28.8	-34.7	14.4	-10.3	-21.1	-8.3	3.3	8.6
Food, beverages, and tobacco	19.6	23.7	17.8	85.6	14.4	-16.3	10.5	-0.9	-6.8	-4.0	-4.2	4.7
Textiles, dressing, leather and fur	8.5	5.5	15.9	53.1	46.9	-54.8	1.9	-13.7	-25.9	-15.2	2.5	3.7
Wood, paper, publishing and printing	3.5	5.7	6.1	90.5	9.5	13.1	-4.2	-6.1	-11.4	6.3	7.6	3.0
Chemicals, petroleum, and plastic	19.3	19.6	10.4	68.1	31.9	-29.4	1.4	-6.8	-19.6	-7.1	0.8	5.0
Nonmetallic mineral products	3.2	3.4	4.0	78.7	21.3	-26.1	15.3	-4.7	-29.0	-2.3	10.7	1.8
Basic and fabricated metals	11.9	9.1	9.1	63.7	36.3	-46.7	11.3	-17.2	-28.6	-18.7	14.0	19.8
Engineering	19.1	15.7	19.4	55.3	44.7	-42.9	29.8	-16.2	-28.9	-11.0	10.3	19.5
Manufacturing of N.E.C., recycling	1.8	1.6	3.0	72.5	27.5	-37.6	5.4	-8.4	-22.3	-10.8	6.7	4.2
Electricity, gas, steam and water supply	10.7	13.7	10.7	99.9	0.1	-11.5	-2.2	0.7	-2.5	-14.3	-2.2	0.3
Industry total	100.0	100.0	100.0	75.6	24.4	-31.9	13.4	-9.3	-18.4	-9.7	4.0	9.2

Source: CSO.

1/ For companies employing more than 20 persons.
2/ At constant prices of 1993.
3/ Current prices.
4/ Output per person employed.
5/ The percentage change figures include data for all corporations.

Table 5. Hungary: Agricultural Production and Average Yields of Selected Crops, 1989-93

	1993	1989	1990	1991	1992	1993
	(Share of total gross production)			(Percentage change)		
Gross production	100.0	-1.3	-3.8	-3.5	-19.2	-9.7
Plant cultivation	58.3	0.1	-7.8	3.1	-24.3	-9.2
Animal husbandry	41.7	-2.7	-0.2	-10.0	-13.1	-10.4
	(Thousands of tons)					
Production of major crops						
Wheat	3,021	-6.9	-5.2	-3.1	-42.2	-12.5
Maize	4,044	11.8	-35.7	72.1	-41.4	-3.2
Barley	1,138	13.3	2.2	13.7	11.0	-34.0
Vintage	607	-21.2	48.8	-12.1	-13.3	-8.3
Fruit crops	1,271	-4.9	-8.8	-7.8	-9.3	10.4
Sugar beet	2,182	17.5	-10.1	23.7	-50.3	-25.5
Vegetable	1,336	-11.3	2.2	-2.1	-15.0	-4.6
	(In thousands, end of period)					
Livestock						
Cattle	999	-5.4	-1.7	-9.6	-15.5	-13.8
Pigs	5,001	-8.0	4.4	-25.1	-3.2	-6.8
Sheep	1,252	-6.6	-9.9	-3.1	-11.5	-28.5
Poultry	33,829	-4.0	-18.9	-4.3	19.7	-13.4
	(In kilograms per hectare)					
Average yields						
Wheat	3,050	-3.9	-3.6	2.8	-21.5	-25.1
Rye	1,660	5.0	-8.4	-5.2	-19.7	-13.5
Barley	2,640	5.4	-2.4	-4.6	-18.1	-26.5
Oats	1,820	2.8	1.8	-19.9	1.8	-35.3
Maize	3,500	13.9	-35.9	68.2	-43.0	-4.1
Rice	2,650	-34.7	41.3	-28.6	-2.6	-13.7
Sugar beet	22,950	11.8	-17.9	3.0	-32.8	-15.6

Sources: CSO, Statistical Yearbook, Agricultural Pocketbook; and data provided by the Hungarian authorities.

Table 6. Hungary: Investment
by Origin of Capital Goods, 1989-93 1/

	Total	Construc-tion	Machinery: Domestic	Machinery: Imported from Ruble Area		Machinery: Imported from Nonruble Area	Total Machinery	Other
			(At current prices in billions of forint)					
1989	269.5	130.8	59.0	15.7		48.2	122.9	15.8
1990	280.5	134.9	58.8	11.6		59.4	129.8	15.8
1991	303.5	145.4	57.9		82.4 2/		140.3	17.8
1992	555.6	277.7	85.1		141.1 2/		226.2	51.7
1993	625.3	312.7	100.8		156.7 2/		257.5	55.1
			(In percent of total)					
1988	100.0	49.8	22.7	6.8		14.7	44.2	6.0
1989	100.0	48.5	21.9	5.8		17.9	45.6	5.9
1990	100.0	48.1	21.0	3.9		21.4	46.3	5.6
1991	100.0	47.9	19.1		27.1 2/		46.2	5.9
1992	100.0	50.0	15.3		25.4 2/		40.7	9.3
1993	100.0	50.0	16.1		25.1 2/		41.2	8.81
			(Percent change in volume terms)					
1988	-8.3	-5.7	-9.1	-14.6		-4.2	-10.2	-14.0
1989	3.9	2.2	-1.8	-12.3		27.2	6.0	2.0
1990	-10.6	-11.4	-15.1	-28.2		1.8	-9.0	-16.1
1991	-11.4	-7.9	-18.7		-11.6 2/		-14.8	-12.9
1992	1.8	-6.4	-12.2		29.3 2/		7.3	16.8
1993	1.5	3.5	3.7		-2.6 2/		1.2	-5.7

Sources: CSO, Statistical Yearbook and Monthly Bulletin of Statistics.

1/ The table contains the investments of legally registered economic organizations. Due to revisions in methodology, the data series have a break in 1992.
2/ Total imported machinery.

Table 7. Hungary: Sectoral Saving and Investment Balances, 1990-94

(In percent of GDP)

	1990	1991	1992	1993	Estimate 1994
Gross National Saving	27.3	17.8	14.4	11.2	12.4
Households	9.1	15.1	14.0	7.8	9.4
Enterprises	13.1	-0.4	-1.2	2.3	5.8
Government 1/	5.1	3.1	1.5	1.2	-2.8
Gross investment	25.4	20.4	15.2	19.7	21.3
Households	3.9	5.4	4.4	3.6	3.3
Enterprises	18.0	10.7	4.7	10.2	14.1
Government	3.6	4.3	6.1	5.9	3.9
Nonfinancial balance 2/	1.9	-2.7	-0.8	-8.4	-8.9
Households	5.2	9.7	9.6	4.2	5.9
Enterprises	-4.9	-11.2	-5.8	-7.9	-8.1
Government 1/	1.5	-1.2	-4.6	-4.7	-6.7

Sources: Ministry of Finance; Central Statistical Office; and staff estimates and projections.

1/ Excludes in 1993 imports of military equipment from Russia in lieu of outstanding claims by Hungary.
2/ The nonfinancial balance is on a national accounts basis and differs from the current account in the balance of payments, which is on a settlements rather than a customs basis.

Table 8. Hungary: Income Distribution by Sectors of Production, 1991-94

	1991	1992	1993	Estimate 1994
		(In billions of forints)		
GDP at market price	2,476.7	2,885.6	3,502.6	4,314.1
Taxes on production	...	432.7	573.4	...
Subsidies on production	...	36.4	34.4	...
Net taxes on production	294.8	396.3	539.0	589.1
Gross value added (basic prices)	2,181.9	2,489.3	2,963.6	3,725.0
Nonfinancial corporations	1,252.3	1,298.0	1,513.1	1,923.0
Financial corporations	179.2	173.7	190.0	220.5
Government units	359.2	469.7	573.9	710.0
Households	391.2	547.9	686.6	871.5
Wages and salaries	1,031.5	1,165.0	1,334.6	1,600.0
Social security contributions	354.9	440.3	510.7	598.6
Compensation of employees	1,386.4	1,605.3	1,845.3	2,198.6
Nonfinancial corporations	995.3	1,092.6	1,224.0	1,441.0
Financial corporations	37.3	49.3	56.8	69.0
Government units	316.7	414.9	507.6	620.0
Households	37.1	48.5	56.9	68.6
Other taxes on production	89.8	66.2	72.0	78.7
Other subsidies on production	22.3	27.9	33.7	40.3
Operating surplus (mixed income)	728.0	845.7	1,080.0	1,488.0
Nonfinancial corporations	201.9	172.1	256.8	450.0
Financial corporations	133.4	123.9	132.1	150.0
Government units	41.3	53.9	65.1	88.9
Households	351.4	495.8	626.0	799.1
		(In percent of GDP)		
Memorandum items:				
Compensation of employees	56.0	55.6	52.7	51.0
Operating surplus	29.4	29.3	30.8	34.5

Sources: CSO; and Ministry of Finance.

Table 9. Hungary: Household Disposable Income, 1991-94

(In billions of forint)

	1991	1992	1993	Estimate 1994
Wages and salaries	1,031.9	1,165.0	1,334.6	1,600.0
Employers' social security contributions	355.0	440.3	510.7	598.6
Compensation of employees	1,386.9	1,605.3	1,845.3	2,198.6
Mixed income	351.4	495.8	626.0	799.1
Property income	54.4	91.9	55.7	124.4
Social benefits in cash	484.7	580.2	694.9	813.0
Other current transfers, net	-557.9	-707.1	-855.8	-959.6
Disposable income	1,719.5	2,066.1	2,366.1	2,975.5
Social transfers in kind	353.8	423.5	520.0	613.0
Adjusted disposable income	2,073.3	2,489.6	2,886.1	3,588.5
Memorandum items:				
Adjusted disposable income, real growth rate in percent 1/	...	-3.4	-6.2	3.5
Final consumption	1,699.3	2,085.3	2,614.6	3,190.3
Saving	374.0	404.3	271.5	398.2
In percent of GDP	15.1	14.0	7.8	9.2
Saving rate 2/	18.0	16.2	9.4	11.1

Source: CSO; and authorities' estimate for 1994.

1/ Deflated by the implicit individual consumption deflator.
2/ Ratio of saving and adjusted disposable income, in percent.

Table 10. Hungary: Employment by Sectors, 1989-94

(In thousand, beginning-of-year)

	1989	1990	1991	1992	1993	Estimate 1/ 1994
Industry	1,661.7	1,623.4	1,565.6	1,377.8	1,247.7	...
Construction	364.6	353.4	347.8	290.0	270.6	...
Agriculture	986.1	955.0	835.4	647.7	431.3	...
Transport, post and telecommunication	433.0	443.2	449.2	398.7	369.4	...
Trade	622.7	618.2	652.3	649.6	654.1	...
Water supply	88.3	84.4	75.4	66.1	56.3	...
Material services	59.6	56.7	55.3	60.5	35.4	...
Personal and economic services	239.9	246.0	240.9	240.7	244.9	...
Health, social and cultural services	767.9	810.8	802.2	767.0	768.3	...
Public administration, public and other services	281.2	280.8	279.8	298.1	274.0	...
Total	5,505.0	5,471.9	5,303.9	4,796.2	4,352.0	4,136.0

Source: CSO; and staff estimates.

1/ Due to revised classifications, the sectoral breakdown in 1994 is not directly comparable to earlier years.

Table 11. Hungary: Unemployment Indicators, 1989-94

	1989	1990	1991	1992	1993	1994
			(In thousands)			
Registered unemployed	28.5	79.5	406.1	663.0	632.1	519.6
Skilled	7.3	21.9	135.7	232.2	226.7	184.3
Semi-skilled	5.3	17.3	97.1	154.9	143.5	123.9
Unskilled	10.3	24.4	105.8	167.1	154.3	120.4
Nonmanual	5.6	15.9	67.5	108.8	107.6	91.0
Job seekers by duration of unemployment 1/	...	...	...	435.6	473.9	408.3
Less than 26 weeks	...	...	...	197.6	176.7	148.7
Less than one year and over 26 weeks	...	...	...	138.2	120.5	86.4
Over one year	...	...	...	99.8	176.7	173.2
			(In percent of respective total)			
Registered unemployed		100.0	100.0	100.0	100.0	100.0
Skilled		27.5	33.4	35.0	35.9	35.5
Semi-skilled		21.8	23.9	23.4	22.7	23.8
Unskilled		30.7	26.1	25.2	24.4	23.2
Nonmanual		20.0	16.6	16.4	17.0	17.5
Job seekers by duration of unemployment 1/	...	...	...	100.0	100.0	100.0
Less than 26 weeks	...	...	...	45.4	37.3	36.4
Less than one year and over 26 weeks	...	...	...	31.7	25.4	21.2
Over one year	...	...	...	22.9	37.3	42.2
Memorandum items:						
Unemployment rate, in percent						
Official 2/	0.6	1.4	7.5	12.3	12.1	10.4
Implied 3/	0.5	1.5	7.8	14.7	13.9	11.1
Persons obtaining unemployment benefits (in thousands)	2.4	61.7	312.1	477.0	326.6	191.6
Average benefit per month, in forint	4,046	5,816	7,310	8,828	9,949	11,237
Nominal growth rate, in percent	...	43.7	25.7	20.8	12.7	12.9
Real growth rate, in percent 4/	...	11.5	-6.9	-1.8	-8.0	-5.0

Sources: CSO, Statistical Yearbook and Monthly Bulletin of Statistics (various issues); and data provided by the authorities.

1/ By duration of job search, based on labor force survey for last quarter of the year. For 1992, the data are not directly comparable and refer to less than 27 weeks, less than 55 and more than 27 weeks, and over 55 weeks, respectively.
2/ Ratio of unemployed at end of the year to the labor force in January of the previous year.
3/ Ratio of registered unemployed to the sum of employed and unemployed in the same period.
4/ Deflated by the consumer price index.

Table 12. Hungary: Consumer Prices and Wages, 1989-94

	Consumption Share	1989	1990	1991	1992	1993	1994
		(Average annual percent change)					
Consumer prices	100.0	17.0	28.9	35.0	23.0	22.5	18.8
Foodstuffs	26.6	17.7	35.2	21.9	19.4	29.2	23.8
Beverages and tobacco	10.3	11.1	30.7	25.1	19.6	18.6	15.9
Fuel and electricity	7.7	11.4	27.6	81.0	43.2	20.3	11.6
Consumer durables	7.8	17.6	20.8	31.7	14.3	11.0	11.8
Other industrial articles	17.5	22.4	28.9	43.4	27.2	21.6	18.8
Clothing	8.5	18.2	23.3	32.1	23.0	16.7	16.2
Services	21.6	16.6	25.6	41.9	26.0	24.1	20.3
Wages							
Gross wages		17.9	27.2	33.4	24.3	21.9	22.8
Net wages		...	23.8	28.1	20.7	17.5	25.4

Sources: CSO, Monthly Bulletin of Statistics; and data provided by the Hungarian authorities

Table 13. Hungary: Producer Prices, 1989-91 1/

(Average annual percent change)

	1989	1990	1991
Industry	15.4	22.0	32.6
Mining	7.3	30.6	47.2
Electric energy	2.6	22.1	33.6
Motallurgy	27.5	21.0	31.3
Engineering	13.8	13.3	35.9
Construction materials	12.9	23.4	42.7
Chemical industry	15.6	24.9	43.7
Light industry	15.2	19.4	26.7
Food industry	19.3	30.4	18.3
Other industries	19.0	10.5	30.2
Construction	9.6	16.3	19.2
Agriculture and forestry	18.1	28.5	-0.9
Memorandum item:			
GDP deflator	18.4	26.0	26.0

Sources: CSO, Monthly Bulletin of Statistics; and data provided by the Hungarian authorities.

1/ Domestic and foreign sales.

Table 14. Hungary: Producer Prices, 1992-94 1/

(Average annual percent change)

	1992	1993	1994
Industry	10.7	11.0	11.3
Mining	4.0	6.3	8.8
Manufacturing	11.8	11.5	13.5
Food, beverages. tobacco	12.2	16.0	18.3
Textiles, clothes, leather, fur	10.7	9.4	10.4
Wood, paper, publishing, printing	15.4	12.7	12.4
Chemicals, petroleum, plastic	7.9	8.0	12.0
Nonmetallic mineral products	9.8	13.2	14.7
Basic and fabricated metals	4.1	5.0	11.0
Engineering	21.0	12.6	10.3
Other manufacturing	18.1	10.5	10.3
Electricity and water supply	6.1	9.2	2.1
Electricity, gas, steam	6.7	7.3	0.9
Water supply	--	29.3	17.5
Construction	17.2	13.2	14.4 2/

Sources: CSO, Monthly Bulletin of Statistics; and data provided by the Hungarian authorities.

1/ Domestic and foreign sales. Data are based on new industrial classifications and are not directly comparable to earlier series presented in Table 13.
2/ January-September.

Table 15. Hungary: Share of Administered Prices by Category, 1990-93 1/

	1990	1991	1992	1993
		(Percent of total)		
Consumer prices	16	11	8	6
Foodstuffs	...	7	--	--
Beverages and tobacco	--	--	--	--
Fuel and electricity	...	89	89	89
Consumer durables	...	...	...	...
Other industrial articles	...	...	...	...
Clothing	--	--		
Services	21	21	21	21
Retail trade articles	9	...	...	...
Ironware and technical articles	--	--	--	--
Means of transportation	80	--	--	--
Households chemicals	--	--	--	--
Furniture	--	--	--	--
Articles for education and culture	1	1	--	--
Fuels and lubricants 2/	96	--	--	--
Construction materials	--	--	--	--
Heating materials	98	87	--	--
Meditments	--	--	--	--
Other household energy 3/	100	100	100	100
Housing investment	--	--	--	--
Producer prices	17	7	...	...
Industry	...	...	...	...
Mining	75	75	23	23
Electric energy	90	90	90	90
Metallurgy	4	--	--	--
Engineering	--	--	--	--
Construction materials	--	--	--	--
Chemical industry	40	6	--	--
Light industry	--	--	--	--
Food industry	3	3	--	--
Other industries	...	...	--	--
Construction	--	--	--	--
Agriculture forestry	18	15	--	--
Transportation and communication	40	40	--	--
Trade	--	--	--	--
Water economy	...	...	...	...

Sources: CSO; Monthly Bulletin of Statistics; and data provided by the Hungarian authorities.

1/ Includes prices subject to a maximum limit.
2/ Petrol and gas oil.
3/ Electricity and gas.

Table 16. Hungary: Number of Business Organizations, 1989-93

(End-Year)

	1989	1990	1991	1992	1993
Incorporated economic associations	15,235	29,470	52,756	69,386	85,638
Of which:					
Enterprise	2,400	2,363	2,233	1,733	1,130
Limited liability company	4,484	18,317	41,206	57,262	72,897
Joint stock company	307	646	1,072	1,712	2,375
Cooperative	7,076	7,132	7,232	7,694	8,175
Nonincorporated economic associations	...	27,571	44,279	60,762	85,867
General partnership	203	418	463	1,187	2,492
Deposit partnership	...	5,789	22,977	41,218	67,301
Other	...	6,524	7,857	9,835	12,169
Individual entrepreneurs	320,619	393,450	510,459	606,207	688,843
Free lance professionals	...	...	137,994	165,689	193,888
Craftsmen	...	...	222,987	237,687	242,023
Retail trader	...	...	146,674	199,047	241,353
Independent farmer	...	...	2,804	3,784	11,579
Government institutions 1/	15,233	15,514	15,977	15,091	14,702
Central	1,194	1,245	1,516	1,488	1,356
Local	14,039	14,269	14,461	13,603	13,346
Social security institutions 1/	...	...	...	...	151
Other nonprofit institutions		22,296	27,407	33,891	38,493
Memorandum items:					
Business organizations with a foreign stake	1,350	5,693	9,117	17,182	20,000
Founder's equity (in billions of forint)	124.4	274.2	475.6	713.1	1,101.7
Of which:					
Foreign capital investment	30.0	93.2	215.0	401.8	642.4
Incorporated economic organizations					
Newly established	4,669	14,867	24,275	18,052	17,720
Terminated	245	632	989	1,422	1,468

Sources: CSO, FDI in Hungary; and data provided by the Hungarian authorities.

1/ Through 1992, social security institutions are included in government institutions.

Table 17. Hungary: Bankruptcies and Liquidations, 1992-94 1/

	1992	1993	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Total
			1993				1994				1992-94 Q3
Bankruptcies											
Declared	4,169	987	372	332	195	88	57	49	45	...	5,307
Voluntary	1,016	137	38	31	22	46	30	40	32	...	1,255
Compulsory	3,153	850	334	301	173	42	27	9	13	...	4,052
Published	2,500	887	295	257	238	97	30	22	18	...	3,457
Cancelled	1,260	740	162	176	152	250	136	74	35	...	2,245
Agreement	740	510	195	121	121	73	39	25	8	...	1,322
Continued in liquidation	703	674	263	219	159	33	17	6	--	...	1,400
Liquidations											
Declared	9,891	7,242	2,180	2,156	1,633	1,273	1,030	1,292	1,285	...	20,740
By creditor	8,131	5,883	1,744	1,767	1,352	1,020	759	1,052	1,074	...	16,899
By debtor	1,760	1,359	436	389	281	253	271	240	211	...	3,841
Published	2,227	2,593	591	683	639	680	526	712	524	...	6,582
Cancelled	4,401	3,975	1,026	1,201	912	836	918	782	514	...	10,590
Conclusion on the merits	562	1,140	431	291	178	240	277	251	242	...	2,472

Sources: Ministry of Finance, Economic Processes (various issues); and data provided by the authorities.

1/ Some of the data series may be inconsistent due to differences in the underlying data sources.

Table 18: Hungary: Consolidated State Budget, 1990-95 1/

(In billions of forint; GFS basis)

	1990	1991	1992	1993	Budget 1994	Estimated 1994	Budget 1995
Revenues	1,020.4	1,163.4	1,332.9	1,667.0	1,886.4	1,960.1	2,324.9
Taxes	955.3	1,053.6	1,210.0	1,539.4	1,695.5	1,769.8	1,977.6
Personal income taxes	59.9	137.0	157.9	235.3	254.8	261.5	283.5
Social security contributions	352.4	408.0	514.5	646.0	705.0	733.3	832.1
Profit taxes	140.8	119.9	65.9	64.1	82.3	86.0	83.0
Indirect taxes	388.3	383.8	589.6	589.6	648.4	684.5	774.5
Turnover taxes	79.0	32.3	19.9	24.7	26.2	17.0	18.0
VAT and excises	256.9	288.7	344.6	436.8	522.0	517.5	621.1
Taxes on foreign trade	52.4	62.8	100.2	128.2	100.2	150.0	135.4
Other taxes	13.8	5.0	7.1	4/3	5.0	4.5	4.5
Nontax revenues	65.1	109.8	122.8	127.6	191.0	190.2	347.2
Privatization	--	--	20.0	1.5	49.7	34.9	150.0
Interest receipts	...	...	8.1	4.9	3.5	0.4	5.0
Other	65.1	109.8	94.7	121.2	137.8	155.0	192.2
Expenditures	1,001.4	1,261.4	1,524.5	1,929.8	2,132.2	2,220.7	2,626.8
Current expenditures	972.1	1,228.0	1,485.9	1,899.9	2,075.7	2,176.7	2,576.7
Goods and services	241.1	382.7	444.8	711.6	637.7	671.9	729.2
Subsidies	196.2	165.6	102.0	114.7	124.0	158.7	155.4
Social security	444.2	571.1	724.5	851.4	946.6	977.0	1,104.6
Interest expenditures 2/	62.2	92.8	170.1	161.5	279.9	285.6	445.9
Other current expenditures 2/	28.4	15.8	44.5	60.7	87.5	83.6	141.6
Capital expenditures 3/	29.3	33.4	38.6	29.9	56.6	44.0	50.1
Overall balance	19.0	-98.0	-191.7	-262.8	-245.8	-260.7	-301.9
In percent of GDP	0.9	-4.0	-6.6	-7.5	-5.8	-6.0	-5.8
Financing	-19.0	98.0	191.7	262.8	...	260.7	...
Bank financing 4/	-11.9	90.4	188.5	33.8	...	80.0	...
Other domestic financing	3.2	13.3	7.2	231.6	...	185.8	...
External financing	-10.3	-5.7	-4.1	-2.6	...	-5.1	...
Memorandum items:							
Overall balance excluding privatization	19.0	-98.0	-211.7	-264.3	-295.5	-295.5	-451.9
In percent of GDP	0.9	-4.0	-7.3	-7.5	-7.0	-6.8	-8.7
Primary balance 5/	81.2	-5.2	-29.7	-106.3	30.5	24.6	139.0
In percent of GDP	3.6	-0.2	-1.0	-3.0	0.7	0.6	2.7
Primary balance excluding privatization	81.2	-5.2	-49.7	-107.8	-19.2	-10.3	-11.0
In percent of GDP	3.6	-0.2	-1.7	-3.1	-0.5	-0.2	-0.2
General government debt	1,411.9	1,878.8	2,331.2	3,192.2	...	2,815.6	4,317.2
In percent of GDP	63.3	75.9	80.8	91.1	...	88.4	83.2
Change in general government debt	...	466.9	452.4	861.0	...	623.4	501.6
Bank consolidation	...			285.6	..	50.0	--
FX related claims on NBH	...	258.7	111.0	293.1	...	218.0	154.0
Other (including state budget deficit)	...	208.2	341.4	282.3	...	355.4	347.6
Consolidated public debt 6/	1,260.2	1,675.6	1,919.5	2,959.5	...	3,557.6	3,986.1
In percent of GDP	56.5	67.7	66.5	84.5	...	82.5	76.8
Of which: domestic	74.4	137.9	355.4	822.7	...	1,058.9	1,345.5
In percent of GDP	3.3	5.6	12.3	23.5	...	24.5	25.9

Sources: Ministry of Finance; and staff estimates.

1/ State budget, consolidated with social security, housing, employment, solidarity, and expo funds, but excluding other extrabudgetary funds.

2/ The costs of advertising, placement, and other debt raising costs are included under other expenditures in 1994 and 1995.

3/ Covers only centrally-decided and enterprise investment. Investments by central budget institutions, extrabudgetary funds, and local governments are not included here.

4/ Estimates of bank financing are taken from net credit to central government in the banking survey; 1994 is a staff estimate.

5/ Overall deficit excluding net interest payments. The primary deficit calculation in 1990 and 1991 does not include interest receipts due to unavailability of data.

6/ Consolidated debt of general government and National Bank of Hungary.

Table 19: Hungary: Revenues and Expenditures of the Consolidated State Budget, 1990–95 1/

	1990	1991	1992	1993	Budget 1994	Estimated 1994	Budget 1995
				(In percent of GDP)			
Revenues	49.1	47.0	46.2	47.7	44.9	45.4	44.8
Taxes	45.9	42.5	41.9	43.9	40.3	41.0	38.1
Personal income taxes	2.9	5.5	5.5	6.7	6.1	6.1	5.5
Social security contributions	16.9	16.5	17.8	18.4	16.8	17.0	16.0
Profit taxes	6.8	4.8	2.3	1.8	2.0	2.0	1.6
Indirect taxes	18.7	15.5	20.4	16.8	15.4	15.9	14.9
Turnover taxes	3.8	1.3	0.7	0.7	0.6	0.4	0.3
VAT and excises	12.4	11.7	11.9	12.5	12.4	12.0	12.0
Taxes on foreign trade	2.5	2.5	3.5	3.7	2.4	3.5	2.6
Other taxes	0.7	0.2	0.2	0.1	0.1	0.1	0.1
Nontax revenues	3.1	4.4	4.3	3.6	4.5	4.4	6.7
Privatization	--	--	0.7	--	1.2	0.8	2.9
Interest Receipts	--	--	0.3	0.1	0.1	--	0.1
Other	3.1	4.4	3.3	3.5	3.3	3.6	3.7
Expenditures	48.2	50.9	52.8	55.1	50.7	51.5	50.6
Current expenditures	46.7	49.6	51.5	54.2	49.4	50.4	49.6
Goods and services	11.6	15.5	15.4	20.3	15.2	15.6	14.1
Subsidies	9.4	6.7	3.5	3.3	3.0	3.7	3.0
Social security	21.4	23.1	25.1	24.3	22.5	22.6	21.3
Interest expenditures 2/	3.0	3.7	5.9	4.6	6.7	6.6	8.6
Other current expenditures 2/	1.4	0.6	1.5	1.7	2.1	1.9	2.7
Capital expenditures 3/	1.4	1.3	1.3	0.9	1.3	1.0	1.0
Overall balance	0.9	-4.0	-6.6	-7.5	-5.8	-6.0	-5.8
				(Nominal growth rates, in percent)			
Revenues	...	14.0	14.6	25.3	13.0	3.9	18.6
Taxes	...	10.3	14.8	27.2	10.1	4.4	11.7
Personal income taxes	...	128.7	15.3	49.0	8.3	2.6	8.4
Social security contributions	...	15.8	26.1	25.6	9.1	4.0	13.5
Profit taxes	...	-14.8	-45.0	-2.7	28.4	4.5	-3.5
Indirect taxes	...	-1.2	53.6	--	10.0	5.6	13.1
Turnover taxes	...	-59.0	-38.5	24.0	6.2	-35.1	5.9
VAT and excises	...	12.4	19.4	26.8	19.5	-0.9	20.0
Taxes on foreign trade	...	19.8	59.6	27.9	-21.8	49.7	-9.7
Other taxes	...	-63.9	41.7	-39.4	16.7	-10.0	0.0
Nontax revenues	...	68.5	11.9	3.9	49.6	-0.4	82.5
Privatization	...	...	...	-92.5	3213.3	-29.9	330.4
Interest Receipts	...	...	...	-39.5	-28.6	-88.6	1150.0
Other	...	68.5	-13.7	28.0	13.7	12.5	24.0
Expenditures	...	26.0	20.9	26.6	10.5	4.1	18.3
Current expenditures	...	26.3	21.0	27.9	9.3	4.9	18.4
Goods and services	...	58.7	16.2	60.0	-10.4	5.4	8.5
Subsidies	...	-15.6	-38.4	12.5	8.1	28.0	-2.1
Social security	...	28.6	26.9	17.5	11.2	3.2	13.1
Interest expenditures 2/	...	49.1	83.3	-5.0	73.3	2.1	56.1
Other current expenditures 2/	...	-44.1	180.8	36.5	44.0	-4.4	69.4
Capital expenditures 3/	...	13.9	15.7	-22.7	89.2	-22.2	13.9
Overall balance	...	-616.6	95.6	37.1	-6.5	6.1	15.8
Memorandum item:							
GDP deflator	26.0	26.0	21.8	24.2	18.1	20.0	19.9

Sources: Ministry of Finance; and staff estimates.

1/ State budget, consolidated with social security, housing, employment, solidarity, and expo funds, but excluding other extrabudgetary funds.

2/ The costs of advertising, placement, and other debt raising costs are included under other expenditures in 1994 and 1995.

3/ Covers only centrally–decided and enterprise investment. Investment by central budget institutions, extrabudgetory funds, and local government are not included here.

Table 20: Hungary: Gross Debt of General Government and Consolidated Public Sector, 1990–94

	1990	1991	1992	1993	Estimate 1994
			(In billions of forint)		
Total debt financing of state budget deficit	465.8	578.6	796.1	1,012.7	1,236.0
National Bank of Hungary (NBH) credits	442.6	492.3	489.4	472.7	441.5
State bonds	13.0	26.3	149.5	319.4	474.0
Treasury Bills	10.2	60.0	157.2	220.6	320.5
Nondeficit related debt of the state sector	361.9	374.9	486.0	749.7	854.4
National Bank of Hungary other credit	333.8	344.9	326.2	307.1	298.3
Recapitalisations and other operations	28.1	30.0	159.8	442.6	556.1
Treasury Bonds to replace housing loans	--	--	83.2	79.4	75.8
Housing Fund finance	19.1	19.1	19.1	19.1	18.0
Bonds for National Bank of Hungary rouble claims	--	--	48.3	48.3	48.3
Bank consolidation bonds	--	--	--	285.6	335.6
Other capitalization	9.0	10.9	9.2	10.2	19.3
Tansformation of devaluation debt	--	--	--	--	59.1
Total domestic debt of the state sector, excluding devaluation item	827.7	953.5	1,282.1	1,762.4	2,090.4
Fiscal liability from forint depreciation	519.2	777.9	888.9	1,182.0	1,400.0
Total domestic debt of the state sector	1,346.9	1,731.4	2,171.0	2,944.4	3,490.4
Credit to local govenrments	27.6	28.6	26.3	29.1	66.0
Social Security deficit bonds	--	--	--	16.0	17.5
Total domestic debt of general government	1,374.5	1,760.0	2,197.3	2,989.5	3,573.9
Total foreign debt of central government	37.4	118.8	133.9	202.7	241.7
Gross debt of general government	1,411.9	1,878.8	2,331.2	3,192.2	3,815.6
Gross consolidated public debt 1/	1,260.2	1,675.6	1,919.5	2,959.5	3,557.6
Domestic	74.4	137.9	355.4	822.7	1,058.9
External	1,185.8	1,537.7	1,564.1	2,136.8	2,498.7
			(In percent of GDP)		
Total debt financing of state budget deficit	22.4	23.4	27.6	28.9	28.7
National Bank of Hungary (NBH) credits	21.3	19.9	17.0	13.5	10.2
State bonds	0.6	1.1	5.2	9.1	11.0
Treasury Bills	0.5	2.4	5.4	6.3	7.4
Nondeficit related debt of the state sector	17.4	15.1	16.8	21.4	19.8
Total domestic debt of the state sector, excluding devaluation item	39.8	38.5	44.4	50.3	48.5
Fiscal liability from forint depreciation	25.0	31.4	30.8	33.7	32.5
Total domestic debt of the state sector	64.8	69.9	75.2	84.1	80.9
Total domestic debt of general government	66.1	71.1	76.1	85.4	82.8
Total foreign debt of central government	1.8	4.8	4.6	5.8	5.6
Gross debt of general government	67.9	75.9	80.8	91.1	88.4
Gross consolidated public debt 1/	60.6	67.7	66.5	84.5	82.5
Domestic	3.6	5.6	12.3	23.5	24.5
External	57.0	62.1	54.2	61.0	57.9

Source: Ministry of Finance.

1/ Consolidated debt of the general government and the National Bank of Hungary (NBH).

Table 21. Hungary: Banking Survey, 1992-94

	Dec. 1992	March 1993	June 1993	Sept. 1993	Dec. 1993	March 1994	June 1994	Sept. 1994	Dec. 1994	Dec. 92 to Dec. 93	Dec. 93 to Dec. 94
	(In billions of forint, end of period)									(Percentage change)	
Net Domestic Assets	2,944.5	3,003.6	3,092.6	3,148.0	3,206.6	3,266.7	3,397.9	3,433.7	...	8.9	...
Domestic credit	2,057.3	2,104.1	2,191.7	2,222.3	2,402.4	2,468.0	2,659.3	2,666.2	2,791.8	16.8	16.2
Consolidated government	1,060.8	1,079.4	1,140.4	1,155.5	1,096.3	1,138.0	1,189.9	1,163.6	1,208.1	3.3	10.2
Of which:											
Credit consolidation bonds	--	81.3	98.6	95.2	275.2	275.1	303.2	297.1	311.3	--	13.1
Securitization of foreign exchange related debt	--	--	--	--	--	--	59.1	59.1	59.1	--	--
Local governments	13.0	12.3	12.7	15.5	22.7	24.2	29.1	37.3	48.8	74.6	115.0
Nonprofit Institutions	6.0	6.0	6.2	6.3	6.4	11.6	12.7	12.8	13.4	6.7	109.4
Enterprises	691.8	651.6	658.0	671.5	676.2	700.4	747.3	775.0	785.4	-2.3	16.1
Working capital	484.9	452.9	453.1	465.9	475.7	489.1	527.2	528.5	522.5	-1.9	9.8
Investment needs	145.1	132.9	129.6	135.6	134.9	139.6	149.5	158.7	169.8	-7.0	25.9
Foreign currency	61.8	65.8	75.3	70.0	65.6	71.7	70.6	87.8	93.1	6.1	41.9
Households	209.1	201.5	200.6	198.9	239.7	231.7	226.4	230.1	277.1	14.6	15.6
Small enterprises	76.3	71.6	74.8	79.3	85.2	86.6	91.2	91.1	88.5	12.3	3.3
Other financial institutions credit	0.3	0.4	0.4	0.1	0.2	0.4	0.4	0.1	0.1	-33.3	-50.0
Other assets, net	887.2	899.5	900.9	925.7	804.2	798.7	738.6	767.5	...	-9.4	...
Net foreign liabilities	1,196.3	1,245.9	1,284.8	1,271.3	1,190.1	1,265.3	1,318.0	1,296.5	...	-0.5	...
Convertible	1,199.7	1,249.3	1,288.4	1,275.2	1,194.2	1,268.9	1,319.9	1,297.5	...	-0.5	...
Nonconvertible	-3.4	-3.4	-3.6	-3.9	-4.1	-3.6	-1.9	-1.0	...	20.6	...
Broad money	1,505.8	1,505.7	1,560.5	1,634.1	1,758.9	1,731.0	1,815.5	1,872.3	1,997.6	16.8	13.6
Currency outside banks	322.4	310.8	334.8	357.0	371.2	378.6	391.4	402.4	415.3	15.1	11.9
Of which:											
Households	269.6	269.6	296.5	316.1	322.1	347.4	355.8	362.8	361.1	19.5	12.1
Enterprise deposits	395.5	391.7	401.7	421.6	499.7	454.3	492.0	489.3	523.9	26.3	4.8
Forint	332.3	327.2	335.2	343.1	374.7	335.4	360.0	360.4	411.9	12.8	9.9
Foreign currency	63.2	64.5	66.5	78.5	125.0	118.9	132.0	128.9	112.0	97.8	-10.4
Household deposits	582.4	613.7	624.6	647.9	696.0	704.3	732.1	777.5	870.4	19.5	25.1
Forint	429.8	447.0	452.5	449.8	491.3	485.4	496.7	504.9	578.2	14.3	17.7
Foreign currency	152.6	166.7	172.1	198.1	204.7	218.9	235.4	272.6	292.2	34.1	42.7
Small enterprise deposits	61.8	28.6	31.3	35.4	33.2	32.6	36.0	36.9	31.5	-46.3	-5.1
Other deposits	143.7	160.9	168.1	172.2	158.8	161.2	164.0	166.2	156.5	10.5	-1.4
Of which:											
Local authorities	73.5	83.0	80.3	88.3	74.6	76.1	81.1	81.3	70.2	1.5	-5.9
Nonprofit institutions	46.6	50.0	53.7	55.0	53.3	56.0	57.9	58.9	58.1	14.4	9.0
Bonds and savings notes	242.5	252.0	247.3	242.6	257.8	270.4	264.4	264.4	291.2	6.3	13.0
Savings notes	74.5	79.3	81.4	79.6	83.2	80.0	76.3	75.0	87.1	11.7	4.7
Certificates of deposits	91.0	90.9	83.0	83.2	91.7	97.2	92.0	85.3	91.9	0.8	0.2
Bonds, other	77.0	81.8	82.9	79.8	82.9	93.2	96.1	104.6	112.2	7.7	35.3
Memorandum items:											
Currency deposit ratio	27.2	26.0	27.3	28.0	26.7	28.0	27.5	27.4	26.2		
Share of foreign currency deposits in total deposits	18.2	19.3	19.5	21.7	23.8	25.0	25.8	27.3	25.5		

Sources: Data provided by the Hungarian authorities; and staff estimates.

Table 22. Hungary: Broad Money, 1990-94 1/

(Year-end, percent change except as noted)

	1990	1991	1992	1993	1994
Broad Money	29.2	29.4	27.3	16.8	13.6
Contributions 2/					
Net foreign assets	6.2	-12.1	11.2	0.4	...
Net domestic assets	26.8	51.6	20.8	17.4	...
Of which:					
Consolidated government	1.5	14.8	15.9	2.4	6.4
Enterprises	20.3	14.1	0.2	-0.4	6.4
Households	2.3	-14.0	0.6	2.0	2.1
Bonds and savings notes	3.7	10.2	4.7	1.0	1.9
Memorandum items:					
Net foreign liabilities	-3.5	9.1	-10.0	-0.5	...
Net domestic assets	9.3	21.2	9.1	8.9	...
Of which:					
Credit to general government, net 3/	1.5	18.3	21.6	29.3	15.1
Credit to nongovernment 4/	20.1	0.5	0.5	2.5	15.5
Bonds and savings notes	39.2	99.1	29.8	6.3	13.0
End-year velocity of broad money	2.3	2.1	1.9	2.0	2.2

Source: Monetary Survey, the National Bank of Hungary.

1/ 1991 banking structure and banking survey, except for 1989, which is 1990 banking structure and monetary survey.
2/ Actual change as percent of previous year-end stock of broad money.
3/ Includes consolidated government, credit consolidation bonds and securitization of foreign exchange-related debt.
4/ Includes enterprises, households, other financial institutions and nonprofit organizations.

Table 23. Hungary: National Bank of Hungary Loans to Financial Institutions, 1990-94 1/

(In billions of forint, end of period)

	Q4 1990	Q4 1991	Q4 1992	Q1 1993	Q2 1993	Q3 1993	Q4 1993	Q1 1994	Q2 1994	Q3 1994	Q4 1994
Refinancing and other credits and loans	222.9	238.5	239.3	232.6	221.9	224.2	215.9	210.0	218.5	227.2	226.6
Short-term	41.6	38.4	39.8	30.1	21.4	17.7	3.8	3.3	3.8	4.4	4.2
Export prefinancing	11.0	23.2	9.5	7.0	4.9	1.8	0.5	--	--	--	--
Other 2/	30.6	15.2	30.3	23.1	16.5	15.9	3.3	3.3	3.8	4.4	4.2
Long-term	181.3	200.1	199.5	202.5	200.5	206.5	212.1	206.7	214.7	222.8	222.4
Credits reducing state debt	--	1.0	9.9	12.5	17.7	21.6	30.4	37.4	46.4	51.4	56.6
Other	181.3	199.1	189.6	190.0	182.8	184.9	181.7	169.3	168.3	171.4	165.8
Foreign exchange credits	44.6	33.6	16.6	17.0	18.9	14.9	9.3	9.4	8.8	6.7	13.2
Credits provided against foreign exchange deposits	66.5	140.7	35.8	8.9	3.1	9.8	20.6	41.1	87.6	109.5	129.8
Short-term	65.9	133.9	28.6	5.6	--	--	--	--	--	--	--
Long-term	0.6	6.8	7.2	3.3	3.1	9.8	20.6	41.1	87.6	109.5	129.8
Repurchase agreements	--	--	-	10.9	45.1	60.9	121.6	109.4	49.9	50.1	42.5
Rediscounted bills of exchange	21.2	4.7	1.7	0.6	0.5	1.3	1.4	1.0	0.8	2.4	1.5
Total	355.2	417.5	293.4	270.0	289.5	311.1	368.8	370.9	365.6	395.9	413.6

Source: National Bank of Hungary.

1/ Combined data of financial institutions, insurance companies, and other insitutions with NBH accounts.
2/ Including refinancing of the discounting of export documents and credits made in foreign exchange.

Table 24. Hungary: National Bank of Hungary Interest Rates, 1992-95

(In percent per annum)

	From Oct. 15 1992	From Jan. 1 1993	From May 3 1993	From June 1 1993	From Sep. 27 1993	From Jan. 20 1994	From Mar. 1 1994	From Apr. 26 1994	From June 15 1994	From Oct. 1 1994	From Jan. 1 1995	From Feb. 1 1995
Refinancing rates												
Base rate 1/	21.0	20.0	19.0	19.0	22.0	22.0	22.0	22.0	25.0	25.0	25.0	28.0
Interest rate on state debt accumulated prior to January 1, 1991	8.4	8.0	7.6	7.6	8.8	8.7	8.7	8.7	8.7	8.7	8.2	8.2
Deposit rates												
Mandatory reserves												
Forint liabilities	3.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	6.0	8.0	8.0	12.0
Foreign exchange liabilities	12.0	11.0	11.0	11.0	11.0	11.0	18.0	18.0	18.0	18.0	18.0	24.0
Voluntary deposits	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0

Source: National Bank of Hungary.

1/ Applies to credit financing the state budget since 1991, liquidity-fund credit for the state budget, credits refinancing financial institutions maturing over one year, excluding:
- export trade loans;
- loans disbursed under tourism facility;
- loans to refinance Existence loans;
- loans to refinance Start and Japanese loans;
- loans for those restarting or starting their careers;
- Employee Stock Ownership Program;
- refinancing credits against foreign exchange deposits.

Table 25. Hungary: National Bank of Hungary Interest Rates on Repurchase Agreements, 1993-94

(In percent per annum)

	One Week	One Month	Three Months
Active agreements			
1993			
January 1	20.0	18.0	18.5
March 29	15.0	18.0	18.5
May 17	20.0	18.0	18.5
July 9	20.0	21.0	21.5
September 24	22.0	23.0	23.5
December 30	23.0	23.0	23.5
1994			
February 14	23.0	23.0	23.5
March 17	23.0	24.0	23.5
March 28	24.0	24.5	24.5
May 17	24.5	24.5	25.0
June 8	26.5	26.5	27.0
July 12	28.5	28.5	29.0
July 25	31.0	31.0	31.0
August 3	31.0	31.0	31.5
September 5	31.0	31.0	--
November 28	31.25	31.25	--
Passive agreements			
1993			
January 1	--	5.0	12.0
March 29	--	5.0	12.0
May 17	--	5.0	12.0
July 9	--	8.0	15.0
September 24	--	10.0	17.0
December 30	--	18.0	18.5
1994			
February 14	15.0	18.0	18.5
March 17	21.0	18.0	18.5
March 28	22.0	19.5	19.5
May 17	22.5	22.0	22.0
June 8	22.0	24.0	22.0
July 12	24.0	24.0	24.0
July 25	24.0	24.0	24.0
August 3	24.0	24.0	24.0
September 5	26.0	26.0	--
December 12	28.0	28.0	--
December 20	28.0	--	--

Source: National Bank of Hungary.

Table 26. Hungary: Interest Rates for the Enterprise and Financial Sectors, 1991-94 1/

(In percent per annum)

	Dec. 1991	Dec. 1992	Dec. 1993	Jan. 1994	Feb. 1994	March 1994	April 1994	May 1994	June 1994	July 1994	Aug. 1994	Sep. 1994	Oct. 1994	Nov. 1994	Dec. 1994
Credits															
Maturity															
Less than 1 year	35.5	28.8	25.6	24.9	25.0	25.6	26.0	25.8	26.7	28.5	28.8	29.2	29.2	29.4	29.7
More than 1 year	34.3	25.4	25.2	26.8	26.7	26.3	26.3	25.7	25.2	27.2	28.2	29.4	29.9	27.9	26.7
Discounted bills of exchange	36.1	27.4	25.1	25.2	24.9	25.3	26.0	25.1	25.6	27.4	29.0	29.0	29.9	28.8	29.8
Deposits															
Current account 2/	24.0	17.0	10.0	12.0	12.0	12.0	12.0	10.0	14.0	12.0	14.0	14.0	19.0	17.0	14.0
Maturity															
Less than 1 month	25.1	12.9	15.5	16.5	15.3	16.7	16.3	16.8	17.0	17.4	19.5	18.5	20.2	21.5	22.5
Less than 1 year	31.1	17.6	17.2	17.9	17.4	17.8	18.5	18.3	19.1	20.6	21.9	22.2	22.7	23.6	23.6
More than 1 year	33.0	19.5	18.7	19.9	20.7	20.4	20.3	20.1	21.4	21.4	23.4	23.4	23.6	25.1	22.3
Interbank money market rate 3/	32.2	15.8	21.6	17.8	21.2	22.7	23.2	23.9	24.9	28.7	25.9	29.1	30.5	28.1	30.9
Volume (forint billions) 3/	3.4	23.4	371.5	312.3	302.6	367.0	368.9	320.4	416.3	364.2	487.0	409.9	327.7	336.3	463.5
Treasury bills															
30 days															
Average rate	30.6	14.4	23.7	21.8	21.0	22.4	23.5	23.6	24.2	27.5	29.9	29.3	27.8	25.9	26.3
Volume	0.2	2.5	47.0	32.0	24.0	36.0	32.0	32.0	32.8	48.6	61.9	42.0	26.0	29.5	12.7
90 days															
Average rate	32.4	14.7	24.3	23.4	23.4	23.5	24.2	24.3	25.2	28.9	30.8	30.5	29.3	30.2	31.7
Volumes	1.5	22.0	22.0	20.0	16.0	18.0	20.0	30.0	8.0	33.0	57.5	46.5	32.0	51.0	60.0
180 days															
Average rate	...	17.0	25.0	24.9	24.6	24.9	25.0	25.0	25.0	26.6	29.5	30.4	30.6	31.3	32.1
Volumes	...	5.4	8.3	15.0	10.0	15.0	15.0	15.0	7.7	0.2	2.2	5.0	8.0	15.0	12.9
360 days															
Average rate	...	18.0	25.0	--	24.9	--	25.0	25.0	--	--	29.0	29.7	30.5	31.4	32.4
Volumes	...	15.0	10.7	--	10.0	--	--	15.0	--	--	5.0	3.0	5.0	10.0	1.2

Source: National Bank of Hungary.

1/ Weighted average.
2/ Maximum rate.
3/ One month or less.

Table 27. Hungary: Net Financial Savings of Households, 1990-94 1/

(In billions of forint, end of period)

	1990	1991	1992	1993 Q1	1993 Q2	1993 Q3	1993 Q4	1994 Q1	1994 Q2	1994 Q3	1994 Q4
Savings	669.8	888.0	1,388.1	1,224.8	1,280.8	1,346.3	1,378.3	1,464.1	1,542.3	1,631.4	1,721.3
Cash	181.2	204.9	322.2	269.6	296.5	316.1	322.2	347.5	355.8	362.8	363.3
Deposits	332.8	432.0	696.1	625.7	652.6	688.0	696.0	721.1	766.4	821.2	874.9
Forint deposits	261.3	302.5	491.4	459.0	480.5	490.0	491.3	502.2	531.0	548.6	582.7
Foreign currency deposits	71.5	129.5	204.7	166.7	172.1	198.0	204.7	218.9	235.4	272.6	292.2
Securities 1/ 2/	125.3	213.8	317.7	284.0	286.2	291.5	308.0	343.5	363.6	391.2	427.1
Of which:											
Financial institutions	79.3	144.8	201.6	200.3	199.5	198.5	201.2	212.6	210.0	213.2	223.2
Provisions for insurance premiums	30.5	37.3	52.1	45.5	45.5	50.7	52.1	52.0	56.5	56.2	56.0
Credits	368.9	241.0	282.8	257.4	264.8	275.1	282.8	288.1	294.0	310.4	327.4
Of which:											
Credits from financial institutions	330.0	202.0	239.7	214.1	221.7	231.9	239.7	244.9	251.3	267.3	284.1
Net savings position	300.9	647.0	1,105.3	967.4	1,016.0	1,071.2	1,095.5	1,176.0	1,248.3	1,321.0	1,393.9

Source: National Bank of Hungary.

1/ Includes accrued interest.
2/ Excludes compensation vouchers.

Table 28. Hungary: National Savings Bank Interest Rates on Household Deposits, 1992-94

(In percent per annum; end of period)

	1992	1993 Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.	1994 Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
Time deposits, fixed for																									
One month	18.8	18.8	15.0	15.0	15.0	13.8	13.8	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	13.0	13.0	13.0	13.0	14.5	14.5	16.5	16.5	16.5	16.5
Three months	19.4	19.4	16.3	16.3	16.3	15.0	15.0	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5	15.5	15.5	15.5	15.5	16.5	16.5	18.5	18.5	18.5	18.5
Six months	20.0	20.0	17.5	17.5	17.5	16.3	16.3	13.8	13.8	13.8	13.8	13.8	13.8	13.7	13.7	17.0	17.0	17.0	17.0	19.0	19.0	20.5	20.5	20.5	20.5
One year	21.3	21.3	18.8	18.8	18.8	18.8	18.8	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.3	19.5	19.5	19.5	19.5	21.0	21.0	22.5	22.5	22.5	22.5
Letter of saving, fixed for																									
One year	21.3	21.3	18.8	18.8	18.8	18.8	18.8	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.3	19.0	19.0	19.0	19.0	20.5	20.5	21.0	21.0	21.0	21.0
Two years	21.9	21.9	19.4	19.4	19.4	19.4	19.4	16.9	16.9	16.9	16.9	16.9	16.9	16.9	16.9	20.0	20.0	20.0	20.0	21.5	21.5	22.0	22.0	22.0	22.0
Three years	22.5	22.5	20.0	20.0	20.0	20.0	20.0	17.5	17.5	17.5	17.5	17.5	17.5	17.5	17.5	20.5	20.5	20.5	20.5	22.0	22.0	22.5	22.5	22.5	22.5

Source: National Bank of Hungary.

Table 29. Hungary: Balance of Payments in Convertible Currencies, 1989-94 1/

(In millions of U.S. dollars)

	1989	1990	1991	1992	1993	Estimate 1994
Trade balance	536	338	189	-50	-3,247	-3,635
Exports	6,446	6,408	9,258	10,028	8,094	7,613
Imports	-5,910	-6,070	-9,069	-10,077	-11,341	-11,248
Services (net)	-2,100	-949	-797	-486	-942	-1,185
Freight and insurance, net	-310	-165	-80	-117	-107	-188
Travel (net)	-349	347	560	590	441	503
Credits	738	824	1,006	1,231	1,182	1,428
Debits	-1,087	-477	-446	-640	-742	-925
Interest income (net)	-1,386	-1,451	-1,331	-1,215	-1,131	-1,286
Credits	219	233	297	419	456	661
Debits	-1,605	-1,684	-1,628	-1,635	-1,587	-1,947
Government expenditures (net)	-57	18	63	78	-17	-55
Other current payments (net)	2	302	-8	178	-128	-159
Unrequited transfers (net)	126	734	860	859	732	909
Current account	-1,438	123	252	323	-3,457	-3,911
Medium- and long-term capital	1,563	349	2,198	439	5,606	2,294
Assets (net)	32	-76	-57	-146	238	36
Liabilities (net)	1,351	88	781	-886	3,039	1,161
Disbursements	3,091	2,186	3,114	2,094	6,309	5,429
Amortizations	-1,740	-2,098	-2,333	-2,980	-3,270	-4,267
Direct capital investment	180	337	1,474	1,471	2,329	1,097
Short-term capital 2/	-44	-883	-617	5	459	960
Capital account	1,519	-534	1,581	444	6,065	3,254
Overall balance	81	-411	1,833	767	2,608	-656
Financing	-87	411	-1,833	-767	-2,608	656
Reserves (inc=-)	71	559	-2,720	758	-2,637	819
Use of Fund credit	-158	-148	887	-8	29	-163
Purchases	66	175	963	109	79	--
Repurchases	-224	-323	-76	-118	-50	-163
Memorandum items:						
Debt service ratio (in percent of exports of GNFS)	45.4	52.3	35.0	38.6	47.4	60.8
Interest payments (in percent of exports of GNFS)	20.4	21.4	14.6	13.3	15.3	19.0
Gross debt (in millions of U.S. dollars)	20,390	21,270	22,658	21,438	24,560	28,521
Total reserves (in millions of U.S. dollars)	1,725	1,166	4,017	4,380	6,736	6,769
Of which: Foreign exchange	1,246	1,069	3,935	4,348	6,692	6,727
Total reserves (months of imports)	3.5	2.3	5.3	5.2	7.1	7.2
Net debt (in millions of U.S. dollars)	16,378	15,937	14,555	13,057	14,971	18,978
Net debt (in percent of GDP)	56.5	48.4	47.1	35.7	41.4	46.3
Net public debt (in percent of GDP) 3/	69.5	61.1	60.3	40.0	40.5	42.4
Current account (in percent of GDP)						
Excluding reinvested profit remittances	-5.0	0.4	0.8	0.9	-9.6	-9.5
Including reinvested profit remittances	-5.0	0.4	0.8	0.7	-9.9	-10.0

Sources: National Bank of Hungary; and authorities' and staff estimates.

1/ Excluding reinvested profit remittances. The data in this table may differ from those in the Staff Report (SM/95/35, 2/15/95) due to more updated information.

2/ Includes net errors and omissions.

3/ Excluding banking system and nonguaranteed enterprise liabilities.

Table 30. Hungary: Balance of Payments in Nonconvertible Currencies, 1989-92

(In millions of U.S. dollars)

	1989	1990	1991	1992
Trade balance	507	190	175	45
Exports	4,047	2,719	439	70
Imports	-3,540	-2,529	-264	-25
Freight and insurance (net)	-56	-9	-8	--
Travel (net)	190	52	-20	-3
Credits	246	159	32	20
Debits	-56	-107	52	-23
Investment income (net)	-7	23	7	--
Credits	13	34	12	--
Debits	-20	-11	-5	--
Government expenditures (net)	27	54	--	--
Unrequited transfers (net)	4	52	5	--
Other current payments (net)	201	-112	-15	-7
Current account	866	251	144	35
Medium- and long-term capital	-278	-97	-7	-650
Assets (net) 1/	-127	24	2	-747
Liabilities (net)	-151	-121	-9	98
Disbursements	20	12	--	196
Amortization	-170	-133	-9	-98
Short-term capital	-109	69	-51	605
Assets 1/	-96	86	-18	618
Liabilities 2/	-13	-17	-33	-13
Capital account	-387	-28	-58	-45
Overall balance	479	223	86	-10
Reserves (inc. = -)	-480	-223	-86	10

Source: National Bank of Hungary.

1/ Nonreserve assets.
2/ Includes net errors and omissions.

Table 31. Hungary: Trade Balance with Countries, According to Currency of Settlement, 1989-94 1/

(In millions of U.S. dollars)

	1989	1990	1991	1992	1993 3/	Estimate 1994
Trade with present and former socialist countries						
In rubles 2/						
Exports	3,627.5	2,520.7	212.8	0.3	--	--
Imports	3,365.5	2,521.5	271.2	12.7	--	--
Trade balance	262.0	-0.8	-58.4	--	--	--
In other currencies						
Exports	918.0	1,089.5	2,188.5	2,491.4	2,341.0	2,473.2
Imports	545.4	667.9	2,466.6	2,789.6	3,707.7	3,489.8
Trade balance	372.6	421.6	-278.1	-298.2	-1,366.7	-1,016.6
Trade with other countries						
In rubles						
Exports	2.3	...	...	--	--	--
Imports	17.7	...	...	--	--	--
Trade balance	15.4	...	...	--	--	--
In other currencies						
Exports	5,057.2	5,974.0	7,776.1	8,198.5	6,573.4	8,127.7
Imports	4,890.0	5,450.8	8,450.5	8,188.1	8,728.5	10,929.8
Trade balance	167.2	523.2	-674.4	10.4	2,215.1	-2,802.1
Trade balance, total						
Exports	9,605.3	9,587.6	10,186.9	10,705.1	8,906.9	10,700.8
Imports	8,815.2	8,646.8	11,382.1	11,078.9	12,530.3	14,553.8
Trade balance	786.1	940.8	-1,195.2	-373.8	-3,623.4	-3,853.0

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis.
2/ Trade flows settled in rubles are converted from their forint value, given in official statistics, at the official U.S. dollar/forint exchange rate.
3/ In 1993 including military technology item worth US$713 million in lieu of state debt of the former Soviet Union.

Table 32. Hungary: Direction of Trade, 1989-94

(In percent)

	1989	1990	1991	1992	1993	Estimate 1994
Exports	100.0	100.0	100.0	100.0	100.0	100.0
Settled in rubles 1/	37.8	25.6	2.1	--	--	--
Settled in currencies other than rubles	62.2	74.4	97.9	100.0	100.0	100.0
Of which:						
Present and former socialist countries	9.6	8.4	21.7	23.3	26.3	24.1
Developing countries	8.6	7.9	8.4	5.3	5.4	3.9
Developed market economies	44.1	58.1	67.9	71.3	67.4	72.0
Of which:						
Germany	11.9	16.9	26.9	27.7	26.6	28.2
Italy	4.7	5.9	7.6	9.5	8.0	8.5
Austria	6.5	7.5	10.8	10.7	10.1	10.0
Switzerland	1.7	1.9	1.8	1.9	1.8	1.5
United Kingdom	1.8	2.0	2.0	2.0	2.3	4.3
France	2.4	2.7	2.9	3.2	3.5	3.6
United States	3.3	3.5	3.2	3.2	4.2	4.0
Japan	1.2	1.2	1.7	0.9	1.0	0.9
Imports	100.0	100.0	100.0	100.0	100.0	100.0
Settled in rubles 1/	38.4	28.5	2.6	0.1	--	--
Settled in currencies other than rubles	61.6	71.5	97.4	99.9	100.0	100.0
Of which:						
Present and former socialist countries	6.2	2.0	22.3	25.2	25.9	24.0
Developing countries	6.0	9.7	7.9	4.2	4.4	4.5
Developed market economies	49.6	59.8	66.6	70.5	69.7	71.6
Of which:						
Germany	16.0	24.0	21.4	23.5	21.6	23.4
Italy	3.4	4.1	7.2	6.3	6.0	7.0
Austria	8.6	10.0	13.3	14.4	11.6	12.0
Switzerland	2.9	3.1	3.2	2.9	2.7	2.6
United Kingdom	2.2	2.1	2.5	2.9	2.5	3.9
France	2.2	2.1	2.7	3.1	3.3	3.4
United States	2.5	2.6	2.6	2.9	3.9	3.1
Japan	1.6	2.1	2.8	2.4	2.7	2.7

Source: CSO, Statistical Yearbook and Monthly Bulletin of Statistics.

1/ Trade flows settled in rubles are converted from their forint value, given in official statistics, at the period average U.S. dollar/forint exchange rate.
2/ In 1993 including military technology item worth US$713 million in lieu of state debt of the former Soviet Union.

Table 33. Hungary: Trade Indices and Terms of Trade, 1989-93

(Changes from preceding year; in percent) 1/

	1989	1990	1991	1992	1993
Trade in rubles					
Exports					
Value	-10.1	-30.5	-91.3	-99.9	--
Volume	-6.0	-26.1	...	...	--
Price	-4.3	-5.9	...	...	--
Imports					
Value	-14.3	-25.3	-88.0	-95.8	--
Volume	-6.9	-17.8	...	...	--
Price	-7.9	-9.1	...	...	--
Trade in currencies other than rubles					
Exports					
Value	5.6	18.2	37.1	7.4	-16.8
Volume	5.0	9.3	...	...	-13.3
Price	0.5	8.2	...	...	-4.1
Imports					
Value	5.2	12.6	75.6	-0.1	13.2
Volume	7.1	2.7	...	...	20.4
Price	-1.8	9.6	...	...	-6.3
Total					
Exports					
Value	-1.0	-0.1	4.3	5.1	-16.8
Volume	0.3	-4.1	-4.9	1.0	-13.3
Price	-1.4	4.1	9.7	4.1	-4.1
Imports					
Value	-3.3	-1.9	29.0	-3.7	13.2
Volume	1.1	-5.2	5.5	-7.6	20.4
Price	-4.3	3.4	22.3	4.2	-6.3
Terms of trade	2.8	0.4	-10.4	-0.5	2.3
Ruble trade	3.7	3.2	...	...	...
Nonruble trade	2.2	-1.6	...	...	2.3

Source: CSO, Monthly Bulletin of Statistics, and staff estimates.

1/ In U.S. dollar terms. See footnotes to Table 35.

Table 34. Hungary: Commodity Composition of Nonruble Trade, 1989-94 1/

(In millions of U.S. dollars)

	1989	1990	1991	1992	1993 2/	1994
Exports						
Energy products	201.4	218.9	180.6	290.0	298.3	351.6
Raw materials and semi-finished products	2,619.3	3,110.7	3,829.8	3,752.3	3,220.4	3,900.2
Capital goods and transportation equipment	622.5	820.3	1,194.1	1,282.9	1,240.7	1,399.3
Industrial consumer goods	895.0	1,100.5	2,244.5	2,812.1	2,245.6	2,859.4
Food products	1,607.1	1,813.0	2,522.6	2,567.5	1,901.8	2,190.3
Total	5,975.2	7,063.5	9,871.6	10,704.8	8,906.9	10,700.8
Of which: Nonenergy	5,773.8	6,844.6	9,791.0	10,414.8	8,608.6	10,349.2
Imports						
Energy products	39.9	525.0	2,630.2	1,606.8	1,581.6	1,599.7
Raw materials and semi-finished products	3,264.7	3,106.0	4,175.6	4,067.5	4,185.5	5,370.3
Capital goods and transportation equipment	938.9	1,102.2	2,247.2	2,288.1	3,372.2	3,387.8
Industrial consumer goods	642.2	811.4	2,402.5	2,454.5	2,652.1	3,204.2
Food products	549.7	574.1	626.7	649.3	739.0	991.8
Total	5,435.5	6,118.7	11,082.2	11,066.2	12,530.3	14,553.8
Of which: Nonenergy	5,395.6	5,593.7	9,452.0	9,459.4	10,948.7	12,954.1
Balance of trade						
Energy products	161.5	-306.1	-2,449.6	-1,316.8	-1,283.3	-1,248.1
Raw materials and semi-finished products	-615.4	4.7	-345.8	-315.2	-965.1	-1,470.1
Capital goods and transportation equipment	-316.4	-281.9	-1,053.1	-1,005.2	-2,131.5	-1,988.5
Industrial consumer goods	252.8	289.1	-158.0	357.6	-406.5	-344.8
Food products	1,057.4	1,238.9	1,895.9	1,918.2	1,162.8	1,198.5
Total	539.7	944.8	-1,110.6	-361.4	-3,623.4	-3,853.0
Of which: Nonenergy	378.2	1,250.9	339.0	955.4	-2,340.1	-2,604.9

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis.
2/ In 1993 including military technology item as reimbursement for state debt of the former Soviet Union.

Table 35. Hungary: Nonruble Export Value,
Volume, and Price, 1989-93 1/

(Percent change)

	1989	1990	1991	1992	1993
Value 2/					
Energy products	8.8	8.7	-23.4	63.8	5.0
Raw materials and semifinished products	10.7	17.4	8.5	2.9	-14.3
Capital goods and transportation equipment	-13.8	31.8	-25.0	20.1	-3.1
Industrial consumer goods	-0.3	23.0	19.0	22.1	-20.2
Food products	9.7	12.8	14.4	0.4	-26.0
Total	5.6	18.2	4.3	5.1	-16.2
Volume					
Energy products	-4.9	-16.6	-21.6	79.9	9.4
Raw materials and semifinished products	10.8	16.2	6.4	-2.2	-8.5
Capital goods and transportation equipment	-11.4	18.1	-42.7	-9.6	3.3
Industrial consumer goods	3.5	10.5	-1.9	17.1	-15.8
Food products	5.8	-2.8	9.0	-8.0	-27.2
Total	5.0	9.3	-4.9	1.0	-13.1
Unit value 2/					
Energy products	14.5	30.4	-2.3	-9.0	-4.0
Raw materials and semifinished products	-0.1	-1.1	2.0	-0.7	-6.4
Capital goods and transportation equipment	-2.7	11.6	24.0	10.6	-6.2
Industrial consumer goods	-3.6	11.3	21.3	4.3	-5.2
Food products	3.7	16.1	4.9	9.7	-1.8
Total	0.5	8.2	9.2	4.1	-4.2

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis. From 1991: total exports.
2/ U.S. dollar.

Table 36. Hungary: Nonruble Import Value, Volume, and Price, 1989-93 1/

(Percent change)

	1989	1990	1991	1992	1993 2/
Value 3/					
Energy products	-52.4	...	42.5	-11.0	-2.0
Raw materials and semi-finished products	-0.3	-4.9	4.6	-4.2	3.0
Capital goods and transportation equipment	31.5	17.4	46.3	-1.4	48.1
Industrial consumer goods	20.4	26.3	86.9	0.1	7.3
Food products	-2.4	4.5	-2.2	-1.2	13.4
Total	5.2	12.6	29.0	-3.7	13.1
Volume					
Energy products	-54.4	...	-13.7	-5.1	14.6
Raw materials and semi-finished products	0.9	-10.8	-6.9	-10.1	9.0
Capital goods and transportation equipment	34.8	6.1	22.5	-9.4	52.7
Industrial consumer goods	24.5	15.4	47.7	-4.3	15.7
Food products	1.3	11.5	-5.2	-2.3	17.7
Total	7.1	2.7	5.5	-7.6	20.9
Unit value 3/					
Energy products	4.6	...	65.2	-6.2	-14.4
Raw materials and semi-finished products	-1.1	6.6	12.4	6.7	-5.6
Capital goods and transportation equipment	-2.5	10.6	19.4	8.8	-3.0
Industrial consumer goods	-3.2	9.5	26.5	4.6	-7.3
Food products	-3.7	-6.3	3.1	1.1	-3.7
Total	-1.8	9.6	22.3	4.2	-6.5

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis. From 1991: total imports.
2/ In 1993 including military technology item in lieu of state debt of the former Soviet Union.
3/ U.S. dollar.

Table 37. Hungary: Commodity Composition of Ruble Trade, 1989-93 1/

(In millions of U.S. dollars)

	1989	1990	1991	1992	1993
Exports					
Energy products	5.2	7.2	--	--	--
Raw materials and semi-finished products	846.7	525.1	42.9	0.1	--
Capital goods and transportation equipment	1,681.8	1,107.9	87.1	0.1	--
Industrial consumer goods	613.1	483.9	53.9	0.1	--
Food products	473.0	400.2	31.3	--	--.
Total	3,629.8	2,524.2	215.3	0.3	--
Of which: Nonenergy	3,614.6	2,517.0	215.3	0.3	--
Imports					
Energy products	929.9	669.2	48.8	5.4	--
Raw materials and semi-finished products	1,194.5	894.0	78.4	1.6	--
Capital goods and transportation equipment	655.0	433.9	73.2	0.9	--
Industrial consumer goods	521.3	448.5	63.0	2.7	--
Food products	82.4	82.2	36.8	2.0	--
Total	3,383.2	2,527.9	300.3	12.7	--
Of which: Nonenergy	2,453.3	1,858.7	251.5	7.3	--
Balance of trade					
Energy products	-914.7	-662.0	-48.8	-5.4	--
Raw materials and semi-finished products	-347.8	-368.9	-35.5	-1.5	--
Capital goods and transportation equipment	1,026.8	674.0	13.9	-0.8	--
Industrial consumer goods	91.8	35.4	-9.1	-2.6	--
Food products	390.5	318.0	-5.5	-2.0	--
Total	246.6	-3.7	-85.0	-12.4	--
Of which: Nonenergy	1,161.3	658.3	-36.2	-7.0	--

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis. Trade flows settled in rubles are converted from their forint value, given in official statistics, at the period average U.S. dollar/forint exchange rate.

Table 38. Hungary: Ruble Export Value, Volume, and Price, 1989-93 1/

(Percent change)

	1989	1990	1991	1992	1993
Value 2/					
Energy products	2.7	-52.4	-100.0	...	--
Raw materials and semifinished products	-4.6	-38.0	-91.8	...	--
Capital goods and transportation equipment	-11.9	-34.2	-91.8	...	--
Industrial consumer goods	-9.2	-21.1	-88.8	...	--
Food products	-14.1	-15.4	-92.1	...	--
Total	-10.0	-30.5	-91.3	-99.8	--
Volume					
Energy products	27.8	-43.7	...	...	--
Raw materials and semifinished products	-1.1	-35.0	-92.4	...	--
Capital goods and transportation equipment	-8.3	-30.6	-92.2	...	--
Industrial consumer goods	-5.1	-12.8	-89.5	...	--
Food products	-8.5	-11.0	-93.1	...	--
Total	-6.0	-26.1	-92.2	....	--
Unit value 2/					
Energy products	-19.6	-15.4	...	...	--
Raw materials and semifinished products	-3.6	-4.6	8.5 3/	...	--
Capital goods and transportation equipment	-3.9	-5.1	5.0 3/	...	--
Industrial consumer goods	-4.3	-9.5	12.0 3/	...	--
Food products	-6.2	-5.0	15.0 3/	...	--
Total	-4.3	-5.9	11.0 3/	...	--

Source: CSO, Monthly Bulletin of Statistics.

1/ F.o.b./c.i.f. basis. Trade flows settled in rubles are converted from their forint value, given in official statistics, at the period average U.S. dollar/forint exchange rate.
2/ U.S. dollar.
3/ Estimated.

Table 39. Hungary: Ruble Import Value, Volume, and Price, 1989-93 1/

(Percent change)

	1989	1990	1991	1992	1993
Value 2/					
Energy products	-15.3	-28.0	-92.6	...	--
Raw materials and semi-finished products	-14.4	-25.1	-91.1	...	--
Capital goods and transportation equipment	-19.0	-33.8	-82.5	...	--
Industrial consumer goods	-4.3	-14.0	-86.2	...	--
Food products	-19.5	-0.2	-55.8	...	--
Total	-14.3	-25.37	-88.0	-95.8	--
Volume					
Energy products	1.2	-11.8	-93.0	...	--
Raw materials and semi-finished products	-9.9	-19.9	-91.9	...	--
Capital goods and transportation equipment	-16.2	-30.0	-81.1	...	--
Industrial consumer goods	-0.3	-11.6	-87.8	...	--
Food products	-15.6	2.8	-61.2	...	--
Total	-6.9	-17.8	-89.3	...	--
Unit value 2/					
Energy products	-16.4	-18.4	5.0 3/	...	--
Raw materials and semi-finished products	-5.0	-6.5	10.0 3/	...	--
Capital goods and transportation equipment	-3.3	-5.4	10.0 3/	...	--
Industrial consumer goods	-4.0	-2.7	15.0 3/	...	--
Food products	-5.0	-3.0	15.0 3/	...	--
Total	-7.9	-9.1	12.0	...	--

Sources: CSO, Monthly Bulletin of Statistics; and National Bank of Hungary.

1/ F.o.b./c.i.f. basis. Trade flows settled in rubles are converted from their forint value, given in official statistics, at the period average U.S. dollar/forint exchange rate.
2/ U.S. dollar.
3/ Estimated.

Table 40. Hungary: Travel to and from Hungary, 1989-94 1/

	1989	1990	1991	1992	1993	Estimate 1994
Settled in nonconvertible currencies						
Travelers to Hungary 2/	12,773	20,184	20,076	3,632 4/	3,058	3,448
Of which: Tourists 2/	9,067	13,314	15,628	1,842 4/	1,575	1,598
Revenues	246	159	35	19 4/		
Travelers from Hungary 3/	...	...	...	...	...	...
Of which: Tourists	...	...	...	...	...	...
Expenditures	56	107	73	22 4/	...	...
Settled in convertible currencies						
Travelers to Hungary 2/	12,146	17,449	13,189	29,859	37,541	36,388
Of which: Tourists 2/	5,169	7,196	6,232	18,346	21,229	19,827
Revenues	738	824	1,006	1,231	1,182	1,428
Travellers from Hungary 3/	...	...	...	...	...	...
Of which: Tourists	...	...	...	...	...	...
Expenditures	1,087	477	446	640	742	925

Source: National Bank of Hungary.

1/ Travelers in thousands. Revenues and expenditures in millions of U.S. dollars.
2/ From 1991 the totals are separated according to the country of origin (former-CMEA and non-CMEA) rather than the currency of settlement.
3/ Data on travelers from Hungary split between travel to the convertible and nonconvertible areas are not available for the period after 1988. The total number of travelers from Hungary in 1989, 1990, 1991, 1992, 1993, and 1994 were 14.5 million, 13.6 million, 14.3 million, 12.1 million, 12.8 million, and 14.4 million, respectively.
4/ Includes only data with Czech and Slovak Federal Republic. Settlements with all other countries are made in convertible currencies.

Table 41. Hungary: Foreign Debt, 1989-94 1/

(In millions of U.S. dollars, at end of period)

	1989	1990	1991	1992	1993	1994
Total foreign debt	20,751	21,505	22,812	21,655	24,566	28,526
In convertible currencies	20,390	21,270	22,658	21,438	24,560	28,521
By original maturity						
Short-term	3,307	2,941	2,177	2,286	2,005	2,397
Medium- and long-term	17,084	18,329	20,481	19,152	22,555	26,124
By type of credit						
Financial loans	18,060	17,587	18,135	16,984	19,990	23,777
Trade-related credits 2/	1,763	1,980	1,777	2,011	2,557	2,488
Intergovernment credits	--	473	1,512	1,446	2,013	2,257
Other	568	1,231	1,234	1,770	--	--
In nonconvertible currencies	361	235	154	217	6	5
By original maturity						
Short-term	87	80	38	16	6	5
Medium- and long-term	274	155	116	201	--	--
By type of credit						
Financial loans	88	71	35	13	4	3
Trade-related credits	--	--	--	--	2	2
Intergovernment credits	260	140	104	190	--	--
Other	12	25	15	14	--	--

Source: National Bank of Hungary.

1/ The data in this table may differ from those in the Staff Report (SM/95/35, 2/15/95) due to more updated information.
2/ Includes World Bank project loans, excludes World Bank Structural Adjustment Loans.

Table 42. Hungary: Comparative Debt and Debt Service Indicators, 1989-94 1/

(In percent)

	1989	1990	1991	1992	1993	Estimate 1994
Current account/exports GNFS						
Hungary	-18.4	1.6	2.3	2.1	-34.6	-40.0
Countries with recent debt servicing difficulties	-8.8	-7.1	-10.9	-17.3	-20.1	-18.2
Countries without recent debt servicing difficulties	-1.6	-1.9	-1.7	-1.8	-4.8	-4.2
Fifteen heavily indebted countries	-3.8	-3.8	-10.9	-17.0	-22.5	-20.8
Foreign exchange reserves/imports GNFS						
Hungary	23.5	16.9	40.0	37.1	51.1	49.3
Countries with recent debt servicing difficulties	15.3	21.5	28.4	32.4	36.8	37.4
Countries without recent debt servicing difficulties	24.1	26.4	29.2	26.1	28.1	28.3
Fifteen heavily indebted countries	18.8	24.7	31.8	36.5	41.6	42.1
External debt/exports GNFS						
Hungary (gross)	260.8	270.6	202.8	174.8	237.2	278.9
(net) 2/	209.5	222.0	150.6	127.2	172.0	213.1
Central Europe	124.2	149.6	158.5	150.5	160.7	145.9
Countries with recent debt servicing difficulties	292.6	287.8	303.0	293.7	294.8	286.9
Countries without recent debt servicing difficulties	90.7	87.6	86.1	82.5	84.6	83.8
Debt service/exports GNFS						
Hungary (gross)	45.4	52.3	35.0	38.6	47.4	60.8
(net) 3/	42.9	49.1	33.5	35.2	43.0	54.3
(net) 4/	28.2	36.5	32.2	35.2	43.0	54.3
Central Europe	17.4	15.6	17.0	15.5	14.2	26.6
Countries with recent debt servicing difficulties	26.3	26.2	27.7	28.2	31.9	30.5
Countries without recent debt servicing difficulties	15.2	13.9	13.0	12.4	12.5	11.1
Fifteen heavily indebted countries	30.5	27.4	30.8	32.5	36.4	35.8
Interest payments/exports GNFS						
Hungary	20.4	21.4	14.6	13.3	15.3	19.0
Countries with recent debt servicing difficulties	15.9	14.0	14.5	13.0	16.1	15.3
Countries without recent debt servicing difficulties	5.9	5.5	5.1	4.8	4.5	4.6
Fifteen heavily indebted countries	18.5	14.5	16.2	14.7	18.6	17.5
Amortization/exports GNFS						
Hungary	25.0	30.7	20.4	25.3	32.1	41.8
Countries with recent debt servicing difficulties	10.4	12.2	13.2	15.2	15.8	15.2
Countries without recent debt servicing difficulties	9.3	8.4	7.9	7.6	8.0	6.5
Fifteen heavily indebted countries	12.0	12.9	14.6	17.8	17.8	18.3
External debt/GDP						
Hungary (gross)	70.4	64.6	73.3	58.7	68.0	69.5
(net) 2/	56.5	53.1	54.4	42.7	49.3	52.8
Countries with recent debt servicing difficulties	53.9	49.2	48.3	45.1	41.2	36.9
Countries without recent debt servicing difficulties	26.4	28.2	29.5	29.7	30.2	33.0
Fifteen heavily indebted countries	43.4	38.1	35.6	39.2	35.8	31.7

Sources: National Bank of Hungary; IMF, World Economic Outlook; and staff estimates.

1/ Convertible currencies unless otherwise indicated. Country classifications are based on IMF, World Economic Outlook, October 1994.
2/ Net debt excluding reserves equivalent to three months of imports.
3/ Interest receipts deducted from interest payments.
4/ Includes nonconvertible exports in denominator.

Table 43. Hungary: Public and Publicly-Guaranteed Medium- and Long-Term External Debt, 1989-94

(In millions of U.S. dollars; end of period)

	1989	1990	1991	1992	1993	Sept. 30, 1994 1/
Official	1,994	2,715	3,862	3,852	3,906	4,070
Multilateral	1,842	2,555	3,342	3,243	3,218	3,418
IBRD	1,275	1,512	1,819	1,968	2,095	2,019
EEC/EIB	--	477	952	872	919	1,100
Bilateral	152	160	520	609	688	652
Japan	56	60	423	502	597	...
Germany	23	35	39	64	65	...
Austria	54	46	43	33	18	...
Private	14,634	15,286	15,068	13,993	16,451	17,445
Suppliers	267	232	223	221	230	219
Financial institutions	10,249	9,647	8,134	6,419	5,131	4,368
Bonds	3,384	4,657	6,009	6,780	10,648	12,458
Export credits	733	750	703	573	442	400
Total	16,628	18,000	18,931	17,845	20,357	21,515
Memorandum items:						
IMF credit	456	330	1,259	1,204	1,231	1,195
Short-term debt	3,307	2,940	2,177	2,286	2,005	2,228
Private MLT debt	--	--	291	103	1095	2,714
Total debt	20,390	21,270	22,658	21,438	24,688	27,652

Sources: NBH; IBRD; and DRS.

1/ Staff estimate.

Table 44. Hungary: Amortization Payments in Convertible Currencies, 1995-2004 1/

(In millions of U.S. dollars)

	Total	Medium- and Long-term	Fund Repurchases
1995	3,373	3,155	218
1996	3,374	3,189	185
1997	2,908	2,728	180
1998	3,236	3,030	206
1999	3,425	3,122	303
2000	2,683	2,323	360
2001	973	705	268
2002	841	841	--
2003	1,282	1,282	--
2004	1,300	1,300	--
Later	1,016	1,016	--

Sources: National Bank of Hungary; and Fund staff estimates.

1/ Based on debt stock and exchange rates prevailing at end-September 1994.

Table 45. Hungary: International Reserves and Other Foreign Assets, 1989-94 1/

(In millions of U.S. dollars, at end of period)

	1989	1990	1991	1992	1993	1994
International reserves in convertible currencies						
Gold 2/	479.1	97.1	82.0	32.6	44.6	42.2
Foreign exchange	1,246.2	1,069.4	3,935.0	4,347.5	6,691.5	6,726.6
Total	1,725.3	1,166.4	4,017.0	4,380.1	6,736.2	6,768.8
Nonconvertible currencies 3/	567.1	802.9	706.0	47.5	45.2	11.8
Total	2,292.4	1,969.3	4,723.0	4,427.6	6,781.4	6,780.6
Other foreign assets						
Convertible currencies 4/	3,764.6	4,165.6	4,086.0	4,005.7	2,897.4	2,816.7
Short-term	2,355.3	2,739.9	2,606.0	2,597.5	1,952.6	1,649.7
Medium- and long-term	1,409.3	1,425.6	1,480.0	1,408.2	944.8	1,167.0
Nonconvertible currencies	669.0	591.8	516.0	1,179.8	652.4	555.7
Short-term	169.4	108.1	117.0	79.1	17.5	17.8
Medium- and long-term	499.6	483.7	399.0	1,100.7	634.8	537.9
Total international reserves and other foreign assets	6,726.0	6,726.7	9,325.0	9,613.1	10,331.2	10,153.0

Source: National Bank of Hungary.

1/ The data in this table may differ from those in the Staff Report (SM/95/35, 2/15/95) due to more updated information.
2/ Actual holdings of gold, at national valuation.
3/ Valued at the official exchange rates. From late 1990, most of this item consisted of ruble denominated claims on the Soviet Union through IBEC.
4/ Mainly trade credit extended by Hungarian enterprises.

III. Recent Shifts in Labor and Capital Compensation in Hungary

1. Introduction

Hungary experienced a major shift in the relative compensation of its basic factors of production during the transition to a market economy. Between 1987 and 1993, the share of income accruing to capital declined by nearly 55 percent, to about 19 percent of GDP. This striking development is of particular note since it would appear to have reduced the incentive for enterprises to undertake investment and constrained their ability to generate resources internally. Thus, the fall in capital's share may represent an impediment to the achievement of higher investment levels and durable growth over the medium term.

This chapter looks at possible reasons for the evolution of factor shares in Hungary, focusing in particular on the roles played by labor market institutions, developments in the social security system, and progress with enterprise reforms. The main conclusion of the paper is that soft budget constraints together with inadequate governance in the enterprise sector during the transition period weakened management's resistance to increases in labor costs. Also contributing to higher real labor costs was a multilevel system of wage determination that was geared towards the maintenance of real consumption wages.

This chapter is organized as follows. The next section compares the behavior of gross operating surplus in Hungary with that in other countries--including other economies in transition--and describes developments in total labor compensation, the complement to capital's income share. Sections 3 and 4 discuss the role of the labor market and the rising burden of social security contributions in the increase in real labor compensation. Section 5 surveys progress with enterprise reform--including development of the private sector and measures taken to strengthen financial discipline in state-owned enterprises. A summary and conclusions are presented in Section 6.

2. The decline of gross operating surplus: international comparison and overview

In 1987, prior to the introduction of major market reforms, Hungary's gross operating surplus accounted for 42 percent of total factor income. Between 1987 and 1991, capital's income share fell sharply to just over

21 percent of total factor income. 1/ Subsequently, the rate of decline slowed, and Hungary's gross operating surplus reached 19 percent of factor income in 1993. 2/ Part of this observed shift in income distribution may, however, reflect mismeasurement resulting, inter alia, from the growth in Hungary's underground economy and the fact that capital income may be more easily concealed than labor income. However, given the magnitude of the recorded shift, there is likely to remain a sizeable proportion of the decline in gross operating surplus that cannot be explained by mismeasurement.

The behavior of gross operating surplus in Hungary, the Czech Republic and Poland is shown in Chart 5. 3/ First, the chart shows that capital's income share is much higher in Poland than in either the Czech Republic or Hungary. A second finding is that capital's income share behaved very differently in each of the three countries during the transition period. Whereas gross operating surplus rose on average in the Czech Republic from 1989 to 1993 and remained about constant in Poland from 1991 onwards, in Hungary, the decline in capital's share was large and sustained. Moreover, the change in relative factor shares in Hungary--which began in 1987--preceded the period of declining output (1990-93) by three years, which suggests that the fall in output *per se* is unlikely to have been the main factor driving these developments. More likely to have played some role was the ongoing--but incomplete--liberalization of product and factor markets which, beginning in 1987, may have contributed to increasing the relative compensation of labor.

In order to place these issues in a broader perspective, Chart 6 compares capital's average share of factor income with average per capita GDP (measured in U.S. dollars) in OECD countries over the period 1985-94. Also included in the chart are observations for the three economies in transition. Among OECD countries, there exists a significant negative correlation between per capita income and capital's share. 4/ On the basis of this relationship, it would appear that factor shares in Poland are

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1/ Hungary's gross operating surplus is based on a system of national accounts that attributes to labor the total (capital plus labor) income generated by the self-employed. Between 1989 and 1994, the number of small businesses in Hungary more than doubled to over 750 thousand. This shift would therefore tend to bias *downward* capital's recorded share of income.

2/ Preliminary data suggests that Hungary's gross operating surplus may have recovered slightly in 1994.

3/ Income share data for Poland under the revised system of national accounts are available only for 1991-93, and therefore do not cover the period prior to the introduction of economic reforms in 1990. In the case of the Czech Republic, the data cover the period prior to the initiation of reforms in 1991. Data for other transition economies are not available.

4/ A simple regression of factor shares against a constant and the per capita GDP level produced a coefficient of -0.5, which was statistically significant.

roughly appropriate given the level of Polish per capita GDP. In the case of the Czech Republic, capital's income share is low relative to the predicted level, although more recent data (rather than the period-average figure shown in Chart 2) would reveal that the gap between the actual and predicted income shares is closing over time. In the case of Hungary, the chart indicates that capital's share is out of line with the level predicted by per capita income. Moreover, in contrast to the Czech Republic, the gap between the actual and predicted levels has been growing during the transition.

Focusing now on the complement to capital's share, total labor compensation as a share of GDP can be decomposed into three elements: average labor productivity, or output per worker; average real wages; and employer-paid social insurance contributions. As seen in Chart 7, labor productivity in Hungary declined by about 10 percent between 1989 and 1991, reflecting the lagged response of employment to the fall in real output. However, sharp reductions in employment over the period from 1991 to 1994 generated a recovery in labor productivity, in fact to levels exceeding those prevailing earlier. As a result of this rebound, developments in labor productivity cannot account directly for the increase in labor's share of income.

Rather than productivity, therefore, the behavior of total real compensation per worker (including employer-paid social security contributions) appears to be at the root of the increase in labor's income share in Hungary. Specifically, total compensation per worker--deflated by the producer price index--increased by more than 50 percent between 1987 and 1994 (see Chart 8). Notwithstanding a 12 percent increase in labor productivity over the same period, this increase in real compensation resulted in a significant increase in unit labor costs. 1/ The following three sections discuss the roles of the labor market, social security costs, and progress with enterprise reform, in effecting the sharp rise in real labor compensation.

3. The role of the labor market

The labor market in Hungary has undergone substantial change since the mid-1980s, as a result of the greater decentralization of wage determination, ongoing reform in the enterprise sector, and the introduction of unemployment benefits. This section examines whether changes in the structure of the labor market or the system of wage determination can provide some explanation for the sharp increase in total labor compensation over the past few years.

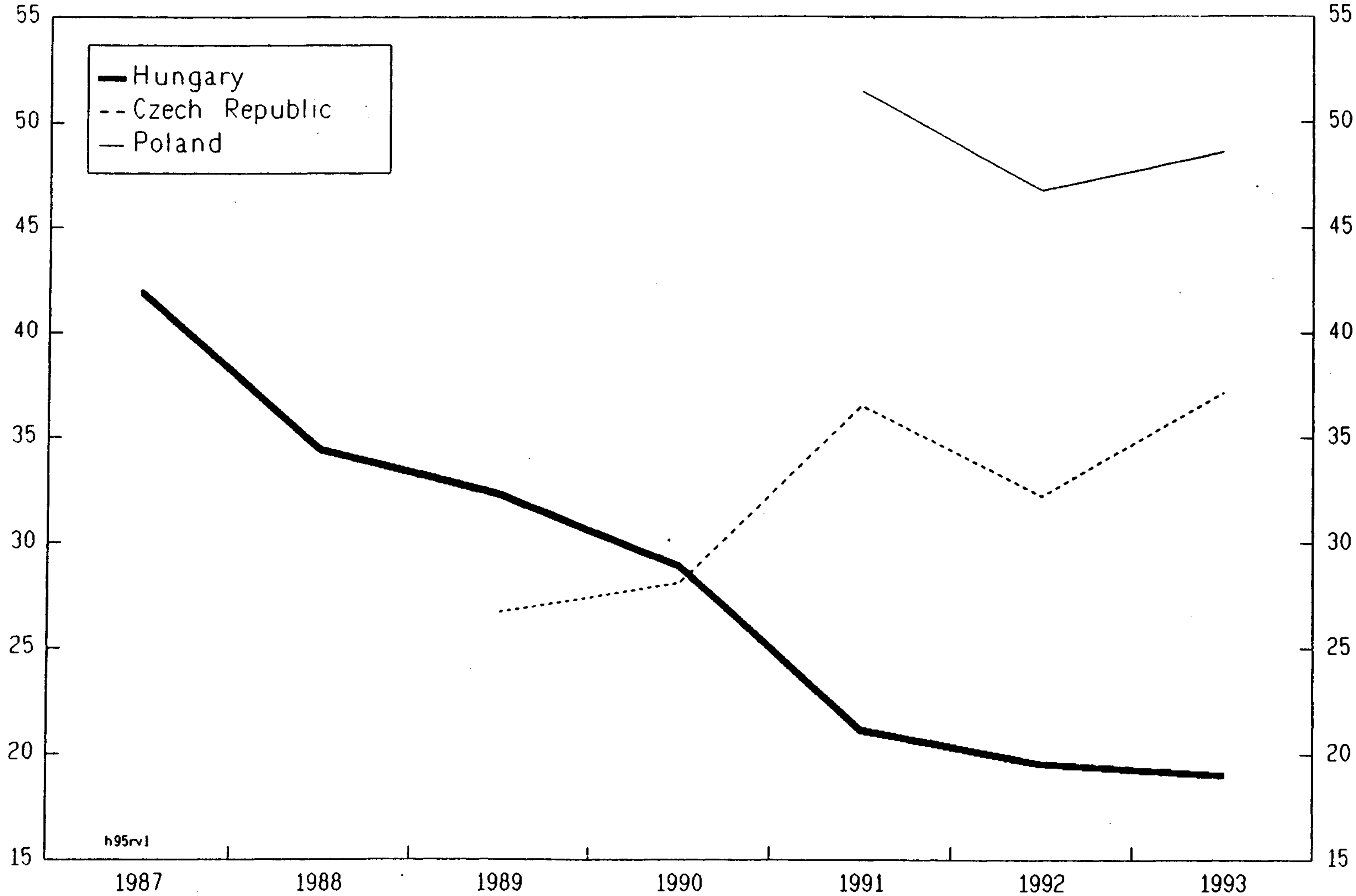
1/ In Poland, the increase in total real compensation per worker was much more modest than in Hungary, whereas in the Czech Republic, total real compensation per worker declined.

Chart 5

HUNGARY

CAPITAL'S SHARE OF INCOME, 1987-93

(Percent of total factor income)



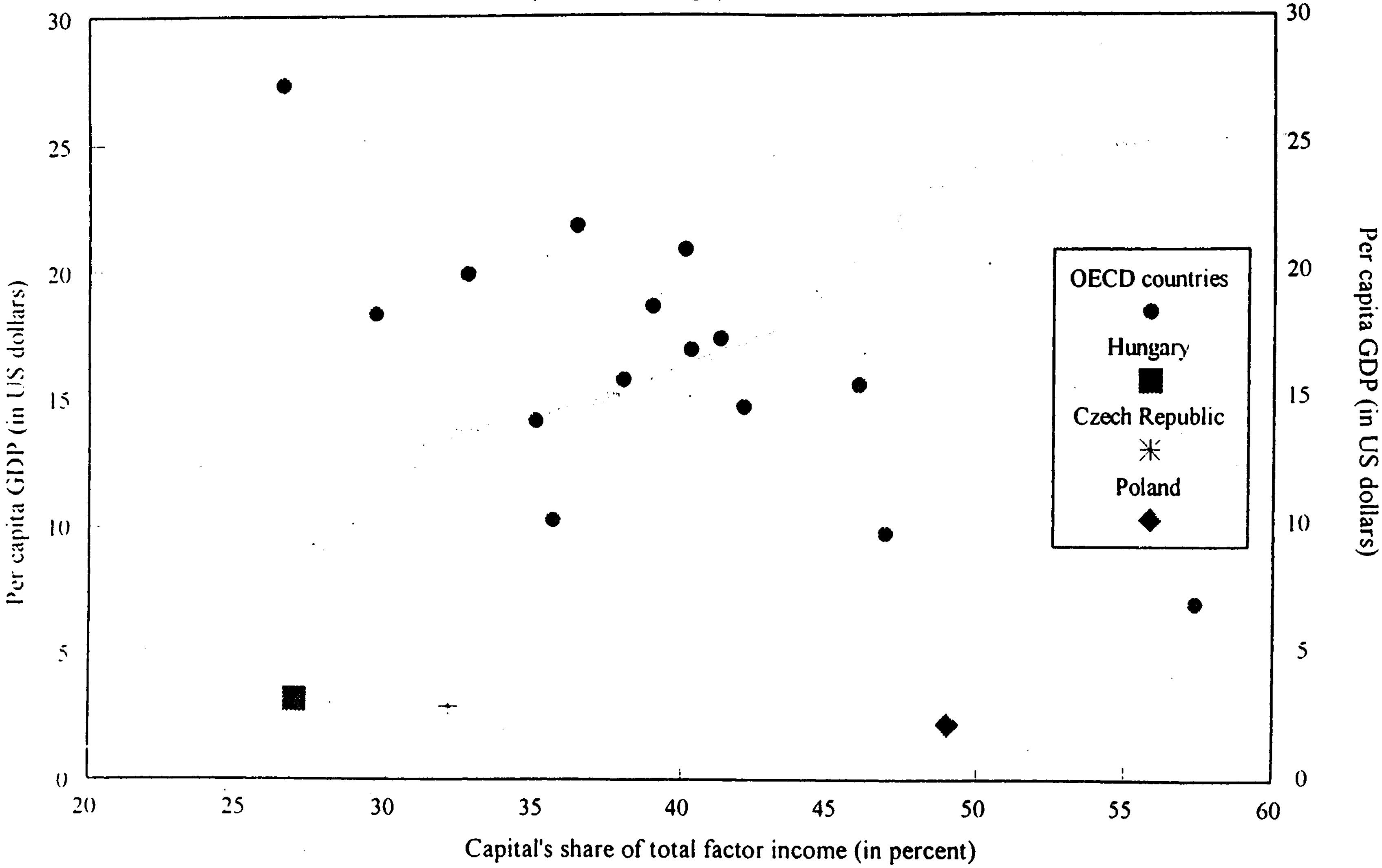
Sources: National authorities' statistical departments; and staff estimates.

Chart 6

HUNGARY

CAPITAL'S SHARE AND PER CAPITA GDP

(Period average) 1/



Sources: OECD database; IMF, International Financial Statistics; and staff estimates.

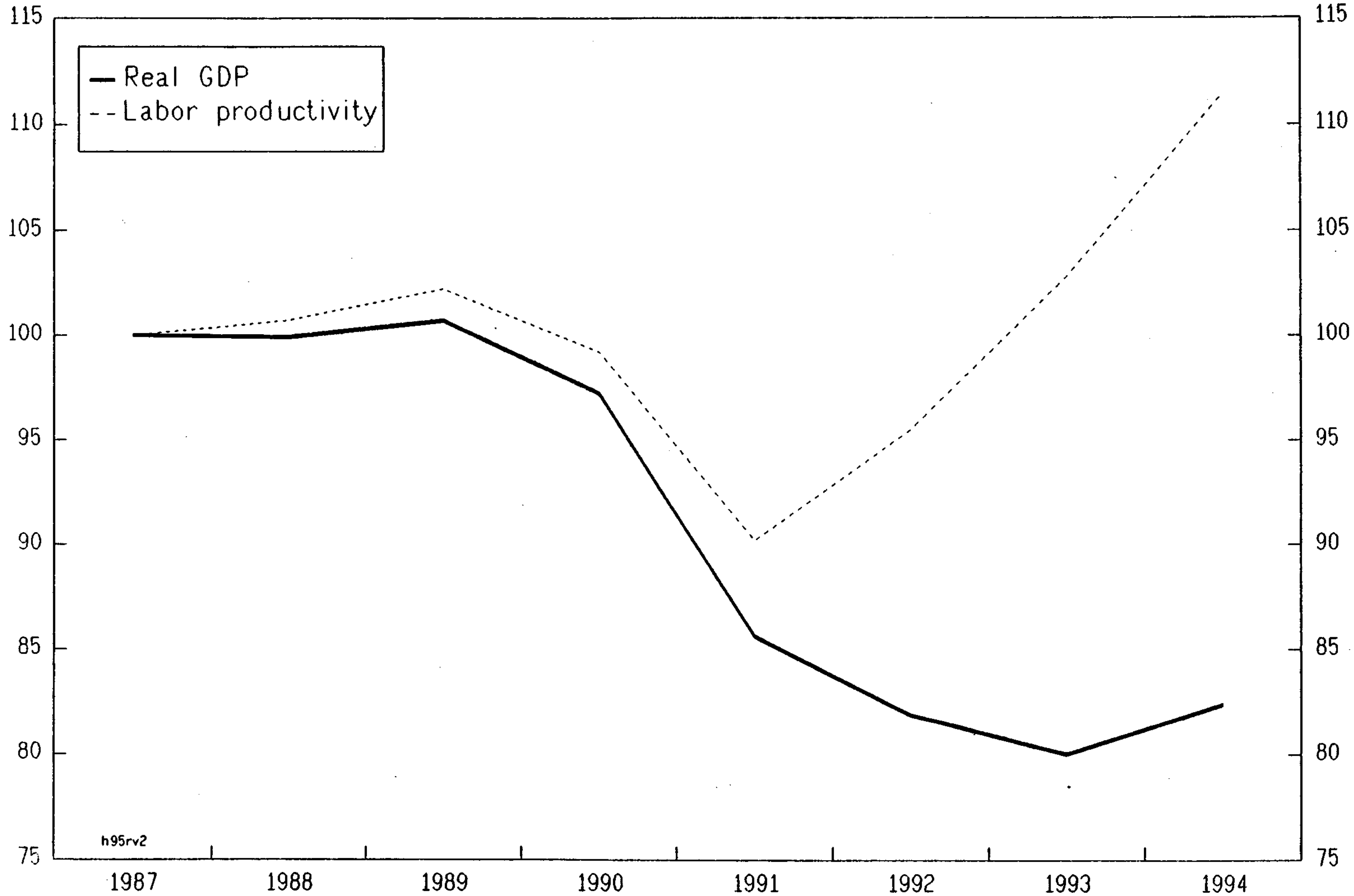
1/ Averages are for the period 1985-94 in OECD countries, 1987-93 in Hungary, 1989-93 in the Czech Republic, and 1991-93 in Poland.

Chart 7

HUNGARY

REAL GDP and LABOR PRODUCTIVITY, 1987-94

(1987 = 100)



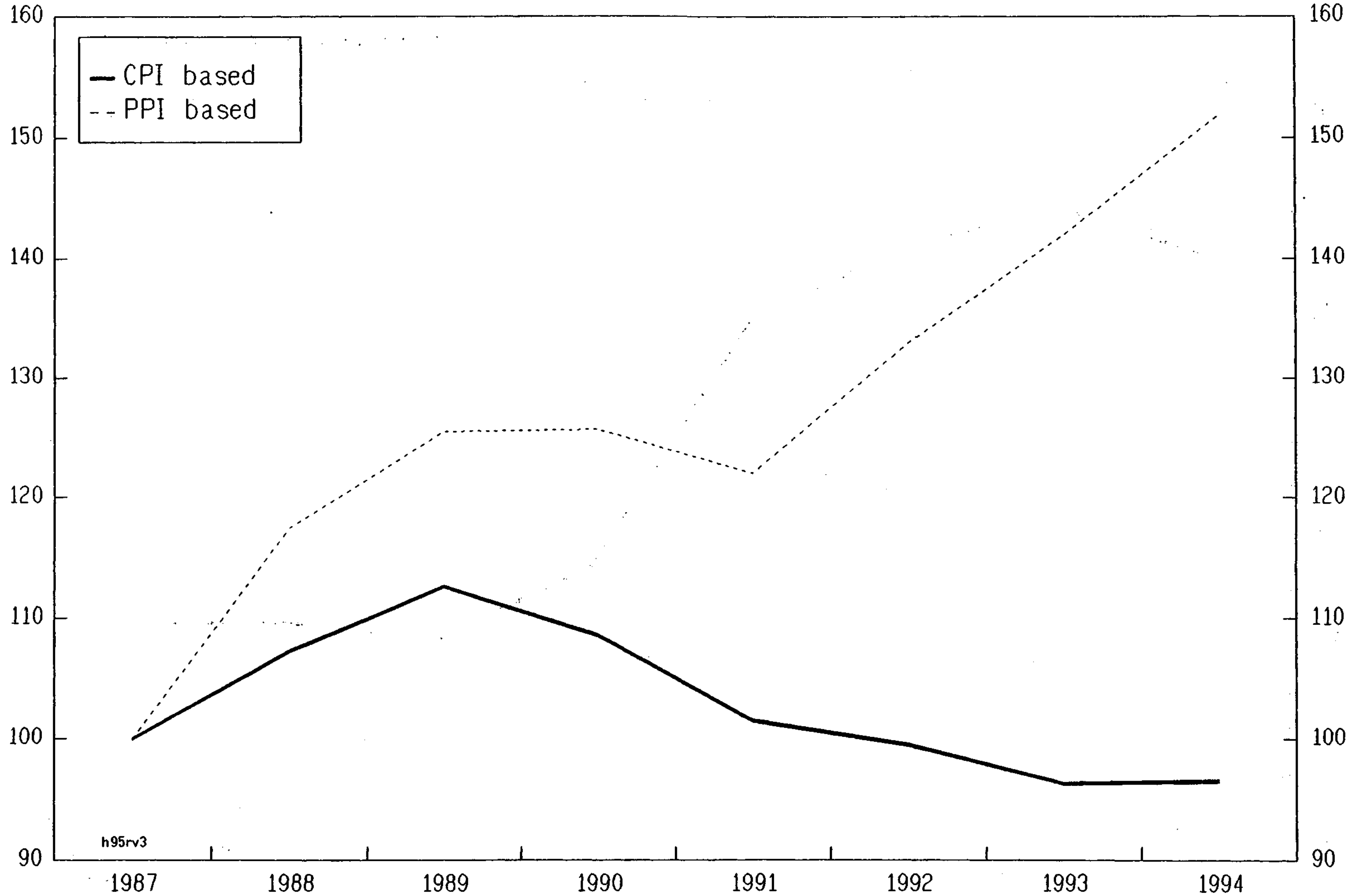
Source: Hungarian Central Statistical Office.

Chart 8

HUNGARY

REAL LABOR COSTS PER WORKER, 1987-94

(1987 = 100)



Source: Hungarian Central Statistical Office.

a. Labor market developments

We begin by investigating whether factors influencing labor *supply* had a substantial impact on the labor market during the period in question. While demographic changes have been relatively minor over the past several years (apart perhaps from a small rise in the share of the population of working age), a significant development on the supply side of the labor market has been a 13 percentage point decline--between 1989 and 1993--in the labor force participation rate. 1/ It is possible that this reduction in labor supply may have put upward pressure on real wages.

While the supply-side effects may offer some explanation of real wage developments in Hungary, the reduction in labor demand associated with the sharp fall in output is likely to have been an important factor in the rise in Hungary's unemployment rate, from about 2 percent in 1991 to a peak of 13.6 percent in early 1994. 2/ The sharp rise in unemployment, however, has not contributed to noticeable downward pressure on real wages, perhaps reflecting the high proportion of long-term unemployed. 3/ Reinforcing these effects, there appears to be considerable mismatch between job vacancies and the unemployed, both in terms of geographical location and skill level. In particular, unemployment rates are highest in remote regions, whereas job creation is centered primarily in urban areas. Since labor mobility is impeded, inter alia, by an inadequately-developed housing market, one would not expect high but localized unemployment to greatly influence wage settlements in other regions.

1/ This decline reflects a sharp fall in participation of individuals outside the standard working age range, primarily those beyond the normal retirement ages. The number of workers in Hungary outside normal working age declined by 46 percent between 1987 and 1994, compared to a decline of 28 percent in overall employment. As a result, the proportion of the employed labor force made up of individuals outside the normal working age declined from a relatively high 9.8 percent to 7.3 percent between 1987 and 1994. Generous retirement benefits may have been a factor in the withdrawal of older workers from the labor force, while the longer duration of schooling may have contributed to a reduction in the labor force participation of younger individuals. Finally, the decline in the official participation rate almost certainly reflects some absorption of labor into the underground economy.

2/ The unemployment rate fell back to 10.4 percent at end-1994.

3/ Currently, 65 percent of the registered unemployed have been out of work for at least one year. There is some evidence that the prolonged separation from employment for this group prevents its members from competing effectively in the labor market. For this reason, the existence of a substantial proportion of long-term unemployed may not produce significant downward pressure on wages.

b. Wage determination

Prior to 1989, Hungary adopted a wage policy designed to compress labor's share of production, mainly in order to promote employment. This was effected through heavy taxation (at rates up to 450 percent) of increases in the wage bill in excess of specified ceilings. However, the final allocation of income was determined by a state-intermediated system of income redistribution, whereby the purchasing power of households was augmented through cash transfers, subsidization of goods and provision of social services, financed mainly by taxation of the enterprise sector. As a result of this policy, both wages and the standard of living were delinked from labor productivity.

With a view towards improving the efficiency of resource allocation, wage determination became more liberalized from 1989. Over the past five years, wages in the nongovernment sector have been determined through a multilevel system of collective bargaining. 1/ At the national level, negotiations take place within the Interest Reconciliation Council (IRC), a tripartite body comprising representatives of the trade unions, employers' organizations and the Government. At present, seven national trade unions, nine employer federations, and representatives from government ministries participate in the IRC. These tripartite negotiations establish by consensus (nonbinding) guidelines for average wage increases and a binding agreement on the minimum wage. Wages are also determined through collective bargaining at the branch and firm levels. 2/

While the minimum wage set by the IRC at the national level applies directly to only a small fraction of the workforce, in practice, its influence is much broader since the minimum wage acts as a floor for wage agreements at the branch and firm levels. Moreover, the minimum wage--which is generally somewhat below the subsistence income level--has usually been adjusted in order to preserve its purchasing power in terms of *consumer prices*. Since consumer prices have risen more rapidly than producer prices (by an average of about 8 percentage points per year since 1987), this has contributed to the shift in income toward labor.

A purported advantage of decentralized wage negotiations is that agreements are able to more fully reflect differences in productivity and profitability across firms and industries. In Hungary, however, agreements reached at the decentralized level rarely reflect these factors and, on

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1/ For a description of recent labor relations in Hungary, see "Labor standards and structural adjustment in Hungary", by Roger Plant, Occasional Paper No. 7, International Labor Office, Geneva, April 1993.

2/ In 1993, there were 36 agreements at the branch level, 12 more than in 1992. There were 394 firm level agreements in 1993, covering more than 20 percent of the enterprise sector.

average, actual wage increases tend to be quite close to the guidelines established at the national level, which are based in large part on expected consumer price inflation.

Although *average* wage growth has been close to consumer price inflation, newly-established private firms have tended to pay lower wages than their state-owned and privatized counterparts, and their wages also tend to reflect more fully outside labor market conditions. However, owing to the dominant role of state-owned and privatized firms in total employment, in general, wage agreements have failed to reflect conditions in the labor market or differences across firms in underlying economic performance. A recent World Bank study revealed that wage increases at the branch level tend to be uncorrelated with sales and ability to pay, especially among large firms (with more than 2,000 employees), where wages (including bonuses) tend to move closely with consumer prices. 1/ Furthermore, value-subtracting firms tend to grant above-average wage increases and bonuses. In contrast, labor compensation in small firms is closely correlated with profitability. This result is due to the fact that bonuses, which are highly correlated with profitability, comprise a larger part of total labor compensation in small firms.

The same World Bank study also examined wage behavior in state-owned enterprises in the portfolio of the State Holding Company, AV Rt, which includes many of the large loss-making enterprises. The study concludes that, on average, real consumption wages in AV Rt-firms increased by about 7 percent in 1993, well above the national average. Wage increases were especially large in enterprises undergoing restructuring and where employment declines were greatest, implying that resources saved through the reorganization process were diverted to increase the compensation of remaining employees.

It can also be argued that the system of multilevel bargaining, in and of itself, has contributed to larger wage increases than would have occurred under a single-stage bargaining system. The reason is that once agreements have been reached at the national level, the bargaining positions of the parties at the decentralized level become asymmetrical. Employers are placed at a disadvantage since their minimum position is constrained by the centrally-agreed wage norms, whereas the bargaining positions of employees are unaffected by the rulings at the national level.

In addition to the practice of wage bargaining, a tax-based incomes policy remained in effect in Hungary until the end of 1992. Under this policy, all wage increases were subject to the corporate profit tax, with the rate set at 50 percent (with a four percent surtax) in 1989 and 40 percent during 1990-92. However, enterprises were eligible for a full

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1/ Commander, S., Kollo, J., and Ugaz, C. Firm Behavior and the Labor Market in the Hungarian Transition, Policy Research Working Paper No. 1373, 1994, The World Bank.

rebate on taxes paid on the basis of wage costs if the increase in their wage bill was below a specified proportion--determined by the IRC--of the rate of increase in their value added. For example, in 1989, a company could avoid the excess-wage tax if it increased its wage bill by less than half of the increase in its value added. Wage increases in excess of this amount were taxed at the prevailing corporate tax rate. Small enterprises with wage costs of less than Ft 20 million and joint-venture firms with at least 20 percent foreign participation were exempted from the excess-wage tax. These provisions exempted about 70 percent of Hungarian companies (reflecting about 10 percent of total employment) from the incomes policy in 1991.

In order to further contain wage growth, a system of differentiated excess wage taxes was incorporated into the incomes policy in 1991. According to this system, if the wage bill increased by more than 28 percent, the entire increase was subject to taxation at the prevailing corporate tax rate; for wage bills that increased between 18 percent and 28 percent, that part of the increase exceeding the lower end of the range was subject to the profit tax; while wage bills that increased by less than 18 percent were untaxed. In addition, the system permitted cost savings from reduced employment to be used by the firm for salary increases of up to five percent. 1/ The incomes policy scheme was modified in 1992, when the excess wage tax was applied only to per-employee wage increases of more than 28 percent or to firms where the average wage increase exceeded 23 percent. Incomes policy was abandoned altogether in 1993.

Despite the relatively moderate rates of excess-wage taxation--both in comparison to rates prevailing in Hungary before 1989 and in comparison to rates in other economies in transition, the amount of excess wages granted and the resulting tax revenues were very small. 2/ Rather than raise worker compensation in the form of wages (which were subject to personal income taxes, social insurance contributions, and excess wage taxes), enterprises chose to grant workers higher remuneration through increases in various payments in kind (e.g., meals, vacations, use of automobiles) and small, nontaxed side payments (e.g., meal money, clothing allowances). In real terms, (using the GDP deflator), such "assimilated incomes" grew by some 91.7 percent from 1989 to 1992, far outpacing the increase in cash incomes (which experienced a cumulative *decline* of 0.2 percent over the same period). Assimilated incomes continue to grow rapidly, although at a slower

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1/ Firms that increased their staff by at least 5 percent were allowed to augment the previous year's wage bill base by the proportional increase in staff when calculating the 18 and 28 percent tax thresholds.
2/ Excess wages comprised at most one percent of total labor income between 1989 and 1992.

pace than in 1989-92. 1/ Thus, while incomes policy may have helped to contain the growth in wages, it was not effective in countering pressures toward higher *total* labor incomes.

4. Developments in employer-paid social insurance contributions

Hungary has an extensive system of social expenditures. In total, more than 28 percent of GDP is intermediated through the government sector in providing pensions, maternity benefits, family allowances, pharmaceutical subsidies, unemployment benefits, housing, public health, and social assistance. This ratio of benefits to GDP is much higher than in other countries at similar levels of development, and is equivalent to those prevailing in the Nordic countries. Most of these programs are financed through employer and employee social insurance contributions.

Employer-paid social insurance contributions in Hungary increased from 43 percent of the wage bill in 1991 to a peak of 51 percent in 1993. This increase in employer contribution rates was intended to cover the growing cost of unemployment compensation. Since April 1994, the employer contribution rate has declined slightly to 49.3 percent. Currently, total employer and employee contributions amount to over 60 percent of the gross wage bill (or more than one third of total labor compensation costs), among the highest rates in the world. 2/

More important from the perspective of income distribution is the apparent failure of employers to shift much, if any, of the burden of increased contributions to employees in the form of lower labor compensation. 3/ Three considerations may be important in explaining this outcome. First, as discussed above, the floor for nominal wage increases determined under the tripartite wage bargaining system has been informally tied to increases in consumer prices. Moreover, owing to the pay-as-you-go

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1/ During 1993-94, the real increases in cash and assimilated incomes have been 5.4 percent and 21.4 percent, respectively. Nonwage labor costs (including bonuses) comprised 45 percent of total labor costs in 1992.

2/ Employers pay contributions equivalent to 44 percent of wage bills to the Pension and Health insurance funds, 5 percent to the Solidarity fund for unemployment compensation and 0.3 percent to the Wage Guarantee fund, to pay for wages owed by firms that are in bankruptcy proceedings and unable to pay their obligations. In addition, employees pay 10 percent of their wages to the Pension Fund and 1.5 percent to the Solidarity Fund.

3/ Public finance theory suggests that the ultimate burden of a tax depends not upon whom it is imposed but upon the relative demand and supply elasticities for the taxed good or service. It is generally agreed that the final burden of social insurance contributions will be borne mainly by labor, as it is thought that supply is relatively less elastic in the long run, especially for primary workers, than is demand. It remains an open question, however, as to the length of time necessary to shift the burden of taxation to labor.

nature of social benefits, workers may fail to perceive a connection between employer contributions made on their behalf and the level of future benefit payouts. Finally, continued soft budget constraints for a number of state-owned loss-making firms--as discussed below--has further hindered wage flexibility.

5. Enterprise reform

Hungary's transition to a market economy has been associated with greater decentralization of decision making in the enterprise sector. However, privatization of state-owned assets is far from complete and, in the interim, weak enterprise governance, coupled with inadequate financial discipline, may have contributed to the absence of wage restraint. This section reviews Hungary's progress with enterprise restructuring and in particular the steps taken to harden enterprise budget constraints, with a view to explaining the decline in capital's share of income.

Enterprise reform in Hungary has consisted of three main elements: (i) privatization; (ii) bankruptcy and liquidation; and (iii) several schemes outside normal bankruptcy and liquidation procedures for resolving the debts of the most troubled enterprises. Considerable progress has been achieved with privatization of the enterprise sector since it began in the late 1980s. Currently, about 60 percent of recorded GDP is generated by the private sector, up from 20 percent in 1989; the private sector is also estimated to produce up to an additional 30 percent of GDP in the underground economy. By and large, the private sector is comprised of small and medium-sized enterprises, and is estimated to account for more than 25 percent of the total employed labor force. 1/ Formation of new firms has been the most important element in the development of the private sector, with the number of incorporated firms increasing from about 15,000 in 1989 to over 85,000 in 1993.

Privatization of previously state-owned firms has also proceeded quite rapidly. During 1990-91, the primary form of privatization of larger companies was the direct sale of majority shares in enterprises to foreign investors who provided access to technology, capital, managerial skill and markets. However, the focus subsequently shifted toward domestic residents and the share of foreign currency in privatization revenues declined. The pace of privatization slowed in 1994, and about two thirds of state assets have yet to be privatized, including many of the large loss-making enterprises. However, the privatization process is to be accelerated in 1995, with the proposed sale of significant shares of the energy, telecommunication and banking sectors.

1/ Including firms that are partly privately owned, the proportion of total employment increases to nearly 40 percent.

In order to improve enterprise financial discipline, particularly in firms that remained in state ownership, a new Bankruptcy Law was introduced in January 1992. The law, one of the toughest in eastern Europe, forced any company (under threat of legal action against its managers) with payments overdue for more than 90 days to initiate bankruptcy or liquidation procedures. Although the automatic triggering of proceedings was repealed in late 1992, by end-1994, nearly 26,000 bankruptcy and liquidation petitions had been filed, substantially more than in other transition economies. However, significant lags existed between the time of filing and the actual disposal of the case. On average, resolution of bankruptcy cases took two years, similar to the period required to conclude liquidation proceedings. As a result of they delays, less than 70 percent of bankruptcy and liquidation cases were completed by 1994.

In addition to the Bankruptcy Law, a Financial Institutions Act was adopted in December 1991. This Act prescribed the gradual attainment of BIS-recommended minimum capital adequacy standards and allowed for provisioning against nonperforming loans out of pre-tax profits. In addition to improving the financial position of the banks themselves, it was envisaged that this Act would buttress the Bankruptcy Law, resulting in a further tightening of enterprise budget constraints.

Hungary has also adopted several programs outside the normal bankruptcy-liquidation procedures to deal with debt resolution, particularly in the most troubled enterprises. These include the 1991 loan guarantees, the 1992 and 1993 Loan Consolidation programs, and the Thirteen plus One Program. Overall, these schemes--described in Box 1 below--substantially eased the financial burden of the enterprises involved but, contrary to expectations, have generated little in the way of enterprise restructuring.

Hungary's 1992 Bankruptcy Law contributed to greater financial discipline in a large number of (mostly smaller) enterprises. However, as discussed above, many of the larger state enterprises were nonetheless able to evade the hardening of budget constraints due in part to the introduction of special debt-resolution channels. As a result of delayed reform among the most troubled enterprises, enterprise losses have remained relatively high.

Box 1. Debt Resolution Mechanisms

Hungary has adopted four major programs since 1991 to effect debt work-outs in the enterprise sector. In the first of these programs, the government provided guarantees for Ft 10.5 billion in banks loans extended to state enterprises prior to 1987, and that were classified as bad in 1991. The majority of guarantees covered loans to the coal mining sector. Under the 1992 Loan Consolidation Program, the state purchased at a discount about Ft 120 billion in bad loans extended by the banks to 2,700 state-owned enterprises. In March 1993, the newly-created state-owned Hungarian Investment and Development Bank (HIDB) purchased Ft 40 billion of these loans to 56 enterprises, selected on the basis of their viability, with a view towards initiating workout procedures. However, 44 of these enterprises are currently undergoing liquidation and 6 are in bankruptcy. The HIDB was successful in reaching debt resolution agreements with all creditors in the case of only 4 enterprises, and turn-around programs are being implemented in these firms. During 1994, the government attempted to sell the remaining Ft 80 billion in bad loans to the public; however, loans with a face value of only Ft 7 billion were sold through this process.

In order to by-pass the normal bankruptcy process, the state provided financial relief to a select group of enterprises through the Thirteen Plus One Program. Under this program, bank loans to thirteen large industrial firms and the State Railway (MAV) were taken over by the state in October 1993. In addition, other support totaling some Ft 18 billion (including writing off and rescheduling debts owed to the state) was provided. Moreover, the state provided an additional Ft 7 billion to modernize and downsize five steel enterprises, two of which were already under liquidation, and committed to providing further support through the budget and loan guarantees.

The most recent debt resolution initiative is the on-going debtor conciliation program, introduced in late 1993 in conjunction with bank recapitalization. Under this scheme, the government acted as mediator in out-of-court debt negotiations to resolve enterprise debt owed to banks and state creditors (tax and custom authorities and social security). Firms with bank loans classified as substandard were eligible for inclusion in the scheme, although participation was voluntary. The program envisaged several tracks for debt conciliation. Two of these (the "accelerated" and "normal" tracks) required the participation of line ministries and mandated the purchase by the state asset management agencies (SAMAs) of substandard bank loans. Involvement of line ministries raised the likelihood that noncommercial considerations would be introduced into the conciliation process. In addition, the mandated purchases of bank loans by the SAMAs created expectations of enterprise bailouts and added to the fiscal cost of debt restructuring. In contrast, the so-called "simplified" procedure for debt resolution

Box 1 (concluded). Debt Resolution Mechanisms

involved direct conciliation between debtors and creditors that is common in market economies, and since line ministries and the SAMAs were not involved in the process, many of the problems associated with the "accelerated" and "normal" procedures were avoided.

Of the 13,235 firms eligible to participate in the debtor conciliation process, only 1,980 applied. Of these, 55 enterprises were given access to the "accelerated" scheme and were required to prepare restructuring proposals by January, 1994. By end-1994, liquidation proceedings had been initiated for 10 of these enterprises, and final reorganization agreements had been reached in only 4 cases, 3 of which involved purchases of loans by SAMAs. Negotiations are ongoing in 31 cases, and 5 enterprises were removed from the scheme.

Coverage of the Debtor Conciliation Scheme was subsequently expanded in March 1994, and 75 (mostly larger) enterprises were selected to participate in the "normal" scheme. Remaining enterprises are expected to proceed through the "simplified" scheme; however, only preliminary negotiations between the banks and their debtor-clients had taken place by end-1994, the initial deadline set for completion of the program. As a result, the program has been extended to mid-1995.

Aggregate enterprise losses rose sharply in the early 1990s, peaking at over 13 percent of GDP in 1992 (see tabulation below). Although they subsequently declined, preliminary data indicate that losses remained at an estimated 8 1/2 percent of GDP in 1994. The initial increase in losses is attributable to a number of factors, including the sharp decline in economic activity, the collapse of CMEA trade, and rising employer social security contribution rates. The large jump in losses in 1992 reflects primarily the effect on the banking sector of the introduction of the Bankruptcy Act and the Law on Financial Institutions (which required banks to provision against their nonloans--see Chapter VI). In addition, a law on accounting, introduced in 1992, that allowed firms to adopt more realistic depreciation rates, further increased *recorded* losses. However, to a large degree the persistence of losses reflects the relatively slow progress in reforming the largest and most troublesome loss-makers. In fact, these losses alone, which peaked at 13.2 percent of GDP in 1992, account for a large part of the decline in capital's share of income.

Hungary: Loss-making firms, 1990-93

	1990	1991	1992	1993
Number of firms reporting losses	997	2,455	27,616	337,766
Aggregate losses (Ft billion),	58	149	380	279
(Percent of GDP)	2.8	6.0	13.2	8.0

Based on a Ministry of Finance survey of 1992 tax returns, enterprise losses were concentrated in a relatively small number of firms. About 600 firms, each with losses of at least Ft 100 million, accounted for more than two thirds of aggregate losses. 1/ Moreover, the 41 largest loss-making firms, each with losses in excess of Ft 1 billion, were responsible for more than one quarter of total enterprise losses. However, of the group of 600 large loss-making enterprises, less than half (including the most problematic) have entered the bankruptcy or liquidation process.

Enterprises have relied on various sources of financing to cover their losses. Initially, direct (voluntary) subsidies and transfers through the budget were the most important source of external support for enterprises. In 1988, these subsidies and transfers amounted to 11 1/2 percent of GDP, but have subsequently fallen substantially, and are estimated at less than 2 1/2 percent of GDP in 1994. In addition, commercial banks tended to roll over credits to large nonviable enterprises, disguising the fact that loans were nonperforming, and thereby avoiding the cost of provisioning against them. More recently, however, banks have been reluctant to inject *net* new funds (i.e., new lending in excess of existing interest obligations) into highly indebted firms (see Chapter VI). As a result of the decline in traditional sources of financing, enterprises have come to rely increasingly on tax and social security arrears as sources of financing. The stock of these arrears is estimated at 4 percent of GDP at end-1994. 2/ In addition, the SAMAs have channeled Ft 46.6 billion of privatization revenues between 1990 and mid-1994 to other enterprises in their portfolios. Additional public resources have potentially been committed to the enterprise sector in the form of loan guarantees provided by the government (with an annual ceiling on new guarantees equal to 3 percent of revenues) and the

1/ This group also accounted for about 40 percent of the enterprise sector's outstanding debt to banks, and around 75 percent of the total impaired debt owed to banks.

2/ In contrast to other transition economies, inter-enterprise arrears were never a significant source of financing in Hungary, due perhaps to the credibility of the bankruptcy threat.

SAMAs (which have issued new guarantees amounting to 1/2 percent of GDP on average between 1992 and 1994). To date, the government and the SAMAs have made payments of Ft 25.2 billion in connection with their loan guarantees. Moreover, loss-making enterprises appear to be financing a significant part of their operations through inventory decumulation and the sale of fixed assets.

In retrospect, experience with enterprise restructuring has been rather mixed. On the one hand, privatization, reductions in enterprise subsidies, and the introduction of effective bankruptcy and commercial banking laws have effectively tightened budget constraints for the vast majority of smaller firms. However, a significant number of large, politically-prominent enterprises, which are regarded as "too big to fail", have largely managed to avoid restructuring and continue to make sizable losses. These enterprises operate under soft budget constraints financed by both voluntary and involuntary subsidies from the budget and social security, the SAMAs and, to a lesser extent, the banking sector. Slow progress in hardening budget constraints in the most troubled enterprises, together with inadequate enterprise governance in the absence of privatization, has weakened management's resistance to wage increases, and contributed to the rapid increases in total real labor compensation observed in large loss-making enterprises.

6. Summary and conclusions

The gross operating surplus of the enterprise sector in Hungary has declined sharply since 1987, in contrast to the experience of a number of other countries in similar circumstances. While part of this decline may reflect mismeasurement, it also reflects a sharp increase in real product wages and a rising burden of employer-paid social security contributions. These developments have taken place despite a significant rise in the role of the private sector in the economy and some (albeit limited) progress in hardening enterprise budget constraints, especially as a result of the introduction of a tough bankruptcy law.

One factor that probably has played a role in depressing gross operating surplus is the system of wage bargaining, which encourages economy-wide average wage increases that are justified only for the more profitable segments of industry. A second factor is the slow progress in hardening the budget constraints of many state enterprises. This failure has, in particular, enabled loss-making firms to grant excessive wage increases (when judged against productivity developments) and has compounded the adverse effects of the wage bargaining system. Indeed, enterprise losses alone account for a large part of the decline in Hungary's gross operating surplus. A third factor has been the slow progress in rationalizing the social security system, which has imposed a growing burden on firms that--partly because of the first two factors--has not been shifted to labor.

Because progress in addressing these issues is ongoing, the reduction in capital's income share may well be reversed in the future as further progress is made with enterprise reform, especially through the new strategy for accelerating privatization. 1/ Reforms of the social security system that lowered the burden of contributions on the enterprise sector might also help to raise gross operating surplus. In the interim, however, loss-making firms will continue to crowd out investments in more efficient enterprises, thereby retarding the pace of economic recovery.

1/ Indeed, the slow-down in the rate of decline in gross operating surplus between 1991 and 1993, together with preliminary evidence which suggests an increase in capital's share during 1994, would also support the view that the reduction in capital's income share may well be reversed.

IV. The Behavior of Household Saving in Hungary During 1985-94

1. Introduction

This chapter reviews the saving behavior of the household sector during the years 1985-94 with particular focus on the more recent period of rapid transition towards a market economy. Household saving increased sharply at the beginning of the transition period in 1990/91 and this cushioned the economy against the decline in saving by other sectors, especially the enterprise sector (Table 46). The rise in household saving in relation to GDP in this period reflected two mutually reinforcing developments: a shift in relative income shares towards households (which is discussed more fully in Chapter III); and a rise in the saving rate of households. The latter was likely in part a result of precautionary saving as output declined and unemployment increased, and the general economic outlook became very uncertain. It is also possible that high measured saving rates in this period reflected the response to inflation and associated capital losses on the stock of private wealth. Relatively tight monetary conditions may also have encouraged private saving to some extent in this period, even though their primary effect is likely to have been on the composition rather than the overall level of saving.

After 1991, household saving rates declined and within a two-year period, the saving rate was halved before rebounding moderately in 1994. Coupled with low government and enterprise saving, the domestic saving level was insufficient to finance the capital stock accumulation when investment activity began to recover in 1993-94. In all, the decline in household saving was thus a key factor in the deterioration of the aggregate saving-investment balance in 1993.

A central question concerns the permanence of these developments. In particular, is the decline in the household saving rate after 1991 a durable feature following unusually large saving in the preceding years that reflected principally precautionary motives; or could one expect at least a partial reversal of the decline in the household saving rate that would go some way toward redressing the overall saving investment imbalance experienced during 1993-94? By reviewing the main determinants of household saving over the past decade, this chapter attempts to shed some light on these issues.

2. Household saving in 1985-89

Household savings in Hungary averaged less than 5 percent of GDP during 1985-89 (Chart 9), a low level in comparison to developed market economies where saving rates were typically above 10 percent over the same period (Tables 47-49). To some extent, the low household saving level reflected several features of the economic system in Hungary at that time. First, there was relatively little risk to a household's income stream. The risk of unemployment was very low, as employment in the state sector was effectively guaranteed. Similarly, the state had established a social safety net for the sick and old that covered essentially the whole population; in particular, this largely obviated the need to save in order to secure a retirement benefit. Furthermore, the wage bargaining system generally provided an insurance against inflation risks. Under these conditions, the motive to save in order to insure against fluctuations in real household incomes was fairly small during this period. 1/

A second factor for the low household saving rates in the 1980s may have been a lack of incentives to save in order to acquire costly consumer durable or investment goods, including the purchase of a house or other real estate properties. Many consumer durables, especially those of better quality, were not easily available within the old CMEA trade regime. And incentives to save towards real estate acquisitions were limited, among others, by low rents on state-provided housing. Finally, the low average saving rate of households may also have reflected a rather small dispersion of household incomes, especially when viewed against developments in the subsequent transition period.

In the context of this economic environment, the rate of saving out of disposable income fluctuated between 6 percent and 8 percent during 1985-89. Overall, the saving rate was relatively stable and this may again have reflected the relative stability of household incomes over this period given the absence of substantial cyclical fluctuations.

3. The boom in household saving in 1990-92

The household saving rate increased sharply after 1989, as real GDP began to decline with the break-up of the old economic structure, including the CMEA trade arrangement. 2/ Under these circumstances, the rate of household saving increased from under 7 percent of disposable income in 1989 to an estimated 18 percent in 1991, before declining moderately in 1992 (Tables 46, 50, and 51). The share of household saving in GDP increased even more over the same period and rose more than three-fold in the three years after 1989, averaging about 14 1/2 percent in 1991/92.

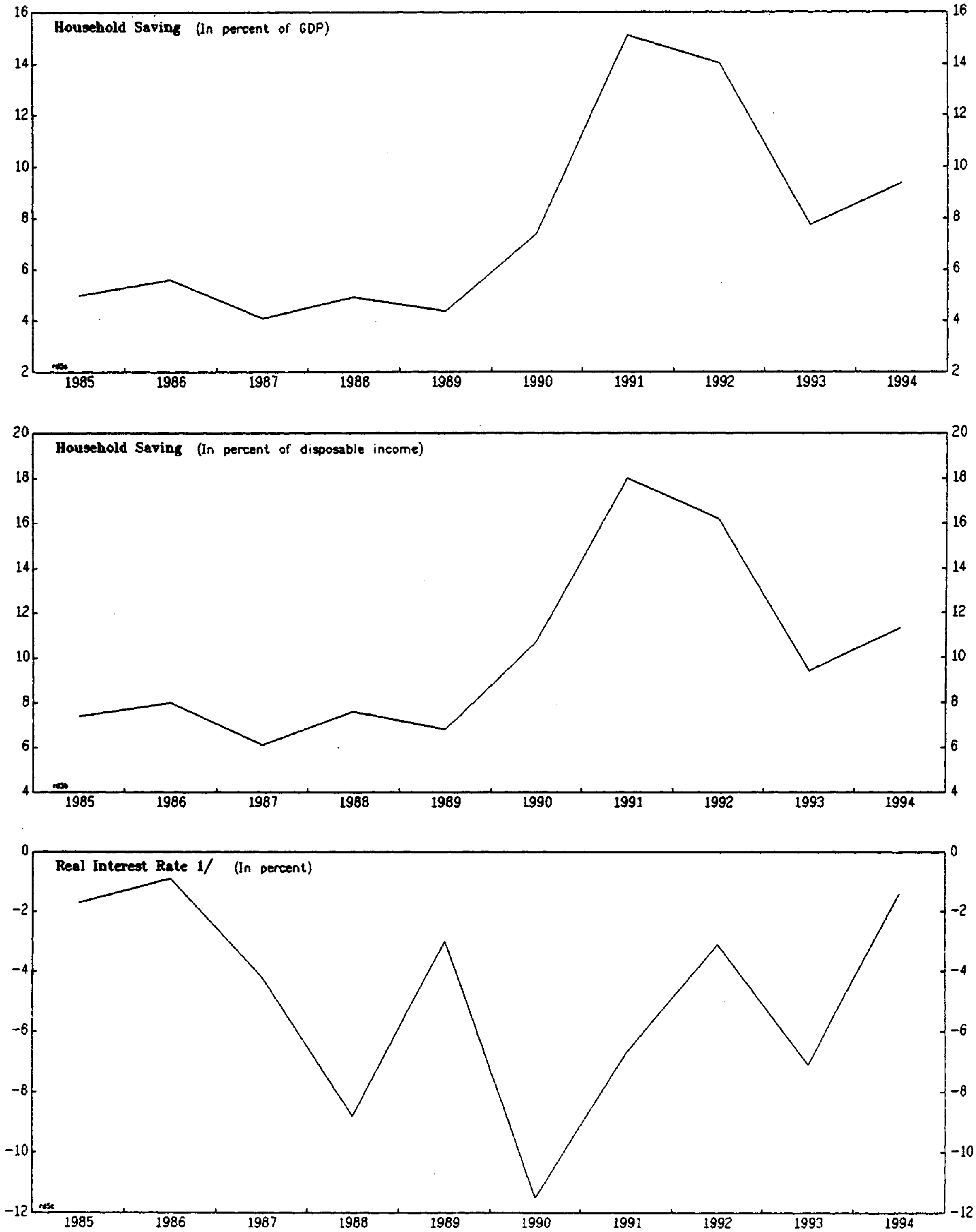
1/ In this context, it is interesting that Sweden also presented a major exception to the saving pattern observed in most industrial countries, exhibiting an even lower household saving rate than Hungary during the 1980s (about 3 percent of GDP). Not unlike Hungary in this regard, Sweden was an economy with strong income and employment security during this period.

2/ Economic developments in the transition period are discussed in more detail in Thomas Krueger and Mark Lutz, Hungary: Developments and Challenges, IMF, mimeo, 1994.

Chart 9

HUNGARY

HOUSEHOLD SAVING AND REAL INTEREST RATES, 1985-94



Source: National Bank of Hungary.

1/ Nominal deposit rate at the National Savings Bank, deflated by the consumer price index.

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At the aggregate level, two fundamental developments affected the gross national saving rate: a redistribution of income towards households; and a change in the saving rates of major sectors in the economy. The first factor--the redistribution of income--dominated the economy-wide development and implied a redistribution towards a sector that had traditionally exhibited relatively low saving rates. The saving rates of households out of disposable income averaged 7.2 percent in 1985-89 while the rest of the economy, mostly enterprises, saved a high 67.9 percent of their incomes over the same period. Under these circumstances, the sharp redistribution in incomes that occurred in 1991--with the income share of the relatively low saving households increasing by about 15 percentage points--had to result in a sharp decline in the national saving rate; ceteris paribus, i.e., at unchanged saving rates of each individual sector, the redistribution would have led to a decline in the average national saving rate of about 8 1/4 percentage points in 1991.

Hungary: Contribution of Household Saving to Gross National Saving 1/

	1985-89	1990	1991	1992	1993	Estimate 1994
	(In percent of GDP)					
Gross national saving	27.3	28.0	17.8	14.4	11.2	12.4
Household	4.8	7.4	15.1	14.0	7.8	9.4
Other	22.5	20.6	2.7	0.4	3.4	3.0
Total change in gross national saving	0.2	-1.9	-10.2	-3.4	-3.2	1.2
Contribution to the change:						
Households	-0.7	3.0	7.7	-1.1	-6.3	1.6
Changes in households income share	-0.3	0.3	1.6	0.4	-0.5	--
Changes in households' saving rate	-0.4	2.7	6.1	-1.5	-5.7	1.6
Other sectors	0.9	-4.9	-17.9	-2.3	3.1	-0.4
Change in income shares	0.6	-3.3	-9.9	-0.7	0.5	-0.1
Change in saving rate	0.3	-1.6	-8.1	-1.6	2.6	-0.3

Sources: CSO; and staff estimates.

1/ The data series have statistical breaks in 1988 and 1991.

The negative effect of the redistribution in incomes on aggregate saving was cushioned by a sharp increase in the household saving rate to 18 percent in 1991, after 6.8 percent and 10.7 percent in 1989 and 1990, respectively. 1/ The increase in the household saving rate occurred at a time when the financial system in Hungary underwent a profound liberalization, which included increasing competition in the banking system and the lifting of all remaining controls on interest rates (see also Chapter VI). There are several channels through which financial liberalization could affect household saving. First, with the liberalization of interest rates and increased competition, one would expect real interest rates on saving instruments to increase. Indeed, this has been observed in many countries that undertook financial liberalization programs, and was frequently a key objective of such programs. However, the effect of rising real interest rates on household saving is in general ambiguous. With households on average representing net asset holders, it would depend on the relative size of income and substitution effects. 2/

In Hungary, as mentioned, interest rates were gradually liberalized after 1987. With the lifting of all remaining controls in 1991, real interest rates on household deposits--measured as nominal deposit rates, deflated by consumer price inflation over the preceding year--did indeed increase significantly and became positive until mid-1992. Foremost, this reflected a decline in inflation rates. However, the period of positive ex-post real interest rates was short-lived and rates on deposits remained negative from late 1992 until the end of 1994 (Chart 10). It is likely that positive effects of financial liberalization on interest rates were counterbalanced by several other developments during much of this period. In late 1992 and early 1993, an easing of the monetary policy stance contributed to an overall reduction in interest rates, including on deposits (see Chapter II.3). Moreover, the ability of many banks to increase real deposit rates was limited by the weakness of their loan portfolio, which resulted in a considerable increase in the interest rate spreads charged by banks (Chapter VI). In all, and except for the temporary interlude in early 1992, a stronger upward movement in real deposit rate began only in the second half of 1993. It is thus likely that this channel through which financial liberalization could have affected household saving played only a relatively small role in explaining the historically high saving rates of 1990-92.

1/ On the other hand, the saving rate of the rest of the economy declined sharply in 1990-91 and this largely offset the direct effect from higher household savings on the gross national savings rate.

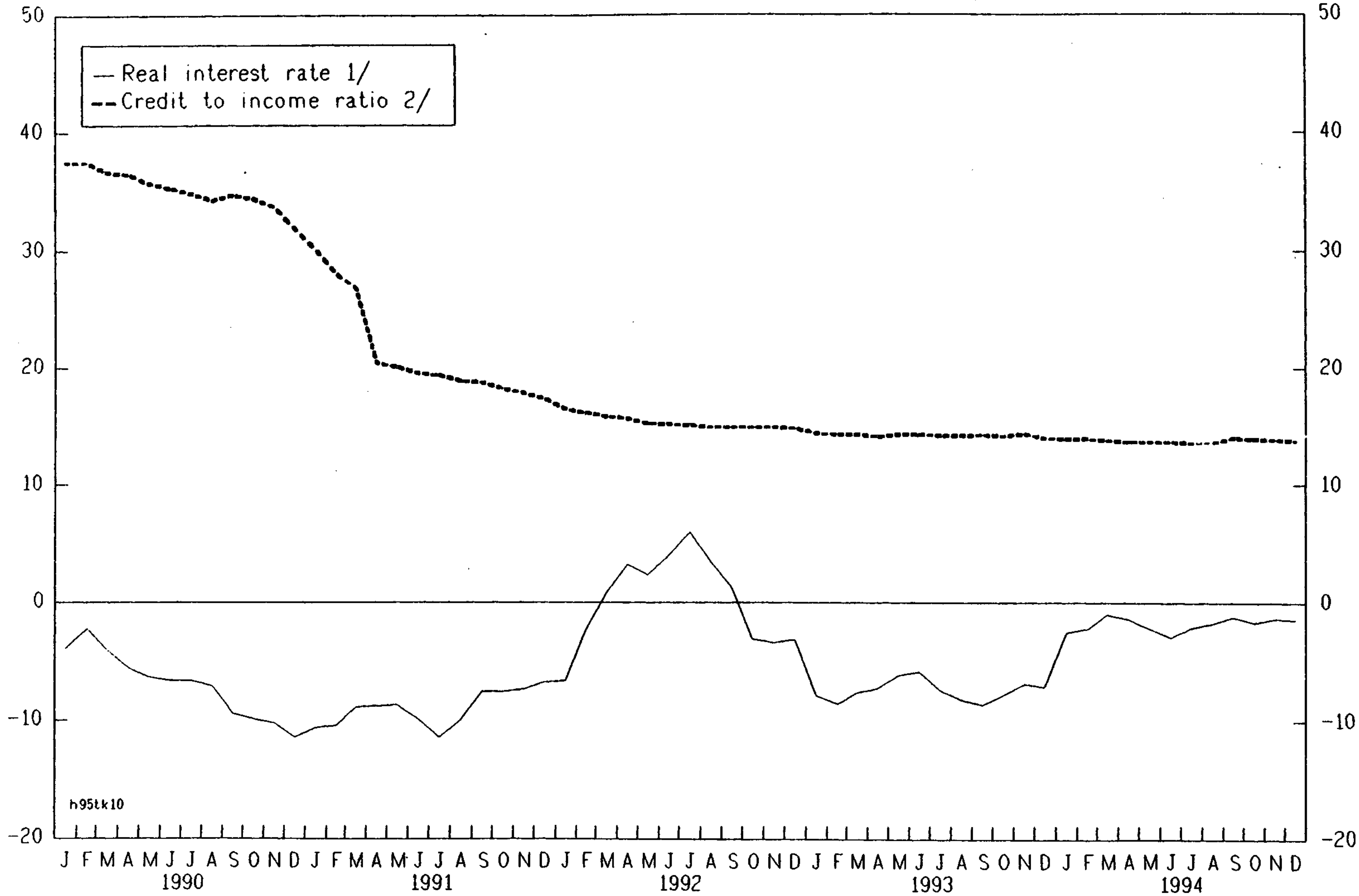
2/ For a related discussion and an attempt to identify these effects, see Masao Ogaki, Jonathan D. Ostry, and Carmen M. Reinhart, Saving Behavior in Low- and Middle-Income Developing Countries: A Comparison, International Monetary Fund, Working Paper, WP/95/3, January 1995.

Chart 10

HUNGARY

HOUSEHOLD CREDIT AND REAL INTEREST RATES, 1990-94

(In percent)



Source: National Bank of Hungary.

1/ Nominal interest rate on household deposits with maturity of 1 year, deflated by the change in consumer price index over the preceding year.
2/ Ratio of household credit to household income.

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Financial liberalization could also ease liquidity constraints faced by the household sector, and this in turn could have implications for the household saving rate through two channels. First, it would tend to lower the saving rates of some households as these would be better able to smooth consumption in the face of income fluctuations. Secondly, the easing of liquidity constraints would likely make households more responsive to movements in the interest rates. 1/ As a result, any given change in the interest rate would have a relatively larger impact on private saving if the liquidity constraints were binding for a smaller number of households, and thus less binding in the aggregate.

It is relatively difficult to measure directly the role of liquidity constraints in the economy. As a rough proxy, one could consider the share of household loans in total income (see Chart 10). 2/ However, in the case of Hungary this ratio has shown no clear trend since mid-1991 (with the data in the earlier period not directly comparable due to a mortgage consolidation program, discussed below). Against this evidence, it would seem unlikely that the easing of liquidity constraints--to the extent observed so far in the Hungarian economy--played a major role in explaining the recent saving trends. This conclusion is also supported by preliminary empirical work that generally found no significant relationship between household saving and indicators of financial liberalization in Hungary.

4. Household saving in 1993-94

In 1993, the share of personal income saved by households fell sharply to 9 1/2 percent from over 16 percent in 1992 and preliminary data indicate some rebound in 1994 to about 11 1/4 percent. With the concomitant redistribution in incomes away from households during 1993-94--though only small in relation to the previous shift--the share of household saving in GDP dropped in 1993 to just over half its level in the previous year, and with a rebound in 1994 stood at about 9 1/2 percent of GDP.

The decline in the saving rate in 1993-94 probably reflected a reduction in precautionary savings that, as discussed, is believed to have played an important role in the savings boom of the previous two years. Nevertheless, saving rates remained at about twice their level in the pre-transformation period of the 1980s. It can be expected that, in coming years, saving would continue to remain higher than in the pre-transformation period as individual income uncertainties remain considerably higher than

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1/ See, for example, John Campbell and G. Mankiw, Consumption, Income, and Interest Rates: Reinterpreting the Time-Series Evidence; O. Blanchard and S. Fischer (eds.), NBER Macroeconomics Annual 1989.

2/ This proxy was used, in the case of France, in some of the empirical analysis in Jonathan D. Ostry and Joaquim Levy, Household Saving in France: Stochastic Income and Financial Deregulation, International Monetary Fund, Working Paper, WP/94/136, November 1994.

under the earlier economic regime. Moreover, the increase in income disparity relative to the earlier period should also contribute to a higher average saving rate for households.

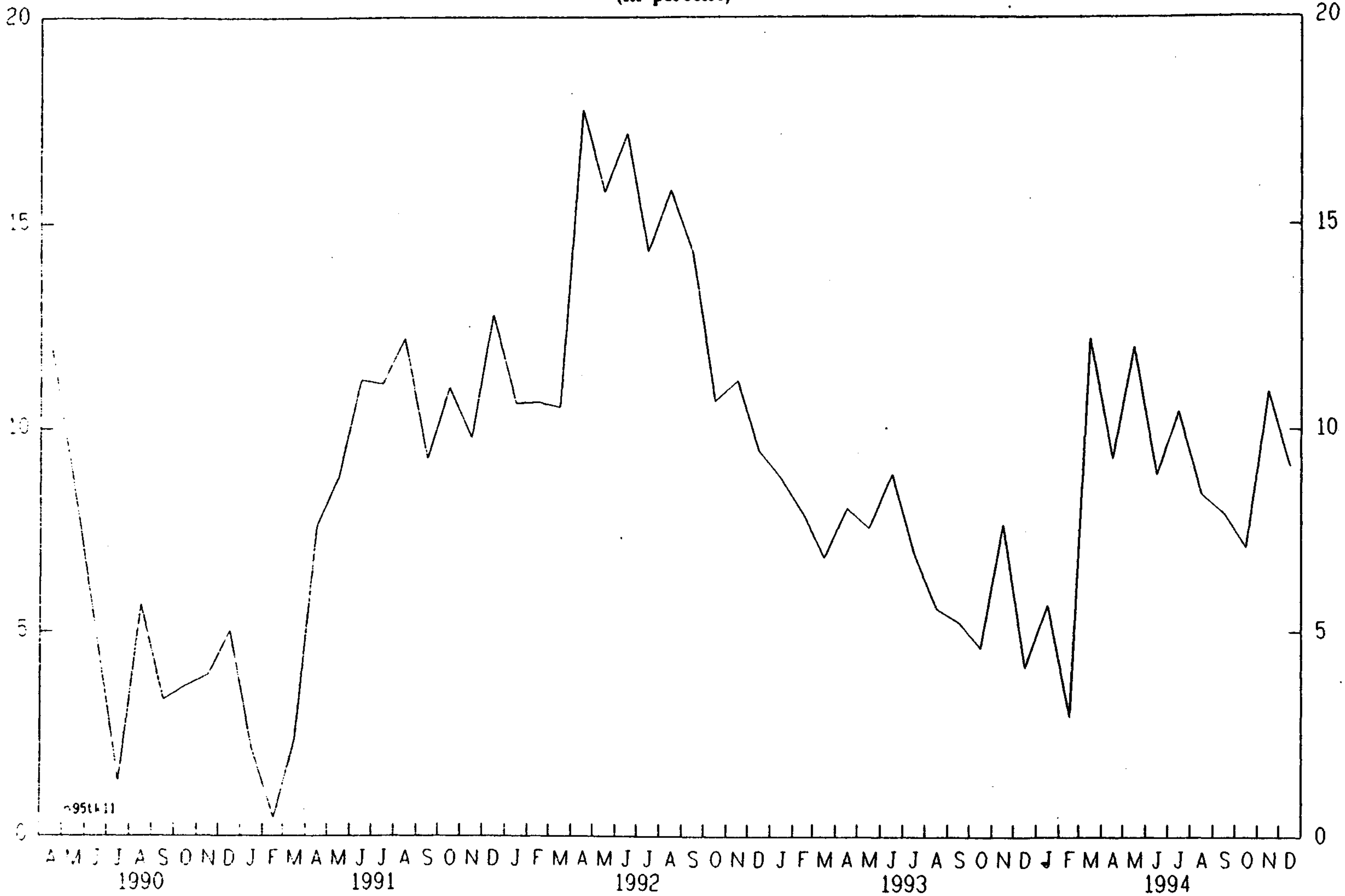
The rise in the saving rate in 1994 may also have been supported by an upward movement in real interest rates as the authorities began to tighten monetary conditions after mid-1993. While nominal interest rates on saving deposits responded gradually and with some lag, households increasingly took advantage of other saving instruments, including government paper, that offered a higher rate of return. This role of the interest rate is discussed more fully in the next section in the context of a discussion of the behavior of financial savings.

5. Financial saving and its role in household saving

Financial savings constitute the most important form of household saving in Hungary and this section discusses developments in this subcomponent in more detail (see Tables 52-53, and Chart 11). With other saving instruments remaining still relatively underdeveloped, financial savings have dominated household saving, accounting for at least 2/3 of total saving in each year during 1991-94. An exceptional year was 1991, when financial savings absorbed over 90 percent of total saving. This outcome was strongly influenced by the decision in the 1991 Budget to eliminate the subsidies on mortgage principal repayments. Households made extensive use of the options offered by repaying at least part of the mortgage principal. These transactions required a significant portion of the households' overall savings resources and this contributed to the exceptional share of financial saving in 1991. 1/ Moreover, as indicated earlier, mortgage repayments may have contributed to the exceptionally high total household saving rate in 1991 as households used a larger portion of their incomes to take advantage of the temporary repayment incentives.

1/ At the time, mortgage holders were provided with two options. Under the first, they would have to pay a higher interest rate (15 percent at the time) than previously on the full amount of outstanding principal. Under the second option, 50 percent of the outstanding principal would be forgiven, but market rates would have to be paid on the remaining portion (32 percent at the time). Of the eligible mortgage holders, about 80 percent elected the second option with their total mortgages amounting to Ft 151.4 billion (6.1 percent of 1991 GDP). Moreover, almost half of these (about Ft 70.4 billion) prepaid their mortgages completely at the time.

Chart 11
HUNGARY
HOUSEHOLDS' SAVING RATE OF FINANCIAL ASSETS,
April 1990 - December 1994
(In percent)



Sources: National Bank of Hungary; and staff estimates.

1/ Gross saving of forint-denominated financial assets; quarterly moving average.

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Hungary: Household Total and Financial Saving, 1991-94

	1991	1992	1993	Estimate 1994
	(In billions of forint)			
Household saving 1/	374.0	404.3	271.5	404.7
Net financial saving	346.1	271.9	186.4	288.8
Other	27.9	132.4	85.1	115.9
	(In percent of total)			
Household saving 1/	100.0	100.0	100.0	100.0
Net financial saving	92.5	67.3	68.7	71.4
Other	7.5	32.7	31.3	28.6

Source: National Bank of Hungary; and staff estimates.

1/ Based on adjusted disposable income.

In assessing the developments of financial savings of households, a second structural change involved the increasing role of foreign currency deposits. Their share in gross saving rose from less than 11 percent at the end of 1990 to 17 percent by end-1994 (see also chapter II.3). With, at least ex-post, returns relatively low on these deposits, it is likely that the rise reflected importantly the gradual liberalization of the foreign exchange system in Hungary, and in particular the gradual increase in the foreign exchange allowance for tourism purposes (Chapter VII).

As data limitations preclude a more detailed analysis of overall household saving, the remainder of this section presents some econometric evidence for the subcomponent of financial savings for the period since 1989. It should be stressed at the outset that the following estimation results are very preliminary and that additional work is needed, especially to better isolate the role of several of the structural changes in the economy and of the sharp rise in uncertainty and probably precautionary saving.

The empirical model employed to identify the determinants of household saving is a simple error correction model for the household saving rate: 1/

$$\Delta s_t = \gamma_1 \Delta s_{t-1} + \gamma_2 \Delta\Delta y_{t-1} + \gamma_3 \Delta r_{t-1} + \gamma_4 \Delta\pi_{t-1} - \beta_1 [s_{t-1} - (\beta_0 + \beta_2 \Delta y_{t-1} + \beta_3 r_{t-1} + \beta_4 \pi_{t-1})] + u_t. \tag{1}$$

In equation (1), the last term in square brackets captures the "longer-run" relationship between the saving rate (s) 2/ and its determinants: the growth in household income (Δy, where Δ indicates the first difference operator and income is expressed in logarithms); the real interest rate (r); and the inflation rate (π). Deviations from the longer-run relationship would be corrected over time and the "short-run" dynamics are captured by the first-difference of the variables constituting the longer-run relationship (possibly, this could also include longer lags for these variables, as well as some other variables affecting saving in the short-run, but not over the longer-run).

The error-correction term measures deviations of the actual saving rate from its estimated longer-run level, and, to correct these deviations, households would adjust their actual saving rates. Accordingly, one would expect that the coefficient β_1 is positive and the speed of the adjustment is to some extent captured by the size of this coefficient. For the other coefficients in the error-correction term, a high growth rate would lead to an increase in the contemporaneous saving rate ($\beta_2 > 0$) if households attempt to smooth their consumption pattern; a rise in inflation would tend to increase the measured household saving rate, especially to offset capital losses; 3/ and the effect of higher real interest rates on household saving is ambiguous, depending on the relative strength of income and intertemporal substitution effects.

Preliminary estimates with monthly data provided by the NBH for the period 1990-94 indicated that deviations from the long-run relationship are corrected relatively quickly--as one would expect in financial markets--and that the short-run dynamics is thus dominated by the error correction term

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1/ A similar model, but not within an error-correction set-up, was estimated for France by Ostry and Levy, op. cit.

2/ Saving refers to gross financial saving and excludes foreign currency deposits, which were likely influenced by external payments liberalization, as discussed above.

3/ However, especially with currency included in the definitions of financial saving, the sign of β_4 is a priori ambiguous.

in equation (3). Specifically, the results indicate the following dynamics of the saving rate: 1/

$$\Delta s_t = \underset{(2.5)}{-0.05}\,\Delta s_{t-1} + \underset{(1.9)}{0.34}\,\Delta s_{t-2} - \underset{(2.8)}{0.45}\,D93 - \underset{(4.3)}{0.72}\,[s_{t-1} - (\underset{(17.4)}{(-2.30)} + \underset{(1.2)}{1.38}\,\Delta y_{t-1} + \underset{(6.3)}{0.05}\,r_{t-1} + \underset{(3.9)}{0.03}\,\pi_{t-1})] \tag{2}$$

R^2=0.64 D.W.=1.94 F(7,45)=11.6 Lagrange $\chi^2(12)$ = 12.1.

The estimation results indicate little residual correlation (D.W. refers to the Durbin Watson statistic and Lagrange χ^2 to the Lagrange multiplier test of residual serial correlation) and preliminary tests identified only lagged changes in the saving rate as statistically significant for the short-run dynamics, in addition to the error-correction term. The parameter estimates have the expected sign. In particular, the coefficient of the error-correction term indicates that about 70 percent of deviations from the estimated longer-run relationship are corrected within a 1-month period; an increase in the inflation rate would increase the saving rate of households; and a rise in the real interest rate would also lead to rise in financial saving, with the impact about twice as large for a 1 percentage point change than for the inflation rate. The data provide little support for the "consumption smoothing" motive, as indicated by the low significance level on the parameter of income growth (although the point estimate of the parameter is positive, as expected). It is possible that the statistical insignificance of this term reflects still extensive liquidity constraints for households that limited their ability to smooth consumption over time.

The statistical results presented in this section are still preliminary. Further work will be needed, especially to identify and assess more directly the effects of financial liberalization on the saving behavior of households. 2/ In addition, the specification above does not take into account the precautionary savings motive that, as discussed, probably played a role in the saving boom of households at the beginning of the 1990s.

1/ Because a number of the right-hand variables in equation (1), and especially the growth rate of household incomes, are likely to be endogenous, the estimation was performed using two-stage least squares with lagged values of the regressors and the unemployment rate as instruments. The final estimate reported in equation (2) also includes a dummy variable, D93, for the last month of 1993. All estimates were performed on MICROFIT.

2/ Including the credit-to-income ratio as a proxy did not yield statistically significant results, not surprisingly in view of the relatively low variability in this data series, as discussed earlier.

However, including proxies for the precautionary savings motive--for example, estimates of the variability of income--did not yield statistically significant results, and further work is needed to better address this issues. Finally, one would like to include a measure of the rising dispersion in household incomes and assess its impact on household saving.

6. Conclusions

A boom in household saving cushioned the Hungarian economy in 1991-92 against the fall in savings in other sectors of the economy. To some extent, the rise in household saving reflected a redistribution of incomes towards the household sector--a development that actually lowered aggregate saving as income was distributed from sectors with high to a sector with a relatively low saving rate. However, household saving also increased as a result of a rise in household saving rates out of any given level of income and the saving rate almost tripled between 1989 and 1991.

The chapter identified several factors that were likely to have influenced household saving behavior in this period. Precautionary saving probably played a key role as the income and employment outlook became exceedingly uncertain in the early years of transition when output and employment losses were much larger than generally anticipated. Financial liberalization and the rise in real interest rates through about mid-1992 may also have affected household saving behavior in this period, as did a widening in the disparity of household incomes.

In 1993-94, household saving rates fell back from their peaks but, at 10 1/2 percent of household income on average, were more than twice the level observed in the second half of the 1980s. Looking ahead, it can be expected that saving rates would stay above their levels in the pre-transformation period as income and employment levels remain more uncertain; stronger incentives to save exist from the expenditure side, including for real estate purposes where most rents have been liberalized; income distribution is likely to continue to show a wider disparity; and higher real interest rates may also foster to some extent higher household saving.

However, it seems unlikely that household saving rates are to return to the high levels observed in 1990/91 within the present economic environment. At the time, the deterioration in incomes and employment was much larger than anticipated and created a general environment of high uncertainty and led to exceptional levels of precautionary saving. Moreover, real interest rates are currently already at high levels for many saving instruments; on this account, one can thus not expect significantly higher savings on a sustainable basis--and, in any case, empirical evidence is quite tenuous concerning the relationship between real interest rate and household saving. In the event, it seems likely that the needed adjustment in the saving-investment balance would have to come from other sectors of the economy, including the government sector.

Table 46. Hungary: The Contribution of Household Saving to Gross National Saving, 1985–94 1/

	1985	1986	1987	1988 1/		1989	1990	1991 1/		1992	1993	1994
				Previous	Revised			Previous	Revised			
	(In percent of GDP, except when indicated otherwise)											
Gross national saving	27.1	25.5	26.2	28.2	28.0	29.9	28.0	17.9	17.8	14.4	11.2	12.4
Households 2/	5.0	5.6	4.1	4.7	4.9	4.3	7.4	13.5	15.1	14.0	7.8	9.4
Other	22.1	19.9	22.1	23.5	23.1	25.6	20.6	4.4	2.7	0.4	3.4	3.0
Total change in gross national saving	...	–1.6	0.8	2.0	1.8	1.9	–1.9	–10.1	–10.2	–3.4	–3.2	1.2
Contribution to the change:												
Households	...	0.6	–1.5	0.6	0.8	–0.6	3.0	6.1	7.7	–1.1	–6.3	1.6
Changes in households' income share	...	0.1	–0.2	–0.1	–0.1	–0.1	0.3	1.5	1.6	0.4	–0.5	0.0
Changes in households' saving rate	...	0.5	–1.3	0.7	1.0	–0.5	2.7	4.6	6.1	–1.5	–5.7	1.6
Other	...	–2.2	2.2	1.4	0.9	2.5	–4.9	–16.2	–17.9	–2.3	3.1	–0.4
Changes in income share	...	–1.1	1.2	1.5	1.6	0.7	–3.3	–9.4	–9.9	–0.7	0.5	–0.1
Changes in saving rate	...	–1.1	1.0	–0.1	–0.7	1.8	–1.6	–6.8	–8.1	–1.6	2.6	–0.3
Memorandum items:												
Gross investment	25.0	26.9	26.7	25.5	25.3	26.6	25.4	20.8	20.4	15.2	19.7	21.3
Saving–investment balance, total economy	2.1	–1.4	–0.5	2.7	2.7	3.3	2.6	–2.9	–2.6	–0.8	–8.5	–8.9
Household income share (in percent of GDP) 2/	67.8	69.5	67.6	65.3	65.2	64.1	68.7	83.0	83.7	86.3	82.4	83.0
Household saving rate (in percent) 2/	7.4	8.0	6.1	7.2	7.6	6.8	10.7	16.2	18.0	16.2	9.4	11.3
Saving rate of rest of the economy, in percent of rest–of–economy income	68.6	65.1	68.2	67.8	66.4	71.3	66.0	26.1	26.1	12.0	16.8	25.8
Real interest rate on saving deposits 3/	–1.7	–0.9	–4.2	–8.8	–8.8	–3.0	–11.5	–6.7	–6.7	–3.1	–7.1	–1.4

Sources: CSO; and staff estimates.

1/ The data series have statistical breaks in 1988 and 1991; the table reports data for these years under the previous and revised statistical system.
2/ Based on adjusted disposable income, i.e. including social benefits in kind.
3/ Nominal interest rate on saving deposits of 1–year maturity at the National Savings Bank, deflated by the consumer price indext

Table 47. Hungary: Gross National Saving and Investment in Hungary and Selected OECD Countries, 1980–89 1/

(Period average, in percent of GDP)

	Hungary	Canada	United States	Japan	Belgium	Finland	France	Germany	Italy	Netherlands	Portugal	Spain	Sweden	United Kingdom	Average excl. Hungary 2/
Gross Saving	27.3	21.2	16.8	31.8	17.6	23.9	22.3	27.7	23.9	25.7	31.4	25.1	18.2	18.3	23.4
Households 3/	4.8	12.6	9.6	15.3	13.2	7.0	10.8	9.0	21.6	9.8	26.8	7.4	3.1	6.6	11.8
Other	22.6	8.7	7.2	16.5	4.3	16.8	11.5	18.6	2.3	15.9	4.6	17.7	15.0	11.7	11.6
Gross Investment	26.1	22.3	18.4	29.6	18.6	25.6	22.8	25.8	25.8	23.2	37.4	24.5	19.9	19.1	24.1
Nonfinancial Balance	1.2	–1.0	–1.6	2.1	–1.0	–1.7	–0.5	1.8	–2.0	2.4	–6.0	0.6	–1.7	–0.8	–0.7

Sources: OECD; NBH; and data provided by the authorities.

1/ Data for Hungary are for 1985–89; for Belgium and Italy for 1980–88; for Portugal, 1980–86; and for Spain 1985–88. Data for Germany refer to Western Germany.
2/ Unweighted average.
3/ Includes accounts of private nonprofit institutions serving households for Japan, Finland and France.

Table 48. Hungary: Household Income and Saving, 1985–91

(In billions of forints)

	1985	1986	1987	1988 1/ Previous	1988 1/ Revised	1989	1990	1991
Disposable income	603.9	652.9	715.9	787.9	787.4	919.1	1,200.2	1,615.2
Labor income	473.3	515.5	561.2	676.4	658.9	783.8	980.9	1,207.3
In cash	434.8	476.3	515.2	624.8	622.2	734.3	920.2	1,143.4
In kind	38.5	39.2	46.0	51.6	36.7	49.5	60.7	64.0
Social benefits in cash	137.3	148.1	162.8	207.0	207.0	257.3	324.1	439.8
Pension	91.7	99.3	110.1	130.0	130.0	156.5	202.1	262.8
Sick payments	11.6	12.8	13.3	17.6	17.6	22.9	26.3	30.9
Family allowance	21.3	21.5	23.2	37.0	37.0	52.8	64.3	82.2
Child care allowance	4.4	5.4	6.1	9.0	9.0	11.0	13.4	17.8
Other	8.3	9.1	10.1	13.4	13.4	14.2	18.1	46.0
Net current transfers	12.7	10.6	9.7	32.1	32.1	49.5	65.8	161.6
Interest	6.2	8.1	11.2	26.3	26.3	34.7	48.0	89.5
Other	6.5	2.5	(1.5)	5.8	5.8	14.8	17.8	72.2
Income taxes and other compulsory payments to government	44.9	51.2	54.6	147.5	138.3	173.3	213.9	281.6
Other	25.5	29.8	36.8	19.9	27.7	1.8	43.3	88.1
Social benefits in kind	97.0	103.4	112.7	132.6	152.2	185.3	236.1	301.7
financed by:								
Government	89.3	95.2	102.1	123.3	142.9	177.0	227.1	290.9
Enterprises	7.7	8.2	10.7	9.3	9.3	8.4	9.0	10.7
Adjusted disposable income	700.9	756.3	828.6	920.5	939.6	1,104.4	1,436.4	1,916.9
In cash	558.7	606.5	662.2	728.1	734.8	853.0	1,122.3	1,533.6
In kind	142.2	149.7	166.4	192.3	204.8	251.4	314.0	383.3
Individual consumption	649.3	695.5	778.5	854.5	868.5	1029.6	1282.5	1605.5
In cash	509.6	548.7	615.2	665.6	672.2	794.3	982.9	1235.6
In kind	139.6	146.8	163.3	188.9	196.3	235.3	299.5	369.9
Household saving, based on adjusted disposable income	51.6	60.8	50.2	66.0	71.1	74.8	153.9	311.4
In cash	49.1	57.9	47.1	62.6	62.6	58.7	139.4	298.0
In kind	2.5	2.9	3.1	3.4	8.5	16.1	14.5	13.4
Memorandum items:								
Saving rates								
In percent of disposable income	8.5	9.3	7.0	8.4	9.0	8.1	12.8	19.3
In percent of adjusted disposable income 2/	7.4	8.0	6.1	7.2	7.6	6.8	10.7	16.2
Capital formation	42.1	46.8	52.3	54.2	63.0	73.8	73.3	−7.3
Net lending (−)	9.5	14.0	−2.1	11.8	8.1	1.1	80.6	318.7
Adjusted disposable income								
Nominal growth rate	...	7.9	9.6	11.1	2.1	17.5	30.1	33.5
Real growth rate 3/	...	2.4	0.9	−3.8	−11.6	0.5	0.9	−1.1
Interest rate on saving deposits 4/								
Nominal	5.0	4.5	4.0	5.3	5.3	13.5	19.0	25.0
Real 3/	−1.7	−0.9	−4.2	−8.8	−8.8	−3.0	−11.5	−6.7

Source: CCET/CSO/OECD, National Accounts for Hungary: Sources, Methods and Estimates, 1994.

1/ The data series have a break in 1988; the table reports data under the previous and the revised statistical system.
2/ This saving rate incorporates social benefits in kind as income with consumption defined as individual consumption.
3/ Nominal growth deflated by the CPI index.
4/ For 1985–88, rate on six–month voluntary time deposits of financial instituions with the NBH; thereafter, 1–year deposit rate of the National Saving Bank (OTP).

Table 49. Hungary: Household Income and Saving, 1985–91

(In percent of GDP)

	1985	1986	1987	1988 1/ Previous	1988 1/ Revised	1989	1990	1991
Disposable income	58.4	60.0	58.4	55.9	54.7	53.3	57.4	70.0
Labor income	45.8	47.3	45.8	48.0	45.7	45.5	46.9	52.3
In cash	42.1	43.7	42.0	44.3	43.2	42.6	44.0	49.5
In kind	3.7	3.6	3.8	3.7	2.5	2.9	2.9	2.8
Social benefits in cash	13.3	13.6	13.3	14.7	14.4	14.9	15.5	19.1
Pension	8.9	9.1	9.0	9.2	9.0	9.1	9.7	11.4
Sick payments	1.1	1.2	1.1	1.3	1.2	1.3	1.3	1.3
Family allowance	2.1	2.0	1.9	2.6	2.6	3.1	3.1	3.6
Child care allowance	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.8
Other	0.8	0.8	0.8	1.0	0.9	0.8	0.9	2.0
Net current transfers	1.2	1.0	0.8	2.3	2.2	2.9	3.1	7.0
Interest	0.6	0.7	0.9	1.9	1.8	2.0	2.3	3.9
Other	0.6	0.2	−0.1	0.4	0.4	0.9	0.8	3.1
Income taxes and other compulsory payments to government	4.3	4.7	4.5	10.5	9.6	10.1	10.2	12.2
Other	2.5	2.7	3.0	1.4	1.9	0.1	2.1	3.8
Social benefits in kind	9.4	9.5	9.2	9.4	10.6	10.8	11.3	13.1
financed by:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government	8.6	8.7	8.3	8.7	9.9	10.3	10.9	12.6
Enterprises	0.7	0.8	0.9	0.7	0.6	0.5	0.4	0.5
Adjusted disposable income	67.8	69.5	67.6	65.3	65.2	64.1	68.7	83.0
In cash	54.1	55.7	54.0	51.7	51.0	49.5	53.7	66.4
In kind	13.8	13.8	13.6	13.6	14.2	14.6	15.0	16.6
Individual consumption	62.8	63.9	63.5	60.6	60.3	59.8	61.4	69.5
In cash	49.3	50.4	50.2	47.2	46.7	46.1	47.0	53.5
In kind	13.5	13.5	13.3	13.4	13.6	13.7	14.3	16.0
Household saving, based on adjusted disposable income	5.0	5.6	4.1	4.7	4.9	4.3	7.4	13.5
In cash	4.7	5.3	3.8	4.4	4.3	3.4	6.7	12.9
In kind	0.2	0.3	0.3	0.2	0.6	0.9	0.7	0.6
Memorandum items:								
Capital formation	4.1	4.3	4.3	3.8	4.4	4.3	3.5	−0.3
Net lending (−)	0.9	1.3	−0.2	0.8	0.6	0.1	3.9	13.8

Source: CCET/CSO/OECD, National Accounts for Hungary: Sources, Methods and Estimates, 1994.

1/ The data series have a break in 1988; the table reports data under the previous and the revised statistical system.

Table 50. Hungary: Household Income and Saving, 1991–94 1/

(In billions of forint)

	1991	1992	1993	1994
Wages and salaries	1031.9	1165.0	1334.6	1588.7
Employers' social contribution	355.0	440.3	510.7	598.3
Compensation of employees	1386.9	1605.3	1845.3	2187.0
Mixed income	351.4	495.8	626.0	799.1
Property income, net	54.4	91.9	55.7	124.6
Balance of primary incomes	1792.7	2193.0	2527.0	3110.7
Social benefits in cash	484.7	580.2	694.9	822.4
Other current transfers, net	–557.9	–707.1	–855.8	–967.4
Disposable income	1719.5	2066.1	2366.1	2965.7
Social transfers in kind	353.8	423.5	520.0	613.0
Adjusted disposible income	2073.3	2489.6	2886.1	3578.7
Final consumption	1699.3	2085.3	2614.6	3174.0
Saving	374.0	404.3	271.5	404.7
Memorandum items:				
Saving rates				
In percent of disposable income	21.8	19.6	11.5	13.6
In percent of adjusted disposable income	18.0	16.2	9.4	11.3
Capital transfers, net	86.3	15.7	10.1	23.8
Gross capital formation	133.3	127.2	125.4	144.5
Net lending/borrowing	327.0	292.8	156.2	284.0

Sources: CSO, National Accounts Hungary, 1991–93; and Ministry of Finance.

1/ Due to changes in statistical classifications, the data are not directly comparable to those reported for earlier years.

Table 51. Hungary: Household Income and Saving, 1991–94 1/

(In percent of GDP)

	1991	1992	1993	1994
Wages and salaries	41.7	40.4	38.1	36.8
Employers' social contribution	14.3	15.3	14.6	13.9
Compensation of employees	56.0	55.6	52.7	50.7
Mixed income	14.2	17.2	17.9	18.5
Property income, net	2.2	3.2	1.6	2.9
Balance of primary incomes	72.4	76.0	72.1	72.1
Social benefits in cash	19.6	20.1	19.8	19.1
Other current transfers, net	−22.5	−24.5	−24.4	−22.4
Disposable income	69.4	71.6	67.6	68.7
Social transfers in kind	14.3	14.7	14.8	14.2
Adjusted disposable income	83.7	86.3	82.4	83.0
Actual final consumption	68.6	72.3	74.6	73.6
Saving	15.1	14.0	7.8	9.4
Memorandum items:				
Capital transfers, net	3.5	0.5	0.3	0.6
Gross capital formation	5.4	4.4	3.6	3.3
Net lending/borrowing	13.2	10.1	4.5	6.6

Sources: CSO, National Accounts Hungary, 1991–93; and Ministry of Finance.

1/ Due to changes in statistical classifications, the data are not directly comparable to those reported for earlier years.

Table 52. Hungary: Net Financial Saving of Households, 1990–94

(In billions of forint; end-of-period stock)

	I. Savings									II. Credits			
		Saving deposits 1/			Securities 1/ 2/								
	Cash	Forint Deposits	Foreign Currency Deposits	Subtotal	Financial Institutions	Other	Subtotal	Provisions for Insurance Premia	Total	Credits by Financial institutions 1/	Credits by Employers and Other	Total	Net Savings (I–II)
December 1990	181.2	261.3	71.5	332.8	79.3	46.0	125.3	30.5	669.8	330.0	38.9	368.9	300.9
December 1991	204.9	302.5	129.5	432.0	144.8	69.0	213.8	37.3	888.0	202.0	39.0	241.0	647.0
December 1992	269.6	429.8	152.6	582.4	190.9	87.0	277.9	41.3	1171.2	209.1	43.2	252.3	918.9
December 1993	322.2	491.4	204.7	696.1	201.6	116.1	317.7	52.1	1388.1	239.7	43.1	282.8	1105.3
December 1994	363.3	582.7	292.2	874.9	223.2	203.9	427.1	56.0	1721.3	271.5	43.3	314.8	1406.5
January 1992	198.8	303.8	134.1	437.9	158.8	70.8	229.6	37.3	903.6	199.1	39.7	238.8	664.8
February	198.2	310.7	134.1	444.8	166.7	72.5	239.2	39.1	921.3	197.8	40.7	238.5	682.8
March	195.4	317.1	135.9	453.0	180.8	74.3	255.1	39.1	942.6	195.4	40.4	235.8	706.8
April	219.0	328.2	134.7	462.9	193.7	76.0	269.7	38.9	990.5	195.5	40.4	235.9	754.6
May	208.2	340.1	135.7	475.8	197.9	77.8	275.7	37.7	997.4	196.0	40.3	236.3	761.1
June	219.4	351.2	140.4	491.6	201.5	79.5	281.0	37.7	1029.7	196.7	40.4	237.1	792.6
July	235.1	368.4	143.5	511.9	200.3	81.3	281.6	39.8	1068.4	198.7	40.5	239.2	829.2
August	234.3	383.5	149.2	532.7	199.5	83.0	282.5	39.9	1089.4	200.1	40.6	240.7	848.7
September	245.7	398.0	152.8	550.8	192.9	84.8	277.7	40.7	1114.9	202.1	40.7	242.8	872.1
October	255.2	407.5	148.5	556.0	189.0	86.5	275.5	41.6	1128.3	205.3	40.6	245.9	882.4
November	265.1	418.9	149.4	568.3	186.9	88.3	275.2	40.4	1149.0	209.2	41.0	250.2	898.8
December	269.6	429.8	152.6	582.4	190.9	87.0	277.9	41.3	1171.2	209.1	43.2	252.3	918.9
January 1993	263.6	441.4	156.8	598.2	194.2	87.2	281.4	43.3	1186.5	211.5	43.6	255.1	931.4
February	266.0	452.2	160.2	612.4	198.0	85.7	283.7	43.3	1205.4	212.0	43.8	255.8	949.6
March	269.6	459.0	166.7	625.7	200.3	83.7	284.0	45.5	1224.8	214.1	43.3	257.4	967.4
April	280.9	468.9	169.9	638.8	200.0	83.7	283.7	45.5	1248.9	215.1	43.4	258.5	990.4
May	282.5	477.4	170.5	647.9	199.9	85.6	285.5	45.2	1261.1	217.1	43.3	260.4	1000.7
June	296.5	480.5	172.1	652.6	199.5	86.7	286.2	45.5	1280.8	221.7	43.1	264.8	1016.0
July	301.2	487.1	178.7	665.8	197.1	86.5	283.6	49.4	1300.0	224.2	43.2	267.4	1032.6
August	300.7	489.6	184.5	674.1	199.0	88.2	287.2	49.3	1311.3	227.2	43.2	270.4	1040.9
September	316.1	490.0	198.0	688.0	198.5	89.1	287.6	50.7	1342.4	231.9	43.2	275.1	1067.3
October	313.6	491.4	198.5	689.9	200.5	93.8	294.3	51.0	1348.8	235.5	43.2	278.7	1070.1
November	327.0	494.3	200.5	694.8	204.6	100.1	304.7	51.0	1377.5	242.3	43.1	285.4	1092.1
December	322.2	491.4	204.7	696.1	201.6	106.8	308.4	52.1	1378.8	239.7	43.1	282.8	1096.0
January 1994	317.8	490.5	210.5	701.0	212.4	116.0	328.4	51.7	1398.9	242.1	43.4	285.5	1113.4
February	307.2	495.1	218.4	713.5	215.7	126.5	342.2	52.0	1414.9	244.4	43.2	287.6	1127.3
March	347.5	502.2	218.9	721.1	212.6	130.9	343.5	52.0	1464.1	244.9	43.2	288.1	1176.0
April	330.5	516.1	222.9	739.0	211.3	136.8	348.1	54.8	1472.4	245.8	43.1	288.9	1183.5
May	342.7	523.1	227.8	750.9	211.1	143.2	354.3	55.3	1503.2	248.3	42.7	291.0	1212.2
June	355.8	531.0	235.4	766.4	210.0	153.6	363.6	56.5	1542.3	251.3	42.7	294.0	1248.3
July	354.5	538.0	241.0	779.0	211.9	157.3	369.2	56.7	1559.4	252.1	42.8	294.9	1264.5
August	356.2	544.9	267.7	812.6	212.4	161.3	373.7	56.0	1598.5	255.2	43.0	298.2	1300.3
September	362.8	548.6	272.6	821.2	213.2	178.0	391.2	56.2	1631.4	267.3	43.1	310.4	1321.0
October	362.1	553.4	280.2	833.6	212.6	181.2	393.8	57.8	1647.3	268.3	43.2	311.5	1335.8
November	382.2	566.2	284.3	850.5	216.9	187.7	404.6	56.0	1693.3	269.6	43.3	312.9	1380.4
December	363.3	582.7	292.2	874.9	223.2	203.9	427.1	56.0	1721.3	271.5	43.3	314.8	1406.5

Source: National Bank of Hungary, Monthly Report.

1/ With accrued interest.
2/ Estimated data.

Table 53. Hungary: Net Financial Saving of Households, 1990–94

(In percent of total saving, end-of-period)

	I. Savings									II. Credits			
		Saving deposits 1/			Securities 1/ 2/								
	Cash	Forint Deposits	Foreign Currency Deposits	Subtotal	Financial Institutions	Other	Subtotal	Provisions for Insurance Premia	Total	Credits by Financial Institutions 1/	Credits by Employers and Other	Total	Net Savings (I–II)
December 1990	27.1	39.0	10.7	49.7	11.8	6.9	18.7	4.6	100.0	49.3	5.8	55.1	44.9
December 1991	23.1	34.1	14.6	48.6	16.3	7.8	24.1	4.2	100.0	22.7	4.4	27.1	72.9
December 1992	23.0	36.7	13.0	49.7	16.3	7.4	23.7	3.5	100.0	17.9	3.7	21.5	78.5
December 1993	23.2	35.4	14.7	50.1	14.5	8.4	22.9	3.8	100.0	17.3	3.1	20.4	79.6
December 1994	21.1	33.9	17.0	50.8	13.0	11.8	24.8	3.3	100.0	15.8	2.5	18.3	81.7
January 1992	22.0	33.6	14.8	48.5	17.6	7.8	25.4	4.1	100.0	22.0	4.4	26.4	73.6
February	21.5	33.7	14.6	48.3	18.1	7.9	26.0	4.2	100.0	21.5	4.4	25.9	74.1
March	20.7	33.6	14.4	48.1	19.2	7.9	27.1	4.1	100.0	20.7	4.3	25.0	75.0
April	22.1	33.1	13.6	46.7	19.6	7.7	27.2	3.9	100.0	19.7	4.1	23.8	76.2
May	20.9	34.1	13.6	47.7	19.8	7.8	27.6	3.8	100.0	19.7	4.0	23.7	76.3
June	21.3	34.1	13.6	47.7	19.6	7.7	27.3	3.7	100.0	19.1	3.9	23.0	77.0
July	22.0	34.5	13.4	47.9	18.7	7.6	26.4	3.7	100.0	18.6	3.8	22.4	77.6
August	21.5	35.2	13.7	48.9	18.3	7.6	25.9	3.7	100.0	18.4	3.7	22.1	77.9
September	22.0	35.7	13.7	49.4	17.3	7.6	24.9	3.7	100.0	18.1	3.7	21.8	78.2
October	22.6	36.1	13.2	49.3	16.8	7.7	24.4	3.7	100.0	18.2	3.6	21.8	78.2
November	23.1	36.5	13.0	49.5	16.3	7.7	24.0	3.5	100.0	18.2	3.6	21.8	78.2
December	23.0	36.7	13.0	49.7	16.3	7.4	23.7	3.5	100.0	17.9	3.7	21.5	78.5
January 1993	22.2	37.2	13.2	50.4	16.4	7.3	23.7	3.6	100.0	17.8	3.7	21.5	78.5
February	22.1	37.5	13.3	50.8	16.4	7.1	23.5	3.6	100.0	17.6	3.6	21.2	78.8
March	22.0	37.5	13.6	51.1	16.4	6.8	23.2	3.7	100.0	17.5	3.5	21.0	79.0
April	22.5	37.5	13.6	51.1	16.0	6.7	22.7	3.6	100.0	17.2	3.5	20.7	79.3
May	22.4	37.9	13.5	51.4	15.9	6.8	22.6	3.6	100.0	17.2	3.4	20.6	79.4
June	23.1	37.5	13.4	51.0	15.6	6.8	22.3	3.6	100.0	17.3	3.4	20.7	79.3
July	23.2	37.5	13.7	51.2	15.2	6.7	21.8	3.8	100.0	17.2	3.3	20.6	79.4
August	22.9	37.3	14.1	51.4	15.2	6.7	21.9	3.8	100.0	17.3	3.3	20.6	79.4
September	23.5	36.5	14.7	51.3	14.8	6.6	21.4	3.8	100.0	17.3	3.2	20.5	79.5
October	23.3	36.4	14.7	51.1	14.9	7.0	21.8	3.8	100.0	17.5	3.2	20.7	79.3
November	23.7	35.9	14.6	50.4	14.9	7.3	22.1	3.7	100.0	17.6	3.1	20.7	79.3
December	23.4	35.6	14.8	50.5	14.6	7.7	22.4	3.8	100.0	17.4	3.1	20.5	79.5
January 1994	22.7	35.1	15.0	50.1	15.2	8.3	23.5	3.7	100.0	17.3	3.1	20.4	79.6
February	21.7	35.0	15.4	50.4	15.2	8.9	24.2	3.7	100.0	17.3	3.1	20.3	79.7
March	23.7	34.3	15.0	49.3	14.5	8.9	23.5	3.6	100.0	16.7	3.0	19.7	80.3
April	22.4	35.1	15.1	50.2	14.4	9.3	23.6	3.7	100.0	16.7	2.9	19.6	80.4
May	22.8	34.8	15.2	50.0	14.0	9.5	23.6	3.7	100.0	16.5	2.8	19.4	80.6
June	23.1	34.4	15.3	49.7	13.6	10.0	23.6	3.7	100.0	16.3	2.8	19.1	80.9
July	22.7	34.5	15.5	50.0	13.6	10.1	23.7	3.6	100.0	16.2	2.7	18.9	81.1
August	22.3	34.1	16.7	50.8	13.3	10.1	23.4	3.5	100.0	16.0	2.7	18.7	81.3
September	22.2	33.6	16.7	50.3	13.1	10.9	24.0	3.4	100.0	16.4	2.6	19.0	81.0
October	22.0	33.6	17.0	50.6	12.9	11.0	23.9	3.5	100.0	16.3	2.6	18.9	81.1
November	22.6	33.4	16.8	50.2	12.8	11.1	23.9	3.3	100.0	15.9	2.6	18.5	81.5
December	21.1	33.9	17.0	50.8	13.0	11.8	24.8	3.3	100.0	15.8	2.5	18.3	81.7

Source: National Bank of Hungary, Monthly Report.

1/ With accrued interest.
2/ Estimated data.

V. The Structure of the Public Sector in Hungary

1. Introduction

The large size of the public sector and its inefficiencies--including those associated with high marginal tax and social security contribution rates--are at the center of some of the economic challenges that Hungary is presently facing. This section reviews key features of the public sector, including its size (also in comparison to other transforming economies in Central Europe), and the main characteristics of the present revenue system. Furthermore, the main elements of the public expenditure programs are discussed with special emphasis on those in the welfare sphere, where the state's redistributive function has remained pervasive. Distinct features of the local governments are highlighted in a separate section.

2. The size and principal features of the public sector

As noted previously (Chapter II.2), the Hungarian public sector is decentralized and complex, with substantial intra-government transfers between the different administrative units which compose the general government sector. The relationship between these subsectors are not easily identified in available public finance statistics. However, and notwithstanding the difficulties in measuring the net size of the public sector, it is clear that the Hungarian public sector is large both in relation to the domestic economy (Tables 54 to 56) and also in comparison with other countries in Europe with which Hungary must compete.

The ratio of total revenues to GDP peaked in 1992 and has since fallen largely as a result of a contraction of revenues from excise duties and personal incomes and enterprise profits, and a decline in social security contributions in relation to GDP. Meanwhile, the ratio of total expenditures to GDP rose sharply during the early 1990s, peaking at about 62 percent in 1992-93, before falling to just under 60 percent in 1994. 1/ An increase in social spending appears to have been the main factor behind the increase through 1993, assisted by large extraordinary expenditures on defense in 1993 (amounting to almost 3 percent of GDP) and, more recently, by rising interest costs (see also Chapter II.2).

Hungary's ratio of general government sector tax revenues to GDP was broadly comparable to that in other neighboring transforming economies in Central and Eastern Europe in 1993 (Table 57). However, among tax revenue sources, Hungary relied more heavily on pension contributions than its neighbors while receiving relatively little revenues from the corporate income tax. Moreover, nontax revenues played a considerably more important

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1/ The 1994 figures are very preliminary, based on staff estimates with incomplete information on many central and extra-budgetary funds as well as local governments, and also on transfers between the various subsectors.

role in Hungary than in the other economies. 1/ Meanwhile, the ratio of general government expenditures to GDP was significantly higher than its neighbors' even allowing for possibly some double counting, and for the large extraordinary defense expenditure in 1993. Moreover, the level of expenditure to GDP is also exceptionally high when compared to a number of major industrial countries. 2/

The structure of the public sector in Hungary has made both budget preparation and execution difficult. In particular, the unavailability of timely and sufficiently disaggregated data on actual operations of Ministries and their Central Budget Institutions (CBIs) in the budget preparation process hinders reallocation of budgetary transfers among CBIs, and the ability of CBIs ability to collect, retain, and spend own revenues, hinders spending control. The system of distributing transfers in advance during the year which are unrelated to specific cost items also handicaps adequate expenditure verification and control. Aside from the difficulty of ex-post auditing of activities, it is difficult to effect rapid cutbacks in budgeted expenditures that may become necessary for macroeconomic reasons. The decentralized nature of central government operations, and the absence of a central Treasury, also poses difficulties in effective and efficient cash and debt management, as budgetary institutions have individual bank accounts and can retain and spend these funds, including interest income.

To help overcome these problems, the authorities have begun initial planning for implementation of a centralized Treasury. Under this plan, it is envisaged that the liquidity fund of the state budget and the bank accounts of budgetary chapters, CBIs, extrabudgetary funds and social insurance funds would be consolidated into a Treasury Single Account at the NBH. This would be accompanied by the development and progressive implementation of a computerized, on-line government financial information system (GFIS).

3. The revenue system of the general government sector and tax administration

The general government consists of the consolidated state budget the state sector, the CBIs, the extrabudgetary funds (EBFs), the two social security funds, and the local governments (LGs). Most of the major taxes are collected by the state budget sector and the social security funds (Table 56), while substantial nontax revenues flow to the CBIs and EBFs.

1/ It is likely that part of the exceptionally high level of general government nontax revenue in Hungary reflects difficulties in fully netting out transfers between the various levels of government.

2/ OECD data for general government outlays as a percent of GDP in 1993 are: Germany (49 percent); France (55 percent); Italy (56 percent); Canada (50 percent); Netherlands (56 percent); Sweden (72 percent); Denmark (63 percent); Finland (60 percent); United States (34 percent); Japan (34 percent); United Kingdom (44 percent); and Australia (38 percent).

a. The major taxes

(1) Personal income taxes

The personal income tax (PIT), which was introduced in 1988, is a progressive schedular tax on earned income. The following rate scale applied in 1994:

Hungary. Personal income tax schedule

Annual income level, in thousands of forint			Marginal rate, in percent
Under		110	0
110	to	150	20
150	to	220	25
220	to	380	35
380	to	550	40
over		550	44

Source: Ministry of Finance.

Less than half of household income is subject to progressive personal income taxation (Table 58). Exempted incomes include almost all pension incomes. in-kind incomes such as public health and education benefits, a number of employer-paid fringe benefits (but see changes in 1995 below), family allowances, maternity and child care benefits, student stipends and scholarships, and incomes derived from small-scale farming. Property incomes are also excluded; however, prior to 1995, interest and dividend incomes were taxed by way of flat 20 percent withholding taxes.

In addition, substantial tax deductions have been granted. The major deductions include social security contributions, employees' union membership fees, intellectual activities, local taxes, and charitable donations. A child deduction was available to 2.5 million families up to 1994; this has been abolished and replaced by a targeted expenditure allowance in 1995.

A special 30 percent deduction has also been available for investment in a restricted range of securities provided that each individual security was retained for three years. 1/ After that time, the residual value of the deduction outstanding could be retained indefinitely. Under new regulations taking effect in 1995, the three-year time limit has been removed and the calculation of portfolios placed on a moving average portfolio basis. Thus, whenever an investor reduces a portfolio, taxes would have to be paid.

The cost of these deductions amounted to about 0.4 percent and 1.2 percent of GDP in 1993 and 1994, respectively (see Table 59). 2/ In 1995, all tax allowances were transformed to specific value tax credits with some net saving in budget revenue (see below).

Several changes were introduced to the PIT in 1995 and the main ones are listed in the table below:

Hungary. Main Changes in the Personal Income Tax in 1995

(In billions of forint)

Measure	Budget cost (-) and saving (+) 1/
1. A tax rebate of Ft 7,200 per annum was made available to lower income earners in 1995. The rebate cuts out above incomes of Ft 500,000 per annum (somewhat above the average wage level)	-13
2. Replacement of Tax Deductions By Tax Credits	6
3. Abolition of Child Deduction	8
4. Fringe benefits tax on private use of business provided cars	8
5. Reduction of dividend withholding tax from 20 to 10 percent plus introduction of front-end deduction of Ft 10,000 for small investors	... 2/
6. Abolition of interest withholding tax	-18

Source: Ministry of Finance.
1/ Assessed against no policy change projections.
2/ No estimates available for this measure.

1/ Qualifying assets include shares in Hungarian joint stock companies, certain other amounts invested in businesses, and long-term treasury bonds.
2/ Calculated assuming an average tax rate of 30 percent.

In addition, the authorities decided to introduce an optional presumptive turnover tax on private entrepreneurs in an endeavor to improve tax compliance. Under these arrangements, taxable income is assumed to be 20 percent of receipts for most industries except retailers where taxable income is assumed to be 7 percent for food and certain other essentials and 13 percent for other goods. The tax rate on presumed income is progressive ranging from 25 percent at the low end to a top scale for 35 percent for presumption income in excess of Ft 800,000 per year. 1/ The tax yield has not been estimated.

(2) Enterprise profits tax

The enterprise profit tax (EPT)--also called the corporate income tax (CIT)--has undergone a number of adjustments since it was adopted in 1989. A flat statutory rate of 50 percent was initially assessed on profits (with a temporary 4 percent surcharge) replacing a number of sector and factor specific taxes. The rate was reduced to 40 percent in 1990. The initial tax contained a number of specific tax reliefs, generally in the form of reduced tax rates, accelerated depreciation rates and other deductions so that effective tax rates varied considerably across industries.

The adoption of the Commercial Bank Law in December 1991 had a major impact on profit tax revenue (see also Chapter VI). The allowance of pre-tax provisioning against nonperforming assets resulted in large refunds for over-payments in 1991 and a loss of revenues equivalent to over 1.5 percent of GDP. The subsequent reform of the EPT in 1992 led to further losses in revenue. Depreciation rates were liberalized, provisioning against overdue receivables was allowed, and the loss carry-forward was extended from two to five years. Considerable tax reliefs are also available to foreign investors and many have an element of discretion built into them.

In 1994, the statutory rate was lowered to 36 percent and several new tax concessions were introduced, including a new tax allowance for companies employing long-term unemployed; concessions with respect to "offshore" activities; and a new, targeted depreciation allowance. A presumptive "minimum" tax assessed at a standard rate of 2 percent of defined sales revenue was also introduced.

For 1995, several additional adjustments were introduced. The major change involved a splitting of the previously unified corporate tax rate into two parts: a tax on retained earnings and a separate and additional tax on distributed dividends. The tax on corporate retained earnings is reduced from 36 percent to 18 percent for income that is retained for at

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1/ In addition, if the presumption income does not exceed Ft 200,000 per year and taxpayers do not owe PIT on income from any other source then they pay only 50 percent of the standard tax (resulting in a 12.5 percent rate on presumptive income).

least three years. Enterprises will be required to establish a special capital account as of January 1, 1995 into which any retained earnings will have to be deposited. On distributed dividends, an additional 23 percent surtax will be levied. Generally, any distributions of earnings from this account will be subject to the 23 percent surcharge unless they have been retained for a period of at least three years.

Further changes introduced to the EPT in 1995 included a special additional investment incentive, providing deductions for investment by companies in certain areas of high unemployment; and the presumptive tax introduced in 1994 has been abolished in light of the presumptive taxes imposed on entrepreneurs under the PIT legislation. The net cost to the budget of all 1995 measures on the EPT is estimated at about Ft 20 billion.

(3) Social security contributions

In 1994, employers were required to pay a levy of 44 percent on wages and certain other remunerations to the Social Security Funds plus a further levy of 5 percent to the Solidarity Fund. In 1994, employers received a special deduction for one year equal to 70 percent of the social security tax payment on employees who were unemployed at the time of hiring. The deduction will be increased to 100 percent in 1995. Also for 1995, the contribution to the Solidarity Fund has been reduced to 4.2 percent.

Employees are required to contribute 10 percent of their total remuneration, exclusive of fringe benefits and incomes in kind, to the Social Security Fund and a further 1.5 percent to the Solidarity Fund. Employees need not contribute on earnings in excess of Ft 900,000 per annum.

Self employed individuals must pay both the employer and employee share of these taxes on net income (they need not pay the 54 percent social security levy on net income over the maximum for individuals). Self employed persons who declare no net income or losses must still pay social security taxes on a base defined as 60 percent of the minimum wage in order to receive social security insurance benefits (this will be raised to 100 percent of the minimum wage in 1995).

The revenue of the social security and health insurance funds has been affected by a growing problem of arrears. 1/ The arrears of these funds have increased more than 20-fold since 1988 and represented about 3 percent of GDP at the end of 1993. A large proportion of these arrears have been outstanding for more than one year and may now be uncollectible. Recently, the funds have taken steps to improve compliance, including substantial

1/ The revenues of the funds were also negatively affected when budgeted revenues from asset transfers by the state did not materialize. The delay in the asset transfers reflected to some extent also the slow pace of the privatization process in 1994.

additional staff in regional offices and new registration arrangements, and some expected benefits from these efforts are built into the budget estimates for 1995.

(4) Value Added Tax (VAT)

Hungary introduced a multiple-rate VAT in 1988. The VAT base is the sale price before tax of goods traded domestically; on imports, the VAT base includes import taxes and customs fees. Rebates are repayable in the case of credit balances. Special exemptions are available on imports of capital goods. A portion of the VAT on purchases of investment goods is refundable (at 20 percent in 1988 and 80 percent since 1991). VAT rates have been increased since 1988 through adjustments in the preferred rates and through reclassification of items in the lower rate categories to the highest rates.

The current rates, which were announced in the supplementary budget for 1994 but not implemented until January 1, 1995, are: zero for exports and some services; 12 percent for food, public utilities, therapeutic goods, transport, and some services; and a 25 percent general rate which applies to about 60 percent of private consumption. Table 60 provides a breakdown of the estimated collections in 1994 and 1995 according to the main consumer goods items. The following table shows the full-year impact of the 1994 measures.

Hungary. Full-year Revenue Yield of VAT Measures in the 1994 Supplementary Budget

(In billions of forint)

Measure	Yield
1. Increase in the 10 percent rate to 12 percent	19.0
2. Reclassification of telecommunications from the 12 percent to the 25 percent category	2.5
3. Imposition of 25 percent VAT on housing construction and refurbishing	14.0

Source: Ministry of Finance; and staff estimates.

In addition to the changes presented in the table above, both the VAT threshold and filing arrangements for small business were adjusted in January 1995 to assist tax administration (see below).

(5) Excise duties

Excise duties cover tobacco, coffee, alcohol and petroleum products plus a number of luxury goods. Table 60 shows the revenue derived from each of the major categories. Major increases to specific duty rates were included in the 1994 Supplementary Budget, including for petroleum products (yielding Ft 17 billion in a full year) and alcohol and tobacco products (yielding Ft 6.5 billion in a full-year). In addition, a diesel oil rebate to assist food processing factories has been introduced in 1995 at a cost of Ft 5.5 billion. It will be funded by reduced agricultural subsidies.

Little change in the underlying excise tax base is expected for 1995 for two reasons. First, the slow growth in household incomes projected by the authorities would restrain the overall demand for consumer goods. Second, the sizeable increases in excise rates are likely to have a significant impact specifically on consumption of these excisable items.

(6) Customs Revenue

Customs duties have been an important source of revenue but changes in trading relations, especially with neighboring European countries, are expected to diminish their importance in the future. Trade-related revenues also include a statistical fee (3 percent on imports in 1994) and deposits are required of importers towards the taxes (mainly VAT and excises) which their goods will be subject to when sold in Hungary.

A number of factors are expected to affect customs collections in 1995 including:

- the small projected increase in the value of dutiable imports;
- reductions in tariffs consequent upon the association agreement with the EU, EFTA, and CEFTA, and under the Uruguay round, which are estimated to lower revenues by about Ft 13 billion;
- increased revenues of Ft 4.5 billion as a result of the recent changes in agricultural tariffs;
- a reduction in statistical fees from 3 percent to 2 percent to meet conditions set in the Uruguay round; and
- improvements in tax administration expected to yield Ft 2.5 billion.

b. Tax administration

The transition to a market economy has fundamentally changed the role and functioning of tax administration. The Tax and Audit Office (APEH) has successfully implemented major tax reforms since 1988, including the VAT, EPT and PIT. 1/ Also, the number of taxpayers has increased sharply. For example, the number of EPT and PIT taxpayers increased from 1.8 million in 1991 to 2.9 million in 1993 and, taken together with VAT, the number of returns handled now exceeds 4 million.

Whilst the APEH has shown a capacity to handle large volumes of returns, there has been concern that its resources have not been sufficiently focussed on certain key tasks needed to boost revenues. Primary among these is the administration of compliance arrangements. The new market-based tax systems place a heavy onus on taxpayers to comply with tax laws and correctly declare their income or sales, as well as deductible expenses. Over recent years, it has become clear that significant problems of noncompliance have emerged in the new system. These take many forms, including failure to file tax returns, underreporting of income or sales, and over-reporting or falsification of deductions of purchases, problems that are clearly not unique to Hungary.

Part of the difficulties for tax administration relate to activities that are not captured in official statistics, including tax returns, and a number of studies have sought to identify the extent of the hidden or black economy. 2/ This research suggests that the hidden economy is large, with estimates ranging up to 30 percent of GDP. Although the tax system itself with its high rates and complexity of tax laws provides incentives to non-compliance, weaknesses in tax administration also appear to be a contributing factor.

Accordingly, the resources of the APEH have been increased (the Office now employs about 7,400 persons with almost half holding graduate degrees) and work has commenced on overhauling administrative procedures to improve compliance. A series of Fund tax administration missions have sought to spell out a program of reform and, in conjunction with the World Bank, a three year Tax Administration Modernization Project (TAMP) was commenced in January 1994.

The TAMP unit has undertaken a strategic review of the necessary administrative reforms and produced two reports--the Tax Administration Strategic Plan and the Information Systems Strategic Plan. The former report covers six priority measures: (i) controlling large taxpayers; (ii) extending the Taxpayer Identification Number (TIN) system of identification;

1/ The APEH does not handle customs and social security collections, each of which are handled by separate organizations.

2/ See, for example, Janos Arvay and Andras Vertes, Preliminary Report: Size of the Hidden Economy in Hungary, October 1993.

Box 2. Tax Administration--Main Reform Plans and Their Current Status

Issue	Status of reform
(i) Systems to monitor and control payments by large taxpayers.	A pilot study is likely to be implemented in 1995.
(ii) A single identification number. A Personal Identification Number (PIN) and a separate Taxpayer Number (TIN) are presently used. This has led to confusion in respect of small individual entrepreneurs who often have two numbers.	A uniform TIN system has been recommended but not yet implemented.
(iii) Decreasing the processing load via increases in thresholds to reduce in the number of taxpayers; quarterly (not monthly) filing of returns for small and medium sized businesses; redesign of forms and rationalization of data collection.	VAT threshold increased and quarterly filing introduced in 1995. Other changes to be implemented.
(iv) Decentralization of collection. The APEH has a highly centralized payments system through the National Bank of Hungary the APEH headquarters which has led to delays in processing and created difficulties in detecting stop-filers and late payers. Difficulties in matching liabilities and payments information also creates problems in identifying tax arrears.	Authorities have signalled an intention to decentralize to the county level with combined return and payment document as a single control document.
(v) Audit procedures. The present procedures are unfocussed and staff resources are poorly utilized.	APEH has developed a new audit strategy and implemented necessary organizational restructuring.
(vi) Computerization of APEH.	A Strategic Plan has been drawn up to guide implementation concentrating initially on large taxpayers.

(iii) decreasing the tax processing workload; (iv) decentralizing administration of taxpayers accounts; (v) improving the detection and collection of arrears; and (vi) increasing the effectiveness of audit. The report was approved by the APEH in November 1994 and attention has now turned to implementation of the report (see Box 2).

The Hungarian Customs and Finance Guard (CFG) is also undergoing a modernization process. A draft Customs Procedure Act is under consideration by the Ministry of Finance; a standard customs form compatible with EU regulations has been designed and work is progressing on a harmonized system; and a computerization project has commenced.

4. Expenditure programs

The bulk of general government expenditure is made through the social security funds, the CBIs and the LGs, with the spending by the last two categories largely funded by transfers from the state budget. This section discusses key features of the main expenditure categories and programs.

a. Goods and services

All levels of government undertake expenditure on goods and services. 1/ The category covers both defense and nondefense items.

(1) Defense expenditure

The bulk of defense spending is financed by the defense department and classified under the CBIs in Table 56. Some additional spending on defense appears under other parts of the budget (for example, on defense housing and capital works), and direct revenues accrue to this sector from such activities as the sale of surplus equipment. These revenues can be used to finance additional expenditures.

The available expenditure data shown in the table below include defense department current spending together with the cost of military aircraft purchased from the Russian Federation in lieu of outstanding debt obligations (see Chapter II.2).

1/ Unfortunately, separate information on expenditure on goods and services by social security funds was not available when this document was prepared (Tables 54 and 56).

Hungary: Military expenditure 1/

(In billions of forint)

	CBI (Defense Department)	Aircraft Purchase	Total Defense	In percent of GDP
1993	54.5	101.5	156.0	4.5
1994 Estimated	59.5	11.6 2/	71.1	1.6
1995 Budget	70.6	5.3 2/	75.9	1.5

Source: Ministry of Finance.

1/ Does not include direct expenditures funded from sale of surplus equipment and other revenues.
2/ These amounts are preliminary and not included in Tables 54 to 56.

The numbers of persons employed by the defensce department amounted to about 147,000 in 1994, of which 90,000 were career service personnel and 57,000 enlisted personnel. Plans have been announced to reduce the numbers of enlisted personnel to 53,000 in 1995 and to restructure and modernize the defensce forces.

(2) Nondefense expenditure

A major component of expenditure on goods and services is the wage paid by the CBIs and local governments together with the 44 percent social security contribution paid by the respective government level for its employees. Total public sector employment at end-1993 was about 1 million, or about 1/4 of economy-wide employment at that time (Table 61). Public employment laws cover three categories. Civil servants constitute a first category; public employees, such as teachers and health workers are included in a second category; and all other employees in a third category. The latter category covers mainly defense and related security personnel (at the central government level) and maintenance, catering and other services at the local government level.

Wage payments per public sector employee increased by 24.3 percent in 1994, compared to an increase of 22.8 percent in gross wages for the overall economy. For 1995, the wage bill is budgeted to increase by 6.4 percent for the public sector, reflecting the combined impact of the following factors: (i) an increase in the monthly base pay of civil servants from Ft 8,000 to 8,500 per month; (ii) implementation of an earlier agreed minimum wage of

Ft 18,000 per month for public employees; (iii) a 10 percent increase in military salaries; (iv) and a projected reduction in public sector employment by 40,000, or about 4 percent.

b. Subsidies

Subsidies extended by the general government have declined markedly during the recent transition period and reached a low of 4.4 percent of GDP in 1993, after still amounting to over 9 percent in 1990 (Table 62). 1/ However, estimates for 1994 indicate a small increase in relation to GDP, mostly on account of rising subsidies to the Hungarian Railways (MAV) and the agricultural sector. With the 1995 Budget, it is estimated that the trend of the earlier years will again continue and that subsidies would fall to some 4 percent of GDP.

Consumer subsidies are now concentrated largely in the personal transport area and, within that sector, mainly on longer service routes (urban transport fares are now closer aligned with costs). In this area, support is mainly targeted to specific needy groups, including persons over 70 years of age, students, and retirees. Pharmaceutical subsidies, which have been rising rapidly, are also included under this heading and amounted to an estimated 1.6 percent of GDP in 1994.

Considerable subsidies continue to be provided for housing, even after operations to consolidate mortgage support for households in 1991 (see Chapter IV). Almost all housing constructed since 1970 was privately built and owned with the result that the share of private ownership of the housing stock is close to 80 percent. The prospective sale of current rental accommodation owned by local governments was predicted to lift this ratio to close to 90 percent by the end of the decade. The construction effort was assisted by substantial government assistance and associated debt, much of it issued at below market rates and financed by the National Savings Bank (OTP). In 1989, the government took over these low interest 40-year housing loans from OTP in return for an equivalent issue of state bonds. The interest cost of these pre-1989 housing loans therefore became a direct budget cost. Post 1989 housing loans have been made at market rates by the banks but the budget continues to make subsidies on these loans in the form of below market interest rates to home buyers. Additional subsidy assistance is provided directly to employees of CBIs and mining employees; also, separate large up-front grants, which were increased by almost 36 percent in 1994, are provided to families to purchase their first home.

1/ The coverage of Table 62 is not identical to the items shown under subsidies in general government operations (Table 54). For example, interest subsidies paid for housing are shown under interest payments in Table 54.

Producer subsidies have been considerably reduced since 1990, from 5.2 percent of GDP to an estimated 2.4 percent in 1994. Those still in existence mainly go to the agricultural sector and fall into four main groups: reorganization subsidies which are directed to restructuring of cooperatives; export subsidies to grain, meat, and a number of other exporters--which grew rapidly in 1994 as both the volume and domestic currency value of exports increased; market subsidies covering a large variety of promotional and organizational costs; and production subsidies designed to reduce costs.

For 1995, changes to agricultural subsidies include a switch from ad valorem to specific rates, and concentration of assistance on products which have a larger export potential. The 1995 estimates for production subsidies make allowance for a decision to reduce assistance to food processors consequent upon introduction of a fuel excise tax rebate to these producers. The main change in nonagricultural subsidies relates to MAV, which will receive Ft 15 billion in 1995 after Ft 26 billion in 1994 (which included Ft 16 billion to clear social security arrears).

c. Social welfare benefits

Total outlays on social welfare benefits amounted to Ft 1,018.5 billion or 23.1 percent of GDP in 1994. 1/ The main benefit programs cover pensions; family allowances and various other family and child support programs; sick pay; support for the unemployed; and social benefits in kind. This section discusses only selected features of these extensive welfare programs.

(1) Pensions

Total outlays on pensions amounted to about Ft 442 billion or 10 percent of GDP. Old age pensions, which are the largest element of this aggregate, are available to the retired civilian work force (military pensions are administered separately). The standard retirement age is set at 55 years for women and 60 years for men. Workers performing under conditions hazardous to their health are entitled to earlier retirement. The initial pension depends on past earnings and income and on the length of the contribution period, and pensions are indexed to nominal wage developments.

The disability pension covers disability and work injury. Disabled refers to a person below retirement age, who is incapable of continuing work due to physical or mental incapacity. Work injury refers to a person disabled by an industrial accident or occupational cause illness. Benefit levels vary with the extent of disability, and eligibility for a full pension exists if a person has lost at least 67 percent of the previous

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1/ If consumer subsidies for pharmaceuticals and various services are included the figure becomes Ft 1,114 billion or 25.8 percent of GDP.

capacity to work. The entitlement can be terminated by a medical council. In 1993, 27 percent of all pensioners received benefits originally awarded on disability grounds.

Survivors' benefits are paid to dependents of old age and disability pensions. Pensions for dependents cover widows pensions, orphans' pensions and parents pensions. Details on the number and average benefit for each of the major pension categories during the period 1993 to 1995 are shown in Table 63.

(2) Family allowances, maternity, child and other benefits

A number of programs that assist families with children are financed by the state budget and the social security funds. Their wide coverage, fairly generous levels of benefit, and lengthy periods of entitlement, result in a high level of expenditure. In 1994, total outlays amounted to Ft 199.7 billion or 4.6 percent of GDP. These payments are of two basic types. First, the family allowance, which is intended to secure the well-being of children, and provides financial support for children to 16 years of age (20 years if in full-time education). Second, a wide array of maternity benefits is available to permit mothers to withdraw temporarily from the labor market in order to bear children and to care for young children (until the child is 3 years old, or 8 years in the case of a third child), with guaranteed income support and job security (after a child's first birthday, fathers are also eligible under these support schemes). The family and maternity allowances have universal access and there is wide eligibility for the pregnancy-confinement allowance, child-care fee, and child-care allowance. Two additional means-tested benefits were introduced in 1994--the third child allowance and the supplementary family allowance.

The GYES scheme supports mothers who have never worked before and the GYED scheme covers mothers who have been employed previously. The uptake of GYED and GYES has risen since 1990, reflecting the depressed state of the labor market and the relatively generous benefit levels. In 1993, about 260,000 women received child-care fees and allowances. Although benefit levels for the third year (GYES) are lower than the minimum wage, the 80 weeks for which GYED is payable are at 65-75 percent of the pervious gross wage, and this compares favorably with unemployment benefits.

In addition to these family benefits, the budget funds benefits to a large number of individuals in specific categories which are not covered by the insurance system including uninsured persons injured on the job who can no longer work; miscellaneous public health care programs, care of pregnant women; an agricultural allowance paid to former workers of cooperatives; allowances for persons incapacitated from birth; allowances for blind people; pensions for "politically rehabilitated" persons; and early retirement for miners. The 1995 Budget also includes an amount of Ft 9 billion for compensation payments to families likely to be seriously affected by the energy price increases announced in January 1995.

(3) Sick pay

A program of paid sick leave covers virtually the entire working population, including the self employed who have participated since 1989. Before 1992, the employer was responsible for paying only the first three days of sick leave and the social security funds for payment from that point onward. From January 1992, employers pay the first 10 days of sick leave. The health insurance fund will then finance up to one year on sick pay, extendable to two years if it is considered that this will help the individual concerned avoid resort to a disability pension. Until the beginning of 1993, the replacement rate under this scheme was 85 percent of the gross wage. This was reduced in two stages to its current level of 75 percent. In calculating the base for sick pay, contributions to both Pension and Solidarity Fund are counted, and sick pay is subject to income tax.

Hungary has one of the highest numbers of compensated sick days per insured, an average of 25 to 30 days per year compared to a Western European average of 18 days in the 1980s. Although the number of paid sick days fell in 1993, the ratio of eligible persons who received sick pay has increased (to around 7 percent of those eligible). While the poor health status of the Hungarian population explains part of this experience, it also reflects the perverse incentives of the system; it allows employers to save wage outlays for the enterprise and avoid formal layoffs, and frequently permits workers to work in the informal sector, all at the expense of the public health insurance system.

(4) Unemployment benefits

The system of unemployment benefits was specified in the Employment Act of 1991, and benefits are financed from the Solidarity Fund. There are three forms of unemployment compensation: regular unemployment benefits, school leavers unemployment assistance, and early retirement. The payment of unemployment benefits is based on the insurance principle, with participation in the scheme obligatory for all wage earners excluding the self employed.

The regulations concerning compensation for the unemployed have undergone considerable changes in an attempt to contain expenditures. In the initial phase, the unemployed were eligible to receive unemployment benefits for up to two years. In 1993, this was decreased to 12 months. In the first 9 months the unemployed received 75 percent of their last payroll check, falling to 60 percent in the last 3 months. However, upper and lower bounds are placed on the amounts that can be received. The average payment in 1994 was about Ft 11,200 per month. After 12 months, the unemployed receive only a minimal cash allowance of Ft 6,700 per month, which is considerably below the minimum wage and is funded by local governments. The reduction in unemployment expenditure in 1994 reflected the changes in eligibility outlined above and a fall in unemployment, only partly offset by a rise in the average level of benefits paid.

(5) Social benefits in kind

Social benefits in kind cover a number of expenditure programs in the social sphere which provide benefits to persons through direct provision of goods and services. The largest component are the public health services financed by the health insurance fund. All Hungarian citizens are entitled to free medical care as a right of citizenship. The delivery service has historically been based on a highly integrated and hierarchical system whereby each individual obtained primary care from a district practitioner who could refer patients to specialists and hospitals. In 1990, ownership of public health services was transferred to local governments and autonomous private practices were legalized. Free choice of a family physician was also introduced. Notwithstanding efforts at containment, the cost of public health programs has increased substantially in recent years reaching Ft 173.1 billion in 1994 or 4 percent of GDP.

The other major expenditure program under this heading is the active assistance to the unemployed provided through the Employment Fund including such measures as retraining subsidies. Expenditure on these programs amounted to Ft 39.2 billion in 1994.

d. Interest expenditures

Interest payments have increased sharply in 1994 to about 6.8 percent of GDP at the general government level, and a further large increase is projected for 1995. As explained in Chapter II.2, the increases reflect both the substantial cumulative deficits of the general government sector since 1991 as well as the issue of debt to finance off-budget activities, including a program to recapitalize the commercial banks and debt issued to the NBH to cover accumulated devaluation losses on its foreign debt. In the Hungarian budget presentation, these latter special government security issues do not appear as a budget expenditure item when the debt is originally issued, but the subsequent interest cost of the debt is included in the budget.

e. Capital expenditure and transfers

Capital expenditures are financed through the state budget itself, the CBIs, the EBFs, and through local governments. In total, capital expenditures and transfers amounted to an estimated Ft 286.4 billion or 6 1/2 percent of GDP in 1994. State budget and CBI capital expenditures covered a wide range of activities including development of the government information technologies; upgrading of medical equipment; and infrastructure projects such as major bridgeworks and sewerage, drainage, and flood prevention programs; funds to develop the rail network; and continuation of a major metro bus re-equipment program.

The main capital expenditures undertaken by EBFs, include national and regional roads and maintenance financed through the road fund and industrial infrastructure financed from the regional development fund. As noted below, local government budgets have responsibility for basic local infrastructure, particularly in the school, hospital, housing and social and cultural affairs areas.

5. The local government sector

a. Revenues

Revenues available to local government come mainly from local governments' share of centrally imposed taxes; central government and social security fund grants; local taxes, fees and institutional revenues; and capital revenues, including privatization (Table 64). Local governments are also entitled to borrow and their borrowing has recently increased considerably.

Local taxes are levied under the authority of the Law on Local Self-Governments enacted in 1990, which established the right of local governments to establish and administer such taxes. The tax rates set by local authorities must observe certain maximum levels; however, local authorities can provide concessions that reduce the tax base or exempt certain activities entirely. The taxes assigned to local governments are taxes on local property--which may be on both buildings and unimproved land; and communal taxes--which include taxes on tourism (based on guest nights and on rented or owned secondary cottages) and lump sum taxes on local residents (via tenancy rights or rental contracts) as well as turnover taxes on local firms (according to their average number of employees). In 1994, only about half of the local governments imposed any of these taxes with the remainder depending completely on other revenue sources. In total, local taxes amounted to less than 1 percent of GDP.

Capital revenues include revenues from privatization, sales of land and property. The role of these revenues has been increasing and they amounted to about 1 1/4 percent of GDP in 1994. The so-called institutional revenues of LGs mainly come from business-type operations managed by local governments, including hospitals and educational institutions. Other revenues include fees and charges, revenues from environmental fines, and miscellaneous duties on acquisition of property.

Local governments receive a share of two centrally-imposed taxes--the personal income tax and motor vehicle taxes. Local governments' share of the PIT was decreased from 50 to 30 percent in 1993 but increased to 35 percent in 1995. However, the payment to local government is lagged by two years (for example, the payment in 1994 is equal to 30 percent of actual collections in 1992). Local governments' share of the tax levied on the weight of motor vehicles is currently 50 percent.

The grants from the central government and social security sector account for around two-thirds of recurrent finances available to local government. The normative grant is the largest transfer and its formula is fixed each year. In 1994, 27 norms were used to assess the grant to each locality. This grant is unconditional and intended to address the vertical and horizontal imbalances within the fiscal system. An equalization grant is also paid to local governments to compensate municipalities with low per capita shares of income tax collections. Targeted and earmarked grants are made for investment purposes and are linked to national priorities. In addition, there is a small operational grant to local governments experiencing severe financial difficulties and about 20 conditional grants from the center for specific projects (such as waterworks, benefits for the long-term unemployed, child care, and others).

Local governments also borrowed a net Ft 30 billion in 1994 to finance their budget deficits. A large portion of this borrowing was made through the placement of securities with the National Savings Bank (OTP). However, local governments also borrow funds from the EBRD and other multilateral institutions, often with central government guarantee. There is no control on borrowing by the central government and guarantees tend to be granted automatically for loans from international institutions. Total debt of the sector amounted to close to Ft 50 billion by end-1994 (see also Chapter II.3).

b. Expenditures

Local government expenditure peaked at 17 percent of GDP in 1993 and then fell to about 15 percent of GDP in 1994 (Table 65). A further fall is in prospect for 1995. Current expenditures accounted for about 80 percent of local spending in 1994 of which the bulk consisted of spending on goods and services. The Law on Local Self-Government transferred a number of important public functions to the lower tiers of government. Moreover, local governments now cover many areas of responsibility that had been performed previously by state enterprises. The main emphasis of local government recurrent outlays is on education (close to 30 percent of current expenditures in 1994), health (about 15 percent), housing (12 percent), as well as other social and cultural services.

Table 54. Hungary: General Government Accounts, 1990-94

(In billions of forint)

	1990	1991	1992	1993	Estimate 1994
Revenues	1,204.2	1,292.1	1,619.8	1,942.2	2,289.7
Tax revenues	994.3	1,048.1	1,196.6	1,473.9	1,693.0
Income taxes	283.9	303.2	293.6	355.0	398.9
Enterprises	157.1	131.2	72.7	70.7	92.6
Individuals 1/	126.8	172.0	220.9	284.3	306.3
Indirect taxes	424.0	419.9	506.9	645.3	746.7
Domestic	312.0	344.9	406.7	520.4	598.7
Of which:					
VAT	146.8	149.5	175.7	286.7	343.5
Excises	108.2	137.3	166.7	148.2	172.0
Other	57.0	58.1	64.3	85.5	83.2
Foreign trade	112.0	75.0	100.2	124.9	148.0
Social security contributions	286.5	325.0	396.0	473.6	547.3
Employers	221.7	245.3	300.3	348.8	408.5
Employees	64.8	79.7	95.8	124.8	138.8
Nontax revenues 2/	209.9	244.0	423.2	468.3	596.7
Expenditures	1,194.5	1,345.6	1,778.1	2,177.4	2,565.2
Current expenditure	1,097.7	1,202.1	1,551.7	1,931.7	2,278.8
Wages and salaries	158.7	209.7	249.6	304.6	348.5
Other goods and services 3/	231.3	200.1	263.4	515.6	447.2
Subsidies	198.9	184.8	162.5	151.8	194.2
Social benefits in cash	309.2	417.3	529.7	628.1	773.0
Pensions	202.5	260.7	305.5	344.4	442.3
Family and other allowances	82.4	107.7	129.6	126.6	199.7
Sickpay	24.3	29.0	28.9	35.3	41.5
Unemployment benefits	--	19.9	47.4	74.8	45.8
Local government benefits	...	...	18.3	28.0	32.0
Social benefits in kind	136.7	95.2	174.1	188.4	235.5
Interest payments	62.9	95.0	172.4	165.0	292.1
Capital expenditures	96.8	143.5	226.4	245.7	286.4
Fixed capital formation	74.7	102.3	177.2	188.5	215.9
Capital transfers	22.1	41.2	49.2	57.2	70.5
Overall balance	9.7	-53.5	-158.3	-238.0	-275.5

Sources: Ministry of Finance; and staff estimates.

1/ Includes interest withholding tax from 1992.
2/ Excludes interest withholiding tax from 1992.
3/ Includes purchase of military aircraft in 1993 valued at Ft 101.5 billion.

Table 55. Hungary: General Government Accounts, 1990-94 1/

(In percent of GDP)

	1990	1991	1992	1993	Estimate 1994
Revenues	54.0	52.2	56.1	55.4	53.1
Tax revenues	44.6	42.3	41.5	42.1	39.2
Income taxes	12.7	12.2	10.2	10.1	9.2
Of which:					
Enterprises	7.0	5.3	2.5	2.0	2.1
Individuals 2/	5.7	6.9	7.7	8.1	7.1
Indirect taxes	19.0	17.0	17.6	18.4	17.3
Domestic	14.0	13.9	14.1	14.9	13.9
Of which:					
VAT	6.6	6.0	6.1	8.2	8.0
Excises	4.8	5.5	5.8	4.2	4.0
Other	2.6	2.3	2.2	2.4	1.9
Foreign trade	5.0	3.0	3.5	3.6	3.4
Social security contributions	12.8	13.1	13.7	13.5	12.7
Employers	9.9	9.9	10.4	10.0	9.5
Employees	2.9	3.2	3.3	3.6	3.2
Nontax revenues 3/	9.4	9.9	14.7	13.4	13.8
Expenditures	53.5	54.3	61.6	62.2	59.5
Current expenditure	49.2	48.5	53.8	55.2	52.8
Wages and salaries	7.1	8.5	8.6	8.7	8.1
Other goods and services 4/	10.4	8.1	9.1	14.7	10.4
Subsidies	8.9	7.5	5.6	4.3	4.5
Social benefits in cash	13.9	16.8	18.4	17.4	17.6
Pensions	9.1	10.5	10.6	9.8	10.3
Family and other allowances	3.7	4.3	4.5	3.6	4.6
Sickpay	1.1	1.2	1.0	1.0	1.0
Unemployment benefits	--	0.8	1.6	2.1	1.1
Local government benefits	--	--	0.6	0.8	0.7
Social benefits in kind	6.1	3.8	6.0	5.4	5.5
Interest payments	2.8	3.8	6.0	4.7	6.8
Capital expenditures	4.3	5.8	7.8	7.0	6.6
Fixed capital formation	3.3	4.1	6.1	5.4	5.0
Capital transfers	1.0	1.7	1.7	1.6	1.7
Overall balance	0.4	-2.2	-5.5	-6.8	-6.4

Sources: Ministry of Finance; and staff estimates.

1/ The figures for 1990 and 1991 are not directly comparable because of a change in methodology to calculate GDP in 1991.
2/ Includes interest withholding tax from 1992.
3/ Excludes interest withholiding tax from 1992.
4/ Includes purchase of military aircraft in 1993 valued at Ft 101.5 billion

Table 56. Hungary: Consolidated General Government, by Sectors, 1994

(GFS presentation; in billions of forint)

		Central Government					
			Central Government				
	Total	Total	State Budget	Central Budget Institutions	Extra-Budgetary Funds	Social Security	Local Government
Revenues 1/	2,289.7	2,043.3	1,162.3	184.4	150.1	546.5	246.4
Tax revenues	1,693.0	1,600.1	1,020.0	--	97.1	482.9	92.9
Of which:							
Income taxes	398.9	337.6	331.0	--	6.6	--	61.3
Payroll taxes	547.1	547.1	--	--	64.4	482.9	--
Property taxes	--	--	--	--	--	--	
Taxes on goods and services	746.7	715.1	689.0	--	26.1	--	31.6
Other taxes	--	--	--	--	--	--	--
Nontax revenues	596.7	443.2	142.3	184.4	52.9	63.5	153.5
Expenditures	2,565.1	2,096.8	707.6	453.4	179.9	755.9	468.4
Current expenditures	2,278.7	1,928.7	634.1	398.4	140.3	755.9	350.1
Of which:							
Wages and salaries	348.5	156.5	--	155.0	1.5	--	192.0
Other goods and services	447.2	339.1	43.7	243.4	52.0	--	108.1
Interest payments	292.1	286.1	286.0	--	0.1	--	6.0
Subsidies and transfers	1,190.9	1,146.9	304.4	--	86.7	755.9	44.0
Capital expenditures	286.4	168.1	73.5	55.0	39.6	--	118.3
Of which:							
Fixed capital formation	213.9	116.4	44.0	55.0	17.4	--	97.5
Capital transfers	72.5	51.7	29.5	--	22.2	--	20.8
Balance 1/	-275.5	-53.5	454.7	-269.0	-29.8	-209.4	-221.9

Sources: Ministry of Finance; and staff estimates.

1/ Excluding net transfers from other general government sectors.

Table 57. Hungary: Central Europe--General Government Budgets, 1993

(In percent of GDP)

	Poland	Hungary	Czech Republic	Slovakia	Slovenia	Croatia
Total revenues	47.6	55.4	49.8	48.0	49.8	34.7
Of which:						
Tax revenues	40.7	42.1	43.9	39.5	43.7	32.7
Of which:						
Personal income tax	10.0	8.1	3.2	4.3	7.2	3.7
Corporate incomet tax	4.2	2.0	7.7	6.5	0.5	0.8
Value added/sales tax	11.4	8.2	7.6	8.1	11.7	20.0
Tax on imports	2.8	3.6	1.6	1.3	3.8	2.9
Pension contributions	11.9	13.5	6.6	6.7	13.5	1.9
Nontax revenues	6.1	13.4	5.1	8.5	3.4	1.7
Total expenditure	49.9	62.2	48.5	55.6	49.4	86.2
Current expenditures	46.7	55.2	41.9	49.4	47.1	34.7
Of which:						
Wages	5.9	8.7	4.2	4.7	5.5	4.6
Interest payments	3.8	4.7	1.6	3.4	1.4	0.5
Pensions	15.8	9.8	8.0	9.6	14.9	7.9
Capital expenditures and transfers	3.3	7.0	6.6	6.2	2.3	1.6

Sources: Ministry of Finance; and staff estimates.

Table 58. Hungary: Personal Incomes and Taxes, 1993-95

	1993	Estimated 1994	Budget 1995
		(In billions of forint)	
Primary incomes			
1. Wages and salaries	1,334.6	1,588.7	1,794.0
2. Employers' social contribution	510.7	598.6	666.9
3. Compensation of employees (1+2)	1,845.3	2,187.0	2,460.9
4. Other	681.7	923.7	1,170.7
5. Total	2,527.0	3,110.7	3,631.6
Net social transfers	359.1	466.4	513.4
Transfers in cash	694.9	822.4	912.0
Transfers in kind	520.0	613.0	670.0
Other net transfers	-885.8	-967.4	-1,670.4
Total income	2,886.1	3,578.7	4,145.0
Progressively taxed incomes	1,256.7	1,495.5	1,670.4
Less deductions	51.4	171.3	--
Progressive tax base	1,205.3	1,324.2	1,670.4
Nonprogressively taxed incomes	1,680.8	2,264.3	2,474.6
Personal income taxes payable			
Nonprogressive tax			
Of which:			
Interest income taxes	20.0	10.0	--
Dividend and other nonprogressive taxes	10.0	10.0	12.0
Progressive tax	241.9	296.0	359.0
Total	271.9	318.0	371.0
		(In percent of GDP)	
Primary incomes			
1. Wages and salaries	38.1	36.8	34.6
2. Employers' social contribution	14.6	13.9	12.8
3. Compensation of employees (1+2)	52.7	50.7	47.4
4. Other	19.5	21.4	22.6
5. Total	72.1	72.1	70.0
Net social transfers	10.3	10.8	9.9
Transfers in cash	19.8	19.1	17.6
Transfers in kind	14.8	14.2	12.9
Other net transfers	-24.4	-22.4	-20.6
Total income	82.4	82.9	79.9
Progressively taxed incomes	35.9	34.7	32.2
Less deductions	1.5	4.0	--
Progressive tax base	34.4	30.7	32.2
Nonprogressively taxed incomes	48.0	52.3	47.7
Personal income taxes payable			
Nonprogressive tax			
Of which:			
Interest income taxes	0.6	0.2	--
Dividend and other nonprogressive taxes	0.3	0.2	0.2
Progressive tax	6.9	6.9	6.9
Total	7.8	7.4	7.1

Source: Ministry of Finance.

Table 59. Hungary: Income Tax Deductions and Credits, 1993-95

(In billions of forint)

	1993	1994	Budget 1995
Tax allowances	51.4	171.3	--
Of which:			
Pension and health contributions	--	110.0	--
Employees subscription fees	20.9	24.0	--
Handicapped persons	1.7	1.8	--
Investment	14.6	20.0	--
Intellectual activities	10.8	12.5	--
Foundations and charities	2.0	1.0	--
Local taxes	0.6	1.0	--
Other	0.8	1.0	--
Tax deductions	22.4	16.5	71.2
Of which:			
For employees	7.1	--	--
Tax rebate	--	--	22.0
Child relief	6.8	8.5	--
Pension and health contributions	--	--	30.0
Subscription fees	5.7	5.7	6.0
Savings for housing	0.3	0.3	0.3
Handicapped persons	--	--	0.4
Investment	--	--	3.0
Intellectual activities	--	--	3.0
Foundations and charities	--	--	0.3
Local taxes	--	--	0.2
Insurances	--	--	3.0
Other	2.5	2.0	3.0

Source: Ministry of Finance.

Table 60. Hungary: Components of VAT and Excise Tax Collection, 1994-95

(In billions of forint)

	1994	1995
Value added tax	343,000	429,000
Foodstuffs	52,600	70,700
Consumer essentials	34,000	38,800
Clothing	27,500	30,700
Other goods	105,500	121,500
Services	58,400	82,800
House construction	3,000	17,500
Other purchases	65,000	71,000
Less timing adjustments	-3,000	-4,000
Excises	172,000	190,000
Tobacco	39,200	43,500
Coffee	2,400	2,400
Alcoholic drinks	28,000	30,200
Petrol	64,500	74,800
Diesel	37,000	38,300
Other petroleum products	0.500	0.600
Other items	1,700	2,400
Less timing adjustments	-1,300	-2,200

Source: Ministry of Finance.

Table 61. Hungary: Public Sector Employment and Wage Bill, 1993-95

	Actual		Estimated		Percentage Change in	Estimated		Percentage Change in
	Numbers	Wage Bill	Numbers	Wage Bill	Wage Bill	Numbers	Wage bill	Wage Bill
	1993		1994			1995		
		(In billions of forint)		(In billions of forint)	(In percent)		(In billions of forint)	(In percent)
Civil servants	104,220	40.1	102,333	49.1	22.4	...	54.5	11.0
Central goverment	55,831	24.9	54,904	29.5	18.5	...	33.9	14.9
Local government	48,389	15.2	47,429	19.6	28.9	...	20.6	5.1
Public employees	734,026	186.6	693,486	226.6	21.4	...	238.0	5.0
Central government	196,226	60.7	192,965	77.2	27.2	...	80.3	4.0
Local government	537,800	125.9	500,521	149.4	18.7	...	157.7	5.6
Other	182,773	54.2	182,949	59.7	10.1	...	64.4	7.9
Central government	156,003	45.1	153,410	47.6	5.5	...	52.3	9.9
Local government	26,770	9.1	29,539	12.1	33.0	...	12.1	--
Total employees	1,021,019	280.9	978,768	335.4	19.4	...	356.9	6.4
Central government	408,060	130.7	401,279	154.3	18.1	...	166.5	7.9
Local government	612,959	150.2	577,489	181.1	20.6	...	190.4	5.1

Source: Ministry of Finance.

Table 62. Hungary: Subsidies, 1990-95

(In billions of forint)

	1990	1991	1992	1993	Budget 1994	Estimate 1994	Budget 1995
Consumer subsidies	64.4	79.7	62.2	76.2	81.6	96.0	103.7
Milk and dairy products	3.9	3.5	--	--	--	--	--
Household energy	20.1	19.7	--	--	--	--	--
Local transport	3.5	6.1	7.5	8.3	9.4	10.5	12.5
Railway transportation	2.4	4.2	6.2	6.2	6.8	6.6	7.9
Other transportation	1.7	3.5	5.5	7.3	6.9	9.8	11.5
Water and sewage services	5.2	3.4	--	--	--	--	--
Pharmaceutical benefits	27.6	39.3	43.0	54.3	58.5	69.0	71.7
Other		--	--	0.1	--	0.1	0.1
Housing sector	100.4	94.4	101.6	92.4	98.3	94.3	119.3
Loans before 1989	52.1	42.5	41.4	23.7	34.2	31.6	34.7
Loans after 1989	22.6	25.3	28.7	32.7	27.5	29.6	40.0
Interest rate subsidy	...	2.8	1.1	2.0	2.5	2.0	2.9
CBI housing	...	2.2	1.7	1.3	1.6	1.6	1.7
Grants	25.7	21.6	28.7	32.7	32.5	29.5	40.0
Producer subsidies	107.4	59.6	60.3	62.4	81.6	102.1	86.2
Closing of mines	...	2.6	2.3	2.8	2.8	2.8	2.3
Other mining	2.5	--	0.4	0.3	0.5	0.5	0.3
Agricultural sector	36.1	38.2	32.4	44.8	56.7	62.5	57.5
Current subsidies	12.8	11.4	2.2	2.2	6.1	5.9	6.5
Disadvantaged areas	3.7	5.9	0.6	--	--	--	--
Other	5.3	5.5	1.6	2.2	6.1	5.9	6.5
Agricultural market subsidies	--	--	7.3	17.1	5.0	6.7	7.5
Export subsidies	23.3	26.8	22.9	25.5	34.6	40.0	35.0
Agrarian production subsidies	--	--	--	--	11.0	9.9	8.5
Intervention fund	...	1.5	0.5	0.2	--	--	--
Railway transport	4.0	2.4	8.2	4.0	9.7	25.9	15.0
Trade policy fund	3.7	5.0	3.2	2.9	2.3	--	--
Other enterprise subsidies	...	--	1.9	1.5	1.6	2.3	1.6
Other (culture, etc.)	1.9	1.6	--	--	--	--	--
Investment subsidies	16.1	8.3	11.4	5.9	8.0	8.0	9.5
Other subsidies 1/	43.0	--	--	--	--	--	--
Total	207.8	154.0	161.9	154.8	179.9	196.4	205.5
Total excluding housing	107.4	59.6	60.3	62.4	81.6	102.1	86.2
Memorandum item:							
Total (in percent of GDP)	9.3	6.2	5.6	4.4	4.3	4.6	4.0

Source: Ministry of Finance.

1/ Mainly CMEA price equalization payments.

Table 63. Hungary: Major Benefits; Beneficiaries and Average Benefits Paid, 1993-95

(Numbers in thousands; and benefits in forint per person per month)

	Actual 1993	Budget 1994	Estimated 1994	Budget	Percent Increase 1995
Social Security Fund					
Pensions--basic benefits					
Numbers	2,249	2,301	2,281	2,318	1.6
Average benefits	10,784	12,437	13,425	15,400	14.7
Pensions--supplementary benefits					
Numbers	302	306	318	332	4.4
Average benefits	2,237	2,237	3,040	3,444	13.3
Pensions--old age					
Numbers	1,532	1,574	1,556	1,583	1.7
Average benefits	11,213	12,945	13,977	16,027	14.7
Pensions--disability and accident					
Numbers	327	340	338	352	4.1
Average benefits	10,963	12,591	13,703	16,027	17.0
Pensions--early retirement					
Numbers	32	35	29	27	-6.9
Average benefits	16,951	19,548	21,552	24,660	14.4
Pensions--widows and dependents					
Numbers	230	220	223	217	-2.7
Average benefits	8,533	9,860	10,613	12,204	15.0
Pensions--widows and orphans					
Numbers	24	25	25	20	4.0
Average benefits	8,037	8,701	9,733	11,090	13.9
Pensions--orphans					
Numbers	98	100	103	106	2.9
Average benefits	7,584	8,267	9,078	10,330	13.8
Health Fund					
Pensions--basic benefits					
Numbers	360	380	377	396	5.0
Average benefits	10,330	11,782	12,646	14,449	14.3
Pensions--supplementary benefits					
Numbers	13	12	14	14	--
Average benefits	2,543	3,098	3,452	3,929	13.8
Pensions--disability benefits					
Numbers	321	340	338	356	5.3
Average benefits	10,781	12,279	13,180	15,028	14.0
Pensions--accident benefits as sole benefits					
Numbers	4	4	4	4	--
Average benefits	14,104	16,098	17,292	19,792	14.5
Pensions--accident benefits as main benefits					
Numbers	23	24	23	23	--
Average benefits	4,070	4,610	4,920	5,652	14.9
Pensions--accident benefits as supplementary benefits					
Numbers	2	2	2	2	--
Average benefits	977	992	1,333	1,667	25.1
Pensions--widows with disabilities					
Numbers	9	9	9	10	11.1
Average benefits	9,430	10,833	11,481	13,167	14.7

Source: Ministry of Welfare.

Table 64. Hungary: Local Government Revenues, 1990-95 1/

	1990	1991	1992	1993	Estimated 1994	Budget 1995
			(In billions of forint)			
Revenues	300.5	385.5	508.5	577.7	646.3	713.2
Own sources	62.1	80.7	142.9	161.0	171.1	197.0
Taxes	6.7	--	17.3	32.0	36.5	39.0
Fees	7.1	16.2	9.3	10.5	8.0	11.5
Privatization	...	...	...	4.4	6.8	7.0
Other capital revenues	...	...	...	44.6	54.5	63.0
Institutional revenues	29.4	40.9	41.1	54.2	55.0	58.0
Other revenues	18.9	23.6	75.2	15.4	10.3	18.5
Transfers and shared revenues	238.4	304.8	365.6	416.7	475.2	516.2
Personal income tax	74.5	47.0	63.0	49.0	61.3	93.6
Motor vehicle tax	...	...	2.3	2.5	2.6	3.3
Social security transfers	50.6	67.1	80.8	91.6	94.2	99.0
State budget transfers	113.3	190.7	219.5	256.6	307.1	307.3
VAT refunding	...	...	...	9.9	5.0	6.0
CBI transfers	...	...	...	4.8	2.5	4.0
EBF transfers	...	...	...	2.4	2.5	3.0
			(Share of GDP in percent)			
Revnues	13.5	15.6	17.6	16.5	15.0	13.7
Own sources	2.8	3.3	5.0	4.6	4.0	3.8
Taxes	0.3	--	0.6	0.9	0.8	0.8
Fees	0.3	0.7	0.3	0.3	0.2	0.2
Privatization	--	--	--	0.1	0.2	0.1
Other capital revenues	--	--	--	1.3	1.3	1.2
Institutional revenues	1.3	1.7	1.4	1.5	1.3	1.1
Other revenues	0.8	1.0	2.6	0.4	0.2	0.4
Transfers and shared revenues	10.7	12.3	12.7	11.9	11.0	9.9
Personal income tax	3.3	1.9	2.2	1.4	1.4	1.8
Motor vehicle tax	--	--	0.1	0.1	0.1	0.1
Social security transfers	2.3	2.7	2.8	2.6	2.2	1.9
State budget transfers	5.1	7.7	7.6	7.3	7.1	5.9
VAT refunding	--	--	--	0.3	0.1	0.1
CBI transfers	--	--	--	0.1	0.1	0.1
EBF transfers	--	--	--	0.1	0.1	0.1

Source: Ministry of Finance.

1/ Figures are shown on a gross basis and therefore differ from Table 54 which nets out intergovernment transfers.

Table 65. Hungary: Local Government Expenditure, 1990-95 1/

	1990	1991	1992	1993	Estimated 1994	Budget 1995
	(In billions of forint)					
Total expenditure	256.7	306.4	389.4	597.5	664.8	714.7
Current expenditure	201.1	242.9	293.2	489.3	546.5	594.7
Wages and salaries	89.1	110.7	146.6	166.3	192.0	205.4
Other goods and services	107.1	114.2	126.4	276.7	304.5	324.5
Of which:						
Social security contributions	38.3	49.6	59.5	74.8	89.5	92.5
Subsidies and other transfers	4.9	18.0	20.2	43.5	44.0	57.8
Interest	...	...	...	2.8	6.0	7.0
Capital expenditure	55.8	63.5	96.2	108.3	118.3	120.0
Fixed capital formation	46.7	63.5	81.3	89.0	97.5	101.0
Capital transfers	9.1	...	14.9	19.3	20.8	19.0
	(In percent of GDP)					
Total expenditures	11.5	12.4	13.5	17.1	15.4	13.8
Current expenditures	9.0	9.8	10.2	14.0	12.7	11.5
Wages and salaries	4.0	4.5	5.1	4.7	4.5	4.0
Other goods and servies	4.8	4.6	4.4	7.9	7.1	6.3
Of which:						
Social security contributions	1.7	2.0	2.1	2.1	2.1	1.8
Subsidies and other transfers	0.2	0.7	0.7	1.2	1.0	1.1
Interest	...	...	...	0.1	0.1	0.1
Capital expenditures	2.5	2.6	3.3	3.1	2.7	2.3
Fixed capital formation	2.1	2.6	2.8	2.5	2.3	1.9
Capital transfers	0.4	...	0.5	0.6	0.5	0.4

Sources: Ministry of Finance; and staff estimates.

1/ Figures are shown on a gross basis and therefore differ from Table 54 which nets out inter-government transfers.

VI. Banking Sector Reforms in Hungary: 1987-94

1. Introduction

The development of a modern and efficient banking system is widely viewed as essential for the achievement of rapid and sustained growth in transition economies. Banking system reforms are seen as contributing to growth by strengthening private saving, raising the productivity of investment, and improving the transmission of monetary policy instruments. Progress with banking sector reform, however, has generally been slower than originally expected, and the goal of establishing an efficient banking system remains to be fully accomplished in most, if not all, economies in transition.

Many of the economies in transition faced a common set of problems at the outset of financial sector reforms when mono-bank systems were abandoned and two-tier banking systems established. In most cases, a substantial proportion of the loan portfolios of the commercial banks was--or eventually became--nonperforming, although frequently, the extent of the bad loan problems was difficult to gauge. At the same time, the debtors--mainly state-enterprises--also faced problems of their own, given their weak financial positions and the poor state of enterprise governance.

Countries approached the dual problems of banking and enterprise reform in different ways. Poland, for example, adopted an integrated approach in which, from the outset, banks played a key role in debt workouts with enterprises. Moreover, the incentives for the banks--who were residual claimants following recapitalization--to facilitate restructuring of their delinquent debtor enterprises and to recover as much of their bad loans as possible, were clearly established. Equally important was that the banks understood that recapitalization was a once-off event, and that privatization would come faster to those financial institutions which had gone furthest in improving their balance sheets.

In Hungary, a more gradual approach to addressing the bad loan problem of the commercial banks was adopted. Banks were not able, following the initial commitment of state support, to *fully* provision against their problematic loans, and a series of schemes was necessary to ultimately restore them to solvency. Nor were there clear incentives for the banks to seek to restructure or liquidate their debtor-enterprise clients and recover as much as possible of their problem loans. As a result, even once technical solvency of the state-owned commercial banks was achieved, the task of negotiating market-based workouts with the enterprises--essential to the *sustainability* of bank solvency--remained very much on the agenda.

This chapter surveys Hungary's experience with banking reform since the establishment of a two-tier banking system in 1987. The next section describes the structure of the banking system following the dissolution of the monobank, including the heavy concentration of bank lending in specific industrial sectors, and the limited degree of competition among the banks. Section 3 discusses the legislative reforms introduced in 1992, which modified substantially the operations of the banks and established new bankruptcy procedures. The next two sections discuss the steps taken by the authorities to shore up the rapidly-deteriorating financial positions of the state-owned banks, including through swaps of government bonds for bad debt, and through bank recapitalization. The final section describes the current state of Hungary's banking system, including the emergence of a group of dynamic small and medium-sized private banks, which has recently made significant inroads in the domestic banking sector. This section also discusses the authorities' current proposals for banking reform, including their intention to privatize the state-owned banks, a process that is to be accelerated in 1995.

2. Initial conditions, 1987-91

Prior to the creation of a two-tier banking system in January 1987, Hungary's commercial banking activities were undertaken by the National Bank of Hungary (NBH). In this context, the NBH's role was to channel household savings to the enterprise sector in a manner consistent with the Government's industrial policy objectives. Household savings deposits, under this system, were held exclusively by the National Savings Bank (NSB) and 260 rural cooperatives, which acted essentially as the retail arm of the NBH. Part of household deposits was used to finance (mainly housing) loans to individuals at heavily subsidized rates, with the remaining deposits being funnelled to the NBH for onlending to enterprises. Under this mono-bank system, there was complete separation of commercial and retail banking.

With the creation of a two-tier system, three commercial banks were established to assume the commercial banking activities of the NBH. These banks were set up as joint stock companies with 80 percent of their capital owned by the State and the remainder owned by enterprises. The loan portfolio of the NBH was allocated to the banks on a sectoral basis. Thus, the loans of the Credit and Commercial Bank (K&H) were heavily concentrated in the agriculture sector; assets of the Hungarian Credit Bank (MHB) consisted mainly of loans to the chemical and machine building sectors; and the loan portfolio of the Budapest Bank (BB) was initially concentrated in the coal mining and construction sectors. Apart from the three newly-created commercial banks, in 1987 the Hungarian banking system consisted of the NSB, the Hungarian Foreign Trade Bank (MKB)--which provided foreign-exchange related services under the monobank system, and several small joint-venture commercial banks.

In order to regulate the volume of lending to enterprises, the NBH established reserve requirements for commercial banks, and set credit ceilings for each bank based on the amount of bank capital. While the NBH continued to set interest rates for the household sector, commercial interest rates were freed. 1/ Enterprises were permitted to hold current accounts in only one commercial bank (which they were free to choose and change after July 1, 1987), although they could borrow from and hold other deposits in any number of banks.

At the beginning of 1987, when the three spin-off commercial banks were created, all the loans in the NBH's portfolio were technically fully performing. However, this was only achieved by extending to enterprises in difficulty sufficient funds to bring their accounts with the new banks fully up to date. The extent of any underlying weaknesses in the portfolios of the new banks therefore could not be assessed at this stage.

Apart from potential weaknesses in the quality of the inherited loan portfolio, the long-term viability of the new commercial banks was also adversely affected by inadequacies in the regulatory environment. An important aspect of this was the stipulation that risk provisioning be entirely voluntary, and that banks only be permitted to provision out of *after tax* profits. Not surprisingly in this environment, considerations relating to the size and quality of the underlying loan portfolio did not influence the level of provisions held by the three major banks--which stood at only about 2 1/2 percent of outstanding loans in 1988.

In addition to the failure of banking regulation to stipulate adequate provisioning against problem loans, certain practices of the commercial banks themselves served both to mask and to exacerbate underlying weaknesses in loan portfolios. For example, unpaid interest on bank loans was routinely capitalized into new credits, thereby overstating revenues. This behavior, the incentives for which may have been related to the fact that a number of heavily indebted enterprises were significant shareholders in the banks themselves, 2/ prevented any accurate assessment of the underlying performance of the commercial banks in the initial period following the creation of the two-tier system.

Although enterprises were permitted to switch banks, it proved difficult in practice to alter the initial allocation of loans across sectors. In part, this reflected the fact that branch offices established under the mono-bank system were allocated to the banks on a regional basis. Since different industries tended to be concentrated in different geographical regions, there was little opportunity for the banks to attract new clients from other industries. Moreover, the ability of enterprises to switch banks was impeded by inadequate information on which to judge their creditworthiness. As a result of these factors, at the end of 1988, between

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1/ Interest rates at the NSB were fully liberalized by end-1991.
2/ For example, in 1988, the 25 largest debtors of each of the three commercial banks held between 11 percent and 13 percent of the capital of the banks from which they borrowed.

one half and three quarters of each state-owned commercial bank's (SOCB's) loan portfolio remained concentrated in loans to only three industrial subsectors.

Partly to address a perceived lack of competition among the banks, in January 1989 the NBH relaxed the regulation that had previously prohibited enterprises from holding current accounts at more than one bank. In addition, in a first step towards the integration of household and enterprise banking, households were permitted to open current accounts at commercial banks (rather than exclusively at savings banks as before). Competition was further enhanced by the establishment of a large number of joint-venture banks over the period 1989-91, which resulted in the number of commercial banks operating in Hungary increasing to 36 by the end of 1991 (see Table 68). As a result of these efforts, competition among the commercial banks for corporate clients increased significantly. For example, by the end of 1991, the share of total bank loans accounted for by the four largest banks (NSB, K&H, MHB, BB) fell to just over 50 percent, from nearly 100 percent in early 1987.

3. Financial sector reforms in 1992

At the end of 1991, the government attempted to ease the burden on the commercial banks attributable to the poor quality of their loan portfolio by providing guarantees for about half the credits transferred to them in 1987 and rated as doubtful in 1991. 1/ While this measure temporarily improved the portfolio risk rating of the commercial banks, it did not contribute to a durable improvement in bank performance, both because a significant fraction of the inherited loan portfolio remained nonperforming (although the full extent of this may have been masked by the continuing practice of capitalizing unpaid interest), and because banks continued to lend imprudently, possibly in the expectation that future guarantees and/or capital injections were in the offing.

In an effort to address longstanding shortcomings in the regulatory environment, the government adopted three key pieces of legislation at the end of 1991 and in early 1992. The Act on Financial Institutions (promulgated on December 1, 1991) mandated provisioning against nonperforming loans and required that banks achieve, by the end of 1994, a minimum capital adequacy ratio (CAR) of 8 percent. Under this Act, three categories of nonperforming loans were identified. Loans were to be classified as "bad" if payments were overdue by more than one year or if the claim was held against a company that had filed for bankruptcy. Full provisioning was required in the case of such loans. "Substandard" and "doubtful" loans were those that were overdue by between 60 and 180 days, and between 180 days and one year, respectively. For these loans, provisions equal to 20 percent and 50 percent, respectively, of face value were mandated. In order to ease the

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1/ Guarantees were issued for loans with a face value of Ft 10.5 billion, and were heavily concentrated in the coal mining sector.

financial burdens on the banks imposed by these regulatory changes, the Act on Financial Institutions permitted banks to accumulate loan-loss reserves over a period of three years, while the Accounting Act (introduced in March, 1992) permitted banks to provision out of *pre*-tax profits (rather than out of post-tax profits as before).

The impact of the Financial Institutions Act on the (perceived) quality of the banks' loan portfolios was compounded by the passage, in September 1991, of the Bankruptcy Act, which automatically triggered bankruptcy proceedings against any enterprise with payment arrears of more than 90 days. 1/ Given the requirement under the Financial Institutions Act that loans to any firm in bankruptcy be classified as "bad" (and, therefore, in need of full provisioning), together these two pieces of legislation had a profound impact on the balance sheets of the commercial banks. 2/ As a direct result of the wide reach of the Bankruptcy Act, more than 10,000 companies were involved in bankruptcy or liquidation proceedings in 1992, including some--absent the automatic trigger provision of the Bankruptcy Act--that might have been able to clear payment arrears in a reasonable amount of time. Reflecting these developments, and the additional impact on Hungarian firms of the collapse of the CMEA trading arrangement and recession in western Europe, there was a large increase in the number of enterprises in financial difficulty. As a result, nonperforming loans rose sharply, from an estimated 9 percent of loans outstanding at end-1991 to about 17 percent at end-1992 (see Table 69). 3/ According to international standards, two of the three main commercial banks were insolvent by the end of 1992.

In response to these developments, the commercial banks sought to boost their profitability by increasing intermediation spreads and by curtailing lending. Spreads rose from about 6 percentage points at end-1991 to around 13 percentage points at end-1992. 4/ Estimates of the direct contribution of the deterioration in loan portfolios on the level of intermediation spreads suggest that banks raised interest rates to good borrowers by nearly 4 percentage points in order to offset the effect on profits of nonperformance on other loans. 5/ However, this estimate ignores the

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1/ The Bankruptcy Act took effect at the beginning of 1992.

2/ In addition, because firms in bankruptcy were granted a 90-day moratorium on payment of their financial obligations, the commercial banks experienced a sharp decline in interest income, at the same time that they needed to increase provisions against their nonperforming loans.

3/ In April 1992, 8 percent of outstanding bank credit was to firms in bankruptcy.

4/ Limited competition in the banking sector gave banks some control in determining spreads.

5/ See OECD Economic Surveys, Survey of Hungary, Centre for Cooperation with European Economies in Transition, OECD, 1993.

additional cost to the banks of building up provisions to acceptable levels, which would have required additional increases in intermediation spreads. 1/

While higher spreads indeed permitted banks to increase provisioning against nonperforming loans, they also contributed to adverse selection problems, as financially sound enterprises were unwilling to borrow at prevailing lending rates. Such problems were magnified to the extent that the joint-venture banks, which had stronger portfolios and capitalizations, could afford not to increase lending rates as much as the SOCBs, and could therefore attract the relatively more creditworthy borrowers that had been crowded out of the SOCB loan-market. 2/ The presence of alternative sources of credit (including foreign sources) for creditworthy borrowers further served to reduce and weaken the asset base of the SOCBs.

In response to these developments, the SOCBs severely curtailed lending to the enterprise sector, choosing instead to purchase less-risky, but lower-yielding, government securities. Combined with increased enterprise lending by other banks (including joint-venture banks), credit to enterprises remained flat in nominal terms during 1992, declining by 11 percent in real terms. 3/

This real decline in credit, however, was not uniform across firms. While lending by SOCBs declined on average, the least profitable and most highly indebted enterprises in fact received large real *increases* in credit, 4/ consistent with the adverse selection hypothesis. On this basis, it would appear that the deterioration in bank loan portfolios may also have reflected continuing inappropriate lending practices (in addition to the poor quality of *inherited* loans). However, it may be noted that with the exception of some highly-indebted yet profitable enterprises, the amount of new lending to indebted firms was, on average, less than their existing interest obligations, implying that banks were not injecting *net* new funds into such firms over this period.

1/ Another factor that boosted spreads was general uncertainty about further potential underlying weakness in the enterprise sector and the consequences this would have for bank balance sheets in the future.

2/ In 1992, average intermediation spreads in joint-venture banks were 2 percentage points below those in the banking sector as a whole.

3/ Corrected for loan consolidation (see below) and deflated by the producer price index.

4/ See J. Bonin and M. Schaffer, Banks, Firms, Bad Debts and Bankruptcy in Hungary: 1991-94, World Bank, processed, 1994. Their results are based on enterprise-level data covering all medium and large enterprises in the nonfinancial sector of the economy (about 5,000 firms with more than 1.5 million employees).

4. Loan consolidation in 1992 and 1993

With concerns emerging that the decline in financial intermediation through the commercial banking system was neither desirable nor sustainable, the authorities initiated, in 1992 and 1993, two separate operations to reduce the volume of nonperforming debts. Essentially, these operations involved swapping bad loans with interest-bearing government bonds.

The first such operation--the 1992 (bank-oriented) Loan Consolidation Program (LCP) which was carried out in March 1993--was directed at banks with a capital adequacy ratio below 7 1/4 percent. Under the program, eligible banks sold to the government claims on domestic enterprises that had been contracted prior to October 1, 1992 and that had been classified--according to the 1991 Act on Financial Institutions--as "bad" on December 31, 1992. 1/ The government bought these claims at a 50 percent discount from face value if they had been classified as bad prior to 1992, and at a 20 percent discount from face value if they were classified as bad in 1992. In the case of loans to a number of selected state enterprises, however, the government purchased claims at full face value. The discounted portion of the claims purchased under the LCP were charged against the banks' provisions.

Under the 1992 LCP, the government initially purchased enterprise debt (including principal and accrued interest) with a face value of Ft 102.5 billion from 14 commercial banks and 68 savings cooperatives. In exchange, these financial institutions received Ft 81.3 billion in designated "credit-consolidation" bonds (CCBs) (see Table 70). 2/ Later in 1993, the government purchased an additional Ft 18 billion in claims (against a number of heavily-indebted enterprises) held by three banks. In total, therefore, about Ft 120 billion of claims (equivalent to about 4.2 percent of 1992 GDP) were purchased under the 1992 LCP (covering some 2,647 debtors 3/), in exchange for bonds worth about Ft 100 billion.

1/ The program did not cover claims on households and foreigners, nor did it include loans that were classified as "substandard" or "doubtful."

2/ Credit consolidation bonds had a twenty-year maturity, paid a market-related rate of interest, and were freely negotiable. Interest was payable once per year, with the first payment due in 1994, at a rate equal to the average interest rate on 90-day treasury bills during the previous half year. (Initially, "Series A" bonds (issued in exchange for principal) paid interest at this rate, while "Series B" bonds (issued in exchange for interest arrears) paid half the interest of Series A bonds; subsequently, the government converted Series B bonds into Series A bonds.)

3/ The claims of some of the largest state-owned enterprises were not included under the 1992 LCP because the commercial banks were reluctant to recognize loans to such enterprises as nonperforming, and were therefore simply capitalizing unpaid interest and rolling over the debts in such cases.

For the most part, claims purchased by the state under the 1992 LCP continued to be managed by the commercial banks. About one third (some Ft 40 billion) of the total was, however, sold to the state-owned Hungarian Investment and Development Bank (HIDB), which was charged with negotiating settlements with the debtors in these cases. During the first half of 1993, a number of agreements were concluded between the HIDB and the debtors, which mainly involved reorganizations (including liquidations) of the enterprises concerned.

As a result of the 1992 LCP, the short-term position of the banks improved markedly. Specifically, banks experienced a more than 50 percent reduction in their holdings of bad debts, and a turnaround in capital adequacy ratios, which had been negative prior to the implementation of the 1992 LCP. With these improvements, incentives for changing bank behavior and for coming to agreements on outstanding claims (now held by the state) diminished.

Moreover, it is not difficult to make the case that the 1992 LCP promoted expectations among the banks of further bailouts in the future. For example, making use of the voluntary nature of participation in the 1992 LCP, banks chose to withhold a large part of "bad" loans that had been classified as such prior to 1992, and that would have been exchanged at a 50 percent discount under the terms of the 1992 LCP. It may well have been reasonable to expect that such debts, many of which had been contracted with some of the larger state-owned enterprises (SOEs), could indeed fetch a higher price under future schemes, especially given the practice under the 1992 LCP that debts to a selected group of large SOEs be exchanged at full face value. These expectations were reinforced by official statements, as early as March 1993 (at which time banks had not yet finalized their decisions about which debts would be sold to the government under the 1992 LCP), of the potential for a second scheme to be implemented at the end of the year. 1/

As it turned out, the authorities indeed implemented a further loan consolidation scheme in the final quarter of 1993. This scheme involved 16 large state enterprises--including the state railway--that were viewed by the authorities as having strategic importance. Under the 1993 (enterprise-oriented) LCP, the government purchased--at between 90 and 100 percent of face value--a significant share of bank claims against this select group of state enterprises. 2/ Specifically, the government exchanged about Ft 62 billion in bank loans for Ft 57 billion (1.6 percent of 1993 GDP) in CCBs. 3/ Nearly 85 percent of these claims were against state-owned industrial enterprises, with the remainder being held against enterprises in the food-processing and agricultural sectors.

Following the acquisition of these loans, the government transferred all claims under the 1993 LCP to two state asset management agencies. In early 1994, one of the agencies--the Hungarian State Holding Company--forgave unconditionally all claims against eight of the state enterprises involved in the 1993 LCP. The remaining claims as well as claims held by the other agency--the State Property Agency--have yet to be resolved.

1/ The extent to which the banks made full use of the rules established under the 1992 LCP was not confined to withholding a number of bad loans to selected large state enterprises. Banks also had some flexibility to determine how to classify problem loans (between "bad" loans--eligible for exchange under the LCP--and "doubtful" or "substandard" loans--not eligible). Recalling that only loans extended prior to October 1, 1992 qualified for exchange under the LCP, it is relevant to note that, in the last quarter of 1992, the value of "bad" loans rose sharply (by about Ft 54 billion) while the value of "doubtful" or "substandard" loans fell by nearly the same amount (about Ft 40 billion). A possible explanation is that the banks delayed classifying some of their loans as "bad" until after the cut off date for the 1992 LCP, in anticipation of more favorable terms for such loans down the road. Another possible explanation is that, given the improvement in the financial position of the banks as a result of the LCP, and the requirement that *excess* provisions be taxable, it was advantageous for the banks to classify more loans as "bad" when their financial positions improved in order to limit the increase in their tax obligations.

2/ It may be noted that many of the debts involved in this scheme had not been classified as "bad" by the commercial banks.

3/ A number of banks that had not participated in the 1992 LCP exchanged debts under the 1993 LCP.

5. <u>Bank recapitalization, 1993-94</u>

Notwithstanding the assumption by the state, under the 1992 and 1993 Loan Consolidation Schemes, of more than Ft 180 billion of commercial bank loans (equivalent to 12 percent of outstanding loans at end-1993, or 5.2 percent of 1993-GDP), some Ft 352 billion (or nearly one fifth of all commercial bank loans) were classified as nonperforming at end-1993. Of these, about half were classified as "bad" (i.e., they had not been serviced for more than a year), a situation unchanged from that which prevailed at the end of 1992, that is, *prior* to loan consolidation. Moreover, the state of the banks' balance sheets was in fact worse than conveyed by these figures, which *inter alia* ignored dubious investments undertaken by the banks in a number of state enterprises in financial difficulty.

In an attempt to arrive at a more reliable assessment of the true state of the banks' balance sheets, the authorities amended at the end of 1993 the Act on Financial Institutions imposing new and more stringent classification and provisioning requirements that were consistent with international standards. <u>1</u>/ Under these new rules, the value of loans classified as problematic rose to Ft 547 billion <u>2</u>/ (equivalent to 15 1/2 percent of 1993 GDP), of which Ft 2543 billion were classified as "bad."

With the failure of the 1992 and 1993 loan consolidation schemes to solve the "bad" loan problem of the commercial banks, the authorities decided on an alternative strategy, albeit with similar objectives. Specifically, while the LCPs had attempted to improve the *asset side* of the banks' balance sheets by substituting low-risk government securities for nonperforming enterprise debt, the new strategy was based on a (two-step) *recapitalization* program for the banks, which would--it was hoped--ultimately allow them to fully provision against all nonperforming items in their balance sheets. Furthermore, while the LCPs were designed to improve the quality of banks' existing portfolios (the *stock* problem), they failed to stem imprudent lending behavior (the *flow* problem) or to improve bank governance. In order to address these outstanding issues, participation in the recapitalization program was conditional on banks' signing "consolidation" contracts with the state, which required them to develop and execute strategies for their reorganization, and to participate actively in enterprise debt resolution programs.

<u>1</u>/ The Amended Act on Financial Institutions, introduced in December 1993, established a more comprehensive system of classification and provisioning than the original Act. Major changes included the requirement that banks classify and provision against *all* their investments and contingent liabilities (rather than just loans, as before), and the requirement of full provisioning against overdue interest. In addition, a new classification, "under observation," was added to cover assets that warranted special attention due, inter alia, to the size of the receivable or the nature of the borrower.

<u>2</u>/ Excluding items classified as "under observation."

end 1993

In the first step of bank recapitalization, which took place at the end of 1993, eight banks received a capital injection of Ft 114.4 billion (77 percent of which went to the two largest banks), sufficient to enable them to show a positive amount of capital on their books. 1/ The State acquired the additional equity in the banks by purchasing newly-issued shares with credit consolidation bonds. 2/

1994 May

The second stage of bank recapitalization took place in May 1994. At that time, the three largest commercial banks (MHB, K&H, BB) received a capital injection sufficient to raise their capital-asset ratios to 4 percent. 3/ Banks received a combined capital injection at the second stage of Ft 23 billion in the form of CCBs. Also at this time, a third capital injection was proposed for the three largest commercial banks, to take place at the end of 1994, which would enable them to achieve capital adequacy ratios of 8 percent, as required by the Act on Financial Institutions.

It was further stipulated that participation in the second stage of the recapitalization program would require building on the consolidation contracts initiated previously, by providing the authorities with acceptable odernization, business policy, and privatization plans. In fact, however, even though the authorities rejected so-called "consolidation programs" submitted by, inter alia, two of the large commercial banks, these banks were nevertheless permitted to participate in the recapitalization program. 4/

CCB = credit consolidation bonds

1/ As a result of the Amendment to the Act on Financial Institutions, *required* provisions in these banks increased by Ft 133 billion, so that the capital injection received at this first stage was sufficient to offset most of the increase in required provisions.

2/ These CCBs were similar to those issued previously under the two LCPs, except that interest was paid twice yearly, rather than once a year as before. The government issued Ft 130 billion in CCBs as part of the first stage of bank recapitalization. In addition to the Ft 114.4 billion used to recapitalize the eight commercial banks, CCBs were used: (i) to purchase Ft 1.9 billion in equity from existing commercial-bank shareholders; (ii) to grant the savings cooperatives Ft 5.9 billion in subordinated loans and to increase their capital by Ft 2.7 billion; and (iii) to grant the NSB a Ft 5 billion subordinated loan.

3/ Four other smaller banks were also recapitalized to a 4 percent CAR through equal purchases of newly-issued equity and extension of subordinated credit. The National Savings Bank also received a capital injection of Ft 5 billion, even though its CAR already exceeded 4 percent.

4/ These banks were given until the end of 1994 to submit revised plans, which were to be a factor in any decision on whether to proceed with the third stage of recapitalization, also envisaged for the end of 1994.

As a result of the first two stages of bank recapitalization, the state's direct 1/ ownership share in seven of the eight participating banks rose sharply, to over 75 percent by May 1994. 2/ With these developments, the state effectively regained its pre-1987 dominant position in the domestic financial system. While a possible advantage of this role might have been the additional leverage that could be used to encourage banks to implement effective restructuring programs and debt workouts with state enterprises, in fact little was done to effect such improvements, as evidenced by the decision to proceed with bank recapitalization even though consolidation programs submitted by a number of banks were judged to be unacceptable.

3. (2) end 1994,

In line with its previous commitment, at end-1994 the government proceeded with the third and final stage of recapitalization of the large commercial banks to enable them to achieve an 8 percent capital-adequacy ratio, stipulated by the Act on Financial Institutions. Four banks, including BB, MHB, and K&H, received a total capital injection of Ft 16.2 billion in this third stage. (It bears mentioning, however, that only BB had submitted a consolidation program acceptable to the government by the end of 1994, as required under the terms of the previous recapitalization operation.) The capital injection took the form of a 30-year subordinated loan from the government. In order to neutralize the budgetary impact of the operation, interest payments on the consolidation bonds issued in connection with the scheme exactly offset interest receipts on the banks' subordinated debt.

6. <u>The current state of the banking system and banking reform</u> 1995-8: 1987-

Eight years after the break-up of the mono-bank, Hungary's banking system consists of two distinct groups of financial institutions. On the one hand, there is a group of five large state-owned banks consisting of four commercial banks and the National Savings Bank. Within this group, the four commercial banks are in the weakest financial position, having only recently achieved the BIS' minimum acceptable CAR of 8 percent as a result of a series of measures to improve their balance sheets. Notwithstanding the level of state support received, the proportion of problematic loans in the portfolios of these large commercial banks has continued to rise, in the most recent period from less than one third at the end of 1993 to nearly

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1/ Includes holdings of the government and government agencies, but excludes bank equity owned by state-owned enterprises.

2/ For the eighth bank (Agrobank), the state's ownership share was 30 percent. Among the large state-owned commercial banks, the state's ownership shares were 68 percent, 84 percent, and 89 percent, respectively, in BB, K&H, and MHB. These state ownership shares were well above the legal maximum (25 percent) mandated by the Act on Financial Institutions and, as a result, the deadline for achieving the legal ownership ceiling was extended to 1997. For the banking sector as a whole, the direct share owned by the state increased from 38 percent at end-1991 to over 67 percent at end-1994.

two-fifths by September 1994. 1/ As a result of the ongoing deterioration in their loan portfolios--itself a reflection both of lack of progress in negotiating market-based workouts of *existing* loans between banks and their state-enterprise clients as well as continuing *new* lending to enterprises in difficulty, these banks are likely to remain weakly capitalized. 2/

The second group of financial institutions that has set up operations in Hungary over the past several years consists of about thirty small and medium-sized private banks, many of which are jointly foreign-owned. It is this group of banks which forms the dynamic element in Hungary's banking system. These privately-owned institutions compete to establish a sound client base consisting of joint-venture firms and the more creditworthy domestic enterprises, 3/ and offer a growing range of financial services. 4/ To date, these banks have concentrated primarily on commercial lending activities, obtaining their funds from deposits of the NSB intermediated through the interbank market. However, these banks are beginning to move into retail banking and, as such, are beginning to compete directly with the NSB. 5/

1/ Compared to the commercial banks, the National Savings Bank, the country's largest financial institution, is in a relatively better position. While the NSB is profitable under current conditions of limited competition, it would be unlikely to remain so were other banks to enter into retail banking on a larger scale, or were the government to market more aggressively its securities directly to the non-bank public.

2/ The amount of capital injected into the banks at the third stage of the recapitalization program enabled them to achieve an 8 percent CAR based on their *end-1993* balance sheets. However, due to continuing deteriorations in their portfolio during 1994, the recapitalization may not have been sufficient to achieve an 8 percent CAR based on *end-1994* balance sheets.

3/ Average intermediation spreads in jointly foreign-owned banks were 3 1/2 and 1 1/2 percentage points below those in large state-owned banks during 1993 and 1994, respectively.

4/ A implication of the undercapitalization of the large state-owned commercial banks is an almost total absence of investment in modern banking technologies. Clearly, the continued use of inadequate and outdated technologies places these banks at a severe competitive disadvantage relative to the growing number of joint-venture and private banks operating in Hungary.

5/ The growing importance of the joint-venture banks is apparent from the fact that, in the first nine months of 1994, the market share in enterprise credits of the three largest state-owned commercial banks (MHB, K&H, and BB) declined by about 4 percentage points, to just under 40 percent, with a corresponding increase in the market share of the private banks. Similarly, over the same period, the market share of the large state-owned commercial banks in enterprise deposits declined by about 5 percentage points, to 43 percent. Finally, in terms of enterprise borrowing, in the first half of 1994, the six largest state-owned banks (including the NSB) accounted for less than 65 percent of new lending.

Although the increasing role of dynamic joint-venture banks is a positive development for Hungary's banking system, the continued weakness of the state-owned banks remains an enduring testimony to the limited success of the multiple reform efforts to durably address the underlying problems of this sector. In essence, this reflects two factors. First, the very gradualist approach to restoring solvency to the state-owned banks created moral hazard problems, as banks came to believe that the terms of possible future state bailouts would be more generous than those of past bailouts. Second, the "carrot" of state support, although *de jure* conditioned on the banks' taking steps to address their operational weaknesses and to recover their debts from their state-enterprise clients, was not withdrawn when such steps were not taken. As a result, although there has been little by way of net new lending to problem enterprises in recent years, the failure to negotiate debt workouts with borrowers who remain in financial difficulty has meant that the stock of bad loans (including capitalized interest) has continued to rise, reaching most recently Ft 268 billion (26 percent of outstanding loans) in September 1994. 1/

At the same time, the counterpart to averting insolvency of the commercial banks has been a major increase in the state's financial stake in these institutions. Specifically, as a result of the multiple consolidation and recapitalization schemes, the state issued about Ft 325 billion in credit consolidation bonds (equivalent to about 7.5 percent of 1994 GDP), which now make up about 15 1/2 percent of total domestic interest-bearing state debt. 2/ The direct cost to the 1995 budget of servicing this debt is estimated to be some 1.7 percent of GDP or 3.9 percent of government revenue. 3/

Recently, the authorities have begun to initiate policies that would *durably* improve the financial positions of the large state-owned banks. In a break with the past, the government announced in December 1994 a new reform program that relies on privatization as the primary means of addressing the fundamental problems of Hungary's banking sector. In line with this new policy, the government's long-term objective is to fully divest itself from any ownership stake in Hungary's banks. 4/ The process is to be initiated in 1995 with the partial privatization of several of the

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1/ As mentioned previously, the proportion of *problematic* loans in the large state-owned banks reached nearly 40 percent in September 1994.

2/ Since the government extended to the banks Ft 27 billion in subordinated loans, net government debt increased by about Ft 297 billion as a result of these operations.

3/ Offsetting in part the fiscal support extended to the banks since 1992 is the overpayment of corporate income tax by the banks prior to 1992 resulting from the inclusion in income of interest due but not received.

4/ The only exception would be the National Savings Bank, in which the state intends to retain a 25 percent ownership share.

large state-owned banks, including the National Savings Bank. 1/ Given the still relatively weak capital base of many of the commercial banks, the government hopes to secure their privatization mainly through capital injections from strategic investors, with little revenue envisaged for the state.

The initiation of a privatization program, however, is only likely to succeed if the authorities are resolved to take the necessary steps to ensure that banks negotiate *market-based* workouts of their nonperforming loans and maintain prudent lending practices. Only these measures will enable banks to remain solvent without ongoing state support in the period leading up to privatization, and to compete on a more equal footing with the private banks. If the state-owned banks do take steps to recover their problem loans--including through restructuring and liquidation of their debtor-enterprise clients--and cease lending to troubled enterprises, the sharp dichotomy which now exists between the state-owned banks and the newly-established private and joint-venture banks could well diminish over the next several years.

Such a scenario could easily be thrown off course, however, if the window of opportunity, afforded by the return to solvency of the state-owned banks, is not seized. A key lesson of Hungary's experience with banking reform is that the costs of not moving rapidly with the implementation of market-based debt resolution programs between state-owned banks and enterprises, both direct costs to the state budget as well as indirect costs in terms of the authorities' lost credibility and the distortionary effects created by large intermediation spreads, are likely to be very high.

1/ The first privatization of a major bank occurred in mid-1994 with the partial sale of the Foreign Trade Bank (MKB) to a group of strategic foreign investors.

Table 66. Hungary: Number of Financial Institutions by Type, 1989-94

(End of period)

	1988	1989	1990	1991	1992	1993	1994
Commercial Banks	15	18	20	31	32	35	36
Of which:							
Hungarian-owned	12	11	12	18	16	15	15
Foreign or jointly-owned	3	7	8	13	16	20	21
Specialized financial institutions	8	5	9	5	8	8	8
Subtotal of banks	23	23	29	36	40	43	44
Insurance companies	4	5	6	11	13	13	13
Savings cooperatives	260	260	260	259	258	255	255

Source: National Bank of Hungary.

Table 67. Hungary: Banks' Loan Portfolios, 1991-94

	December 1991	September 1992	December 1/ 1992	December 2/ 1992	September 1993	December 3/ 1993	December 4/ 1993	September 1994
	(In billions of forint)							
Stock of loans classified as problematic	152	262	276	193	262	352	547	597
Of which:								
Under observation	--	--	--	--	--	--	124	200
Substandard	30	41	37	40	31	82	55	39
Doubtful	82	96	60	66	89	84	115	90
Bad	40	125	179	87	142	186	253	268
	(In percent)							
Share of problem loans in the total stock of enterprise loans	19.9	34.1	35.9	27.4	34.9	46.2	71.7	68.9
Share of bad loans in the total stock of enterprise loans	5.2	16.3	23.3	12.4	18.9	24.4	33.2	30.9
Share of problem loans in the total stock of loans	9.4	16.2	16.9	11.1	14.0	17.5	22.2	25.8
Share of problem loans in the total loans of the large SOCBs	...	...	...	12.4	...	25.1	32.1	38.8

Sources: National Bank of Hungary, and Ministry of Finance.

1/ Prior to loan consolidation.
2/ After loan consolidation.
3/ According to 1991 classification rules.
4/ According to 1993 classification rules.

Table 68. Hungary: Credit Consolidation Bonds Issued to Banks Under the Loan Consolidation and Bank Recapitalization Programs

	December 1992	April 1993	May 1993	December 1993	May 1994	December 1994
	(In billions of forint)					
Program						
Loan consolidation	81.3	14.7	2.6	56.5	--	--
Bank recapitalization	--	--	--	129.9	23.0	16.2
Total	81.3	14.7	2.6	186.4	23.0	16.2
In percent of corresponding year's GDP	2.8	0.4	0.1	5.3	0.5	0.4
	(Cumulative stock)					
CCBs issued to the banks	81.3	96.0	98.6	285.0	308.0	324.2
CCBs in percent of 1994-GDP	1.9	2.2	2.3	6.6	7.1	7.5
CCBs in percent of end-1994 broad money	4.1	4.8	4.9	14.3	15.4	16.2

Sources: National Bank of Hungary; and staff calculations.

Table 69. Hungary: Total Assets of the Banking System by Banking Group, 1989-94 1/

(In billions of forint; end of period)

	1989	1990	1991	1992	1993	1994 2/
Large banks 3/	640.4	781.2	921.5	1,049.3	1,151.3	1,211.3
(Percent of total assets)	47.8	46.0	41.5	43.7	42.7	38.6
Medium-sized banks	136.3	238.1	499.3	450.8	529.7	761.8
(Percent of total assets)	10.2	14.0	22.5	18.8	19.6	24.3
Specialized financing institutions	22.3	43.0	29.7	10.9	48.3	58.7
(Percent of total assets)	1.7	2.5	1.3	0.5	1.8	1.9
National Savings Bank and cooperatives	540.0	637.1	769.9	889.1	968.6	1,106.1
(Percent of total assets)	40.3	37.5	34.7	37.0	35.9	35.3
Total	1,339.0	1,699.4	2,220.4	2,400.1	2,697.9	3,137.9
Of which:						
Fully Hungarian-owned	1,287.6	1,535.2	1,894.3	2,034.0	1,943.7	2,162.2
(Percent of total assets)	96.2	90.3	85.3	84.7	72.0	68.9
Foreign or jointly owned	51.4	164.2	326.1	366.1	754.2	975.6
(Percent of total assets)	3.8	9.7	14.7	15.3	28.0	31.1

Source: National Bank of Hungary.

1/ New accounting law incorporated from 1991 onward.
2/ Preliminary.
3/ From 1992 data of the five largest banks (excluding NSB).

Table 70. Hungary: Composition of the Liabilities of the Banking System, 1989-94 1/

(In percent of total, end of period)

	1989	1990	1991	1992	1993 2/	1993 3/	1994
Equity	7.5	7.6	8.7	9.4	13.5	6.5	8.8
Deposits and securities	55.0	57.4	63.6	64.2	60.9	65.9	66.7
Loans	18.9	19.1	16.1	20.5	18.3	19.8	17.1
Other	18.6	15.9	11.6	6.1	7.3	7.9	7.4
Total liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Bank of Hungary.

1/ For 1989-1990, annual balance sheets of the banks. For 1991, sectorized balance sheets of the banks including savings cooperatives. For 1992 and 1993 annual balance sheets of the banks and savings cooperatives.

2/ Data are comparable with the content of the balance sheets in 1992.

3/ Balance sheet data in the new (1993) structure.

Table 71. Hungary: Equity Composition of the Banking Sector at the End of the Year, 1989-93 1/

(In percent of total)

	1989	1990	1991	1992	1993
Share capital	79.2	74.8	61.1	72.0	168.3
Accumulated capital	10.6	9.7	--	--	--
Reserve capital	--	10.0	--	--	--
Reserve capital (new)	--	--	1.9	1.4	8.8
Reserve profit	--	--	12.3	18.2	15.1
General reserves	--	--	10.0	13.3	13.4
Retained profit for the year	--	--	14.8	-5.0	-105.6
Risk fund	10.2	5.5	--	--	--
Total equity	100.0	100.0	100.0	100.0	100.0

Source: National Bank of Hungary.

1/ For 1989-90 annual balance sheets of the banks; for 1991 and 1992 sectorized balance sheets, partly estimated by the National Bank of Hungary.

VII Exchange and Trade System

This section reports key aspects of Hungary's exchange and trade system, focusing in particular on changes since the last Recent Economic Developments paper. 1/ It should be noted that Hungary is in the process of preparing a new foreign exchange law and regulations intended to remove remaining restrictions on payments for current transactions and--as described below--to allow Hungary to accept the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

1. Exchange rates

The exchange rate of the forint is derived on the basis of a basket of currencies, the composition of which has been adjusted several times in the recent past. Prior to December 9, 1991, the basket consisted of 11 currencies, weighted to reflect the currency composition of foreign trade turnover, with the weights adjusted annually. Between December 9, 1991, and August 2, 1993, the basket consisted of equal proportions of U.S. dollar and ECU. Between August 2, 1993, and May 16, 1994, the basket comprised equal proportions of U.S. dollar and Deutsche mark. Since May 16, 1994, the basket has been composed of the ECU and the U.S. dollar, with weights of 70 percent and 30 percent, respectively.

The value of the peg to the basket has been adjusted periodically, mainly on the basis of the difference between domestic and foreign rates of inflation. The NBH has the authority to adjust the exchange rate by a cumulative 5 percent, after which a decision by the government is required for the next devaluation. Through end-1991, the exchange rate was adjusted in relatively large steps; on January 7, 1991, the exchange rate was devalued by 15 percent and on November 8, 1991, by 5.8 percent. Even so, these sizable devaluations could not prevent a real appreciation of the exchange rate. Since the beginning of 1992, a policy of gradual, more frequent adjustments of the exchange rate has been implemented. During 1992, there were three devaluations ranging from 1.6 percent to 1.9 percent, for a cumulative total of 5.4 percent. The five devaluations in 1993 ranged from 1.9 percent to 4.5 percent, for a cumulative total of 15 percent. During 1994, there were seven devaluations for a total of 16.8 percent. These included a larger-than-usual devaluation of 8 percent on August 5, 1994, which reflected growing concern over the size and persistence of the external current account deficit. The magnitudes for the devaluations listed above are from the domestic perspective, i.e., in forints per unit of the foreign-currency basket; from a foreign perspective--the standard Fund definition--the forint was devalued by a cumulative 5.1 percent, 13.0 percent, and 14.4 percent in 1992, 1993, and 1994, respectively.

1/ SM/92/52 (3/12/92). A detailed description of Hungary's exchange and trade system is contained in IMF, Annual Report on Exchange Arrangements and Exchange Restrictions (1994).

The establishment of an interbank market for foreign exchange on July 1, 1992, significantly liberalized the exchange system. Whereas previously the NBH had quoted daily official exchange rates in 19 currencies and effected transactions in all of these currencies, the exchange rate is now determined in the interbank market. Initially, the NBH continued to effect transactions in any amount and in any of 19 convertible currencies and the ECU at the official exchange rate, which was determined daily at noon. Spot buying and selling margins were set at +/-0.25 percent of the official rate, but licensed banks were free to determine their own margins within this band. On March 10, 1993, margins were widened to +/-0.3 percent and a minimum amount of the equivalent of US$1 million was imposed for transactions with the NBH. From January 1, 1994 onwards, this minimum amount was raised to US$2 million, margins were widened to +/-0.5 percent and the NBH stopped intervening at the official rate which is being quoted only for statistical and customs valuation purposes. These margins were widened to +/-1.25 percent on August 5, 1994 and further to +/-2.25 percent on December 23, 1994. The widening of the margins was intended to limit the short-run speculative pressures related to exchange rate adjustments. Since October 1994, the NBH has been conducting transactions in U.S. dollar only, rather than in any of the quoted convertible currencies. The NBH intervenes solely at the market rate to keep it within the margins of the peg.

Prior to November 7, 1991, the NBH quoted forward exchange rates for the majority of the currencies quoted in the spot market. Thereafter, the NBH stopped providing forward cover, and until the establishment of the interbank foreign exchange market there was no effective forward foreign exchange market. Such a market between licensed banks developed in the context of the interbank foreign exchange market, stimulated by the establishment of a foreign exchange futures market on the Budapest commodity exchange. Although there has been a gradual expansion over time, the forward market remains shallow, with transactions limited to banks and their major client-exporters, mainly joint-ventures.

With the break-up of the CMEA trading arrangements and the conversion of trade to world market prices in early 1991, the multiple currency practice associated with broken cross-currency rates resulting from transactions with CMEA partners was eliminated. Another multiple currency practice arising from tourism-related transactions with the former Czechoslovakia was eliminated in February 1991. There are no remaining multiple currency practices.

2. Foreign exchange transactions

With the establishment of the interbank foreign exchange market on July 1, 1992, the state monopoly for foreign exchange operations was abolished. The range of foreign exchange operations that could be undertaken by commercial banks had been expanding gradually since 1988. In 1988, commercial banks were allowed to open foreign exchange accounts for private persons and nonresidents and to quote forward exchange rates to domestic exporters and importers. In July 1989, commercial banks were authorized to lend foreign exchange to the domestic enterprise sector. Banks were authorized in February 1990 to conduct foreign exchange operations on behalf of their clients. Since the introduction of the interbank foreign exchange market, banks have been allowed to hold open positions for up to 30 percent of their risk adjusted assets. Forward positions are covered under this limit.

In tandem with the development of the interbank market, foreign borrowing by private and public enterprises has been further liberalized. Although licenses are still required for such borrowing, approval is quasi-automatic provided certain conditions on interest rates, fees and the creditworthiness of borrower and lender are satisfied. Banks--other than five joint ventures established under separate charters and guarantees, which are not subject to restrictions on capital transactions--require permission to borrow abroad; this permission is granted liberally and is mainly used for registration purposes. Hungarian enterprises and residents are generally not authorized to hold bank accounts abroad.

Resident and nonresident individuals may open foreign currency bank accounts in Hungary without declaring the source of the foreign exchange. They may freely withdraw foreign exchange from these accounts for conversion into forint, for expenditure on imported goods and services, or for transfers abroad. Enterprises are not permitted to hold foreign currency accounts except that joint ventures may open foreign currency accounts in Hungary with the proceeds of foreign capital and with interest and dividends for remittances abroad. There is a full surrender requirement for export proceeds.

Since July 1992, Hungarian and foreign exporters have been allowed to accept payment for exports in forint, and nonresident holders of such balances have been allowed to open foreign trade forint accounts to be used for payments in forint. As of June 1, 1994, foreigners were allowed to convert balances in such accounts in foreign exchange for transfer abroad.

3. <u>Import payments, export receipts and licensing</u>

Importers have the right to purchase foreign exchange through the banking system for all bona fide imports of goods and most services. When applying for foreign exchange, importers must declare the use of the foreign exchange and the NBH conducts random checking of enterprises and banks for compliance with regulations.

On July 1, 1992, the requirements of securing import contracts by a letter of credit or bank guarantee and of depositing the forint equivalent of deferred payments arrangements undertaken by commercial banks on behalf of their clients with the NBH were abolished. Restrictions on entering into deferred payment agreements for a period up to one year were eliminated, while a mandatory declaration requirement was introduced for such agreements exceeding three months. For deferred payment agreements exceeding one year, permission of the NBH is required.

There has been a progressive liberalization of the import licensing regime since 1984 resulting in a general authorization of imports since December 1990, except for a negative list of items. A global quota has also been maintained on imports of selected consumer goods that are subject to license and settled in convertible currencies. The value of the quota was raised from US$200 million in 1989 to US$630 million in 1991, US$720 million in 1992, US$750 million in 1993 and maintained at that level in 1994, while the number of products covered by the quota was reduced. The number of imported vehicles has also been subject to quota: it was raised from 140,000 in 1992 to 160,000 in 1993, and maintained at that level in 1994. The quota for car imports does not appear to be binding as only an estimated 129,000 vehicles were imported in 1994.

Export proceeds must be received in officially quoted convertible currencies and, since July 1, 1992, may also be received in Hungarian forints. In the former case, such proceeds must be surrendered against Hungarian forints to a licensed bank within eight days of receipt of foreign exchange, rather than to the NBH as was the case until July 1, 1992. Certain exemptions may be granted subject to specific approval by the NBH. There is no limitation on the time within which foreign exchange earnings have to be repatriated following the shipment of goods. Export proceeds received in forint may be deposited in a special foreign trade account with a licensed bank but could not be converted into foreign exchange until June 1, 1994. Prior to this date, they could be used only for payments for goods and services in Hungary.

4. Invisibles

In November 1989, Hungary tightened restrictions on the availability of convertible currency for travel abroad; this restriction is subject to approval under Article VIII, Section 2(a). These restrictions were eased in 1992 under the automatic provision of existing legislation and as a result of additional measures: annual allowances for tourist travel were raised to US$350 per person on July 1, 1992; limits for business were increased; and the availability of foreign exchange for travel arranged through travel agencies was increased. Tourism allowances were further raised to US$800 per person on April 1, 1994, and an unlimited amount of foreign exchange was made available to travel agents. Even though the present limits do not appear to represent a binding limitation, fear of capital flight through this channel makes the authorities reluctant to eliminate completely the limitation on tourism allowances. 1/ Upon return to Hungary, a resident

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1/ It should be noted that Hungarian citizens have the right to obtain the tourism allowance without having to prove that this allowance is actually spent abroad. As a result, many citizens acquire the allowance and deposit it in a foreign currency account in the domestic banking system.

traveler must reconvert into forint the convertible currencies that were not spent, except for Ft 4,000 which is generally exempt from the surrender requirement. Restrictions on business travel were lifted at the end of 1993.

No minimum spending or conversion requirement applies to nonresident travelers to Hungary, but they must have a certain amount of money at their disposal to cover anticipated expenditures. Nonresidents may take out of the country foreign exchange assets and economic assets, in addition to their personal effects, without license, provided they registered such assets upon arrival. Nonresident travelers may take out of the country all of the articles purchased in Hungary with forints converted from convertible currency, but proof of conversion may be demanded.

No foreign exchange is made available for study abroad. Students' living expenses and tuition fees must be covered by scholarships or financial support from nonresidents or from convertible currency accounts of the person in question. No foreign exchange is made available for purchase of insurance directly from abroad or for the transfer of pensions. Transfers abroad by nonresident workers in Hungary are determined on the basis of agreements between domestic and foreign institutions or enterprises.

5. Capital account transactions

Under the Central Banking Law approved by the Parliament on December 1, 1991, financial institutions must report all foreign borrowing to the NBH. Foreign borrowing by all other legal entities and the extension of foreign credits by Hungarian banks is subject to approval by the NBH. For non-financial entities, foreign borrowing at interest rates in excess of LIBOR plus 2 percent are generally not permitted. More recently, the approval requirement has been used more as a registration requirement and permission to borrow abroad has been granted more liberally.

While direct investment flows are encouraged, the authorities are cautious about liberalization of the capital account for portfolio flows. Nevertheless, on several occasions foreigners have been allowed to subscribe to specially marked issues of domestic government bonds. The absence of a liquid secondary market in government paper and restrictions on registration and transaction agents for these issues severely limited foreign interest. Outward portfolio investments remain prohibited, however.

6. Bilateral payments agreements

The only remaining operative bilateral payments agreements of Hungary are with Brazil, Ecuador, and the Slovak Republic. The bilateral agreement with the Slovak Republic encourages the use of the two national currencies for noncommercial transactions between residents of the two countries, subject to the exchange control regulations that otherwise apply.

With respect to outstanding balances under inoperative bilateral payments agreements, mostly with former CMEA members and other socialist countries, agreement has been reached in most cases for the settlement of these balances. Hungary was a net debtor only to the GDR, and has agreed on a schedule of payments to settle the outstanding balance in convertible currency by end-1995. Russia, the largest net debtor of Hungary, has agreed to settle the amount owed (US$1.7 billion) by end-1997 through the delivery of goods and services or debt-equity swaps. US$800 million of this amount has been settled through delivery of military equipment in 1993-94.

7. Other restrictions

Hungary continues to maintain payments restrictions against Iraq in accordance with United Nations Resolution 661. On June 3, 1992 and May 6, 1993, the Hungarian authorities imposed restrictions on payments and the provision of financial services to the Federal Republic of Yugoslavia (Serbia/Montenegro) in accordance with United Nations Resolutions 757 and 820, respectively.