COMMISSION OF THE EUROPEAN COMMUNITIES

SEC(91) 1421 final

Brussels, 25 July 1991

REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

ON THE IMPLEMENTATION OF
COUNCIL DECISION 90/83/EEC OF 22.2.1990
PROVIDING MEDIUM-TERM ASSISTANCE FOR HUNGARY

REPORT FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

ON THE IMPLEMENTATION OF
COUNCIL DECISION 90/83/EEC OF 22.2.1990
PROVIDING MEDIUM-TERM ASSISTANCE FOR HUNGARY

1. Introduction

In the fall of 1989 Hungary reached a critical turn in its recent history. The general political and economic situation was in steady evolution : implementation of comprehensive measures of economic reform and liberalisation, opening of frontiers with the West and preparation of the first free election in post-war history (eventually held in April 1990).

The economic situation at the end of 1989 was extremely tense. For several years, the country had been in the process of gradually implementing market-oriented reforms with the support of the IMF and the World Bank. But the sharp deterioration in domestic and external economic and financial performance in the first part of 1989 led to the suspension of IMF support in the summer of 1989. Particularly worrying was the appearance of a large current account deficit (1.4 billion US$), which further strained the already precarious external financial position of the country.

At the Paris Summit in July 1989, the major industrial countries decided to implement a special initiative, to be coordinated by the EC Commission, to assist Hungary and Poland. The Hungarian authorities subsequently asked the European Community to provide supplementary financial assistance aimed at helping the country meet its growing debt servicing burden.

As a result of this request and on a proposal by the Commission, at the end of 1989, the European Council took the decision in principle to grant Hungary a medium-term balance of payments loan to an amount of 870 million ecu. The main condition for the loan was the conclusion of a new stand-by arrangement with the IMF. This positive orientation became a formal decision in February 1990 (Decision 90/83/EEC of 22.2.1990) adopted by the Council after consultation of the European Parliament which delivered its positive opinion. The main elements of the Decision were as follows :

- the Community would grant a medium-term loan to a maximum amount of ecu 870 million in principal, with a maximum duration of five years. The loan would be managed by the Commission in full consultation with the Monetary Committee in a manner consistent with any agreement between the IMF and Hungary (art.1).
- The Commission was empowered to negotiate with the Hungarian authorities the loan terms and conditions. The Commission would verify at regular intervals that the economic policy of Hungary accords with the objectives of the loan and that its conditions are being fulfilled (art.2).
- The loan would be made available in tranches (art.3).
- At least once a year the Commission were to submit to the European Parliament and to the Council a report that would include an evaluation on the implementation of the Council Decision.

In early 1990, before the new free political elections took place, the Hungarian government formulated a programme of economic adjustment and liberalisation that eventually was discussed and approved by the Executive Board of the IMF in March. Following the adoption of the IMF stand-by agreement a Memorandum of Understanding was agreed between the EC Commission and Hungary, in consultation with the Monetary Committee, describing the terms and conditions attaching to the financial assistance that would be provided by the Community. Together with the basic loan agreement, the Memorandum was signed in Brussels at the end of March 1990 by Vice-President Christophersen and Commissioner Van Miert as EC representatives and by Mr. Bekesi, Minister of Finance and Mr. Bartha, Governor of the National Bank as representatives of the Hungarian authorities.

In early April 1990, the first tranche of the loan amounting to 350 million ecu was borrowed by the EC Commission on the international capital markets and disbursed to Hungary. The agreement and conditions attaching to the EC loan were confirmed in June by the new government formed after the completion of free elections.

* *
*

The present report, submitted pursuant to Art.7 of the Council Decision describes the evolution of the economic situation of Hungary in 1990 and early 1991 with particular reference to the implementation of the conditions attaching to the loan, including the disbursement of the second tranche of 260 million ecu in February 1991.

The most recent evolution of the general economic and financial situation of the country is encouraging, despite a number of domestic and external difficulties including a serious drought, the implications of the Gulf crisis, a sharp terms of trade deterioration vis-à-vis the Soviet Union, and a major compression of exports to the Soviet Union. Some reluctance by the banks to extend new credits to the country, particularly in the spring of 1990, have further complicated the situation.

Nevertheless, some positive results have been registered on the external side, with the current account balance (in convertible currencies) recording a surplus of 127 million US$ in 1990 against a deficit in 1989 of about 1.4 billion US$. A surplus was also recorded in the first quarter of 1991. Thanks to this outcome, which was more favourable than initially expected, and to the external support provided on bilateral and multilateral basis by Germany, Japan, EEC, the IMF and the World Bank, Hungary was able to continue to service its external debt and to maintain access to capital markets. There is no doubt that the Community's financial support to Hungary has contributed to preventing a financial crisis in 1989/90, thereby helping to safeguard the country's external creditworthiness. Indirectly, the assistance has thereby contributed to ease the transition towards democracy and the establishment of a market-based economy.

Despite these encouraging signs, however, the difficulties for Hungary have not yet been entirely overcome. While the price liberalisation process and foreign trade re-orientation towards the West is almost completed, Hungary will have to reduce the growing inflationary pressures that have resulted from higher prices on imported energy as well as the reduction of subsidies on basic consumer goods. Hungary also needs to actively pursue its structural reform effort, and especially to speed up the privatisation of the economy. And that the external financial situation remains fragile is illustrated by the decision of the Group of 24 industrial countries to extend additional loans of some US$ 500 million during 1991 (including an additional US$ 250 million from the Community).

2. General economic situation

With the introduction of its first New Economic Mechanism in 1969, Hungary, together with Yugoslavia, has the longest experience among Central and Eastern European countries in the move towards a market economy. The reform process brought about a gradual opening of the Hungarian economy, a fiscal reform (introduction of VAT) as well as some managerial and administrative reforms at enterprise level essentially aimed at introducing a higher degree of autonomy in decision making and increasing efficiency. However, the early reform failed to address some key industrial and more general economic issues including the problems caused by loss-making state enterprises, price liberalisation and reduction of state subsidies to production, consumption and export. These issues were eventually brought to the fore following a steady deterioration of the general economic situation in 1989, particularly illustrated by a growing budget deficit and a sharp deterioration of the balance of payments.

In the event, a series of comprehensive macro-economic adjustment measures and sectoral reforms were adopted in 1990, with external financial support of the IMF and the World Bank. In particular, in March 1990 the IMF adopted a 12 months stand-by arrangement with Hungary to an amount of 170 million US$. The policy programme underlying this arrangement was designed mainly to contain growing inflationary pressures (through restrictive monetary and credit policies), to reduce the budget deficit (through a fiscal reform and the abolition of subsidies), to liberalise prices, and to initiate the privatisation of state-owned enterprises.

Although the stabilization and adjustment process in 1990 was carried out by the political coalition in a particularly difficult domestic and external environment, the first results have been encouraging. Nevertheless, the economic and social situation remains difficult due to a sharp fall in real incomes, rising unemployment and continuing inflationary pressures.

1) Output and demand

Real GDP is estimated to have declined in 1990 by 4.6%, a little less than earlier feared. This figure, however, does not take into account the impact of the newly established and emerging private sector for which no reliable statistical data are so far available. Activity in the industrial sector, which accounts for 43% of GDP and 38% of employment, registered a substantial decline. The recession decline in production was felt by the large state-owned enterprises which still account for almost 90% of industrial output.

The agricultural sector, which represents 21% of GDP and 19% of employment, also plunged into deep recession last year. The sector was badly hit by the most severe drought in recent years but also by the lack of investment, insufficient marketing and shortages of inputs. Still unresolved problems of land ownership and privatization negatively affected both output and productivity.

Activity in services (36% of GDP and 42% of employment) declined only moderately in 1990. Tourism and some transport activities showed an encouraging positive trend.

Private consumption contracted sharply in 1990 (estimated decline of 5-6%) as a direct consequence of the erosion of real incomes of about 5%. Gross fixed investment also fell (-4.8%)

with the investment/GDP ratio down from 26.4% in 1989 to 24.8% in 1990. A further decline in both consumption and investment is foreseen in 1991.

Despite a restrictive monetary and credit policy the average inflation rate in 1990 (consumer price index) reached to about 30%. The high inflation rate can be explained by a large number of transitory factors including cuts in subsidies; increases in duties; adjustment of domestic petroleum prices to world market levels; the impact of the drought on agricultural prices; and by the domestic impact of the devaluation of the forint.

Although employment in the private sector is in steady expansion, unemployment is rising at a pace faster than earlier expected, which risks creating social tensions in the near future, particularly in view of the scope of the country's provisions. The statistics in this area are somewhat misleading, however. While the number of unemployed people was still only some 100,000 (2% of the total workforce) by the end of 1991, this official figure does not take into consideration concealed unemployment concentrated in particular in agriculture and state enterprises.

2) Budget and monetary policies

Corrective budgetary measures were taken by the government in July 1990, aimed at reversing emerging slippages so as to comply with the requirements under the IMF stand-by arrangement. As a result, the consolidated 1990 budget deficit was contained at 8.0 bn forints (0.4% of the GDP) as compared with a deficit of 14.3 bn forints in 1989 (0.8% of GDP).

On the revenue side receipts were influenced by important carryovers from 1989 of tax payments by financial institutions. Personal income taxes and social security contributions substantially increased in 1990 against the previous year, reflecting fiscal measures to reduce consumption and imports. Revenue from indirect taxation and from taxes on the imports of luxury goods expanded moderately too.

On the expenditure side the government introduced significant cuts in outlays on administration, defence, and subsidies towards social expenditure (health care, pension system, family allowances etc.). The responsibility for the social assistance programmes was transferred from central to local authorities. The cut in social expenditures of the central authorities, however, was more than compensated by a sharp increase in outlays under the Employment Fund (administering unemployment insurance, retraining and job placement support) and the Social Security Fund. These two Funds constitute the core of a social safety net that is being set up to protect the most exposed segments of the population during the phase of economic transition and sectoral restructuring. State financing to enterprises has been virtually eliminated, leaving only infrastructure financing, which appears to have remained unchanged in real terms.

The cautious fiscal stance was supported by a restrictive monetary and credit policy aimed at containing the inflationary consequences of external price increases and domestic price reform. The implementation of this policy was delegated to the National Bank of Hungary, which made effective use of traditional instruments of monetary and liquidity control. In 1990 net domestic assets expanded by about 10%, in line with the commitment under the IMF arrangement. However, other monetary aggregates registered faster growth. For example, by the end of 1990 broad money showed an expansion of 29.3% vis-à-vis the last quarter of the previous year. Issuance of government bonds and saving notes also increased substantially (+39.7%) reflecting the growing use by the Government of market instruments to finance public borrowing requirements.

In 1990 the government continued to adjust the external value of the forint with the aim of reducing the differential between domestic and foreign rates of inflation. In March 1990 the forint was devalued by 15%; another devaluation of 15% was carried out in

January 1991. The gap between the official and parallel market exchange rate of forint was reduced from about 40% in 1989 to some 15% by the end of 1990.

3) Trade and current account

Even though Hungary's total external trade fell in 1990 by some 5 to 6% substantial progress was registered in the restructuring of trade from COMECON (and the USSR in particular) to western markets. The foreign trade reorientation reflected the Government's policy to encourage enterprises to restrict their trade relations with former COMECON partners, and the ability of Hungarian products to penetrate EC markets, in particular.

As a result of these trends, Hungarian exports to Comecon countries fell by 27% in volume terms between 1989 and 1990 and imports from the same group decreased by 20%. For the first time in many years rouble trade was almost balanced in 1990. At the same time, exports in convertible currency rose by 14-15% in volume and imports increased by 4%. The share of trade with western economies rose from 50% in 1989 to 60% in 1990. This significant result has been achieved notwithstanding the rise in oil prices (paid to the USSR mainly) in the second half of 1990.

The trade balance in convertible currency recorded a surplus of 348 million US$ in 1990. Owing essentially to a favourable tourism balance and despite increased interest payments the current Account in convertible currency showed a small surplus of 127 million US$, which implies a striking turnaround from a deficit of 1.4 bn US$ in 1989. This improvement corresponds to 4.4% of GDP.

During 1990, Hungary experienced significant short-term capital outflows related to domestic uncertainties as well as to banks' uneasiness over the general outlook for Eastern Europe (and the USSR). Indeed, the country experienced considerable difficulties in concluding some medium term borrowing operations with western banks that became increasingly reluctant to increase their exposure in Central and Eastern Europe. As a result, foreign exchange reserves decreased further in 1990 to about 1.1 bn US$, the equivalent of only 2 months convertible currency imports. Notwithstanding these difficulties, the Hungarian authorities have continued to promptly service the country's external obligations and they have maintained good relations with western commercial banks.

At the end of 1990, the <u>external debt</u> stood at some 21.8 bn US$, implying a debt/GDP ratio of about 76% and a debt service ratio (in convertible currency) of 57% (55.4% in 1989).

3. <u>Status of reform process</u>

Main aspects of the reform process currently being implemented include the following:

<u>Economic programme</u>

In September 1990 the government issued a three-years "Economic Programme of National Renewal". This programme, which was revised in early 1991 and adopted by the Hungarian Parliament in March as a "Programme of Conversion and Development for the Hungarian economy - stabilization and convertibility", was endorsed by the IMF in the form of an extended Fund arrangement.

With the adoption of this document the government commits itself to the establishment of a <u>social market economy</u>. Structural changes, macro-economic stabilization and anti-inflation policies will be associated with appropriate employment and retraining policies as well as with the establishment of a social safety net to protect those segments of the population most affected by the transformation process.

<u>The re-orientation</u> of foreign trade will continue with the aim of reducing the country's heavy dependence on energy imports from one major single source and developing new markets for Hungarian products.

A national privatization strategy will be implemented following a new legislative framework on ownership and compensation. The process of deregulating the economy will continue with a view to further stimulating the private initiative and entrepreneurial spirit and to attracting foreign direct investment.

Fiscal reform and budget policy

The redistributive role of the central budget was substantially reduced in 1990. At the same time greater fiscal discipline and new tax rules were introduced.

The budget for 1991 (and agreed with the IMF) foresees a deficit corresponding to 1.5% of GDP. To achieve this target the government is committed to reducing subsidies (subsidies for consumer goods, investment and housing were reduced from 13.2% of GDP in 1989 to 9% of GDP in 1990 and are expected to be reduced to no more than 7% in 1991). Additional reductions are foreseen in government transfers for tourism, regional development and social organisations. A system of fiscal monitoring to better control developments in public expenditure and revenues is being set up. The social welfare system has been partly revised to accommodate self-supporting mechanisms, including a social safety net.

Monetary and credit policy

Domestic credit expanded moderately in 1990 and became more selective with the aim of assisting in particular the newly established small and medium-scale enterprises. In 1991, a firm monetary policy will continue to be pursued to contain the potential inflationary consequences of price reform and to safeguard the stability of the forint. Open market financial instruments were introduced in 1990 and will be further developed in 1991.

Further steps towards convertibility of the forint are being considered (in practice the forint is already quasi convertible for most commercial transactions). A restructuring of the

International currency basket to which the forint is pegged is under discussion in order to better reflect the growing role of European currencies in Hungary's international transactions.

Trade system

Despite efforts to liberalise, Hungary has maintained some degree of restriction on foreign trade. Until recently imports of some goods have continued to require joint import/foreign exchange licenses. The availability of foreign exchange for services and transfers was also subject to restrictions. Nevertheless, in 1990 it was estimated that more than 70% of imports from the convertible currency area were free of trade and exchange restrictions.

In 1991 further import liberalization is foreseen, to achieve a target of 87% that would not be subject to restrictions. The liberalization will concentrate on commodities, raw materials, capital goods and manufactured items which may allow energy savings and may contribute to the protection of the environment.

Price liberalisation

As of January 1991 the degree of price liberalisation applied to almost 90% of turnover of consumer goods as compared with 77% in January 1990.

Banking reform and security market development

A two-tier banking system was established in Hungary in 1987. About 30 new commercial banks have been granted permission to be established so far. Some foreign banks have also been authorised to start up joint ventures in Hungary or to open representative offices in Budapest. A bill on the new role of National Bank of Hungary as an autonomous body accountable only to the Parliament is being discussed for possible adoption in 1991. A new role of commercial banks in foreign exchange transactions as well as new prudential regulations are being considered in the framework of a foreign exchange decentralization policy whose first phase started in the first quarter of 1990.

A Bank Association, a Bankers Training Centre and a Clearing Centre have also been set up in 1990. A security market law was approved in January 1990, which eventually led to the formal opening of a Stock Exchange mid-1990. However, the number and value of securities traded was limited in 1990.

Privatisation

The privatisation programme is managed by the State Property Agency, established in March 1990, with the aims of managing the state assets that have been either "corporatized" or partially privatised; implementing the government's privatization programme; and achieving a satisfactory degree of transparency to the operators. The government's privatization strategy consists of five major components:

- active privatization programme
- enterprise-initiated privatization
- buyer-initiated privatization
- small privatization (pre-privatizations)
- privatisation of smaller enterprises.

Two active privatization programmes have been launched on a pilot basis in 1990 concerning two groups of 20 state companies each. An additional five programmes are foreseen in 1991. Under the enterprise initiated programme some 200 state enterprises have been transformed into joint ventures in 1990. Further initiatives in this field are foreseen also in 1991.

The third type of privatization seen less progress so far. However, in 1991 some 100 State companies are expected to be privatized in this way. Small privatization through open auctions is also under way particularly in the small-scale service sector. As regards the privatisation of smaller enterprises, Hungarian authorities are putting in place the necessary legislation.

The government's medium term goal is to reduce the public sector's share of the economy by at least 50% of the total assets of the competitive sector of the economy by 1994.

4. <u>Review of performance criteria and structural indicators attached to the EC Memorandum of Understanding</u>

1. <u>Performance criteria</u>

A Memorandum of Understanding was signed in March 1990 between EC Commission and Hungary describing the terms and conditions attaching to the EC medium-term loan. The Memorandum, which was agreed after consultation with the Monetary Committee, foresees the periodical monitoring of an agreed set of five performance criteria (Annex 1) as well as a number of structural economic and sectoral indicators (Annex 2). The results achieved by the Hungarian authorities have so far been broadly in compliance with the commitments undertaken taken in the Memorandum. In particular, the current account performance in 1990 has been better than initially expected and the performance with respect to referring to external reserves, the total amount of external financing obtained from private creditors during the year under consideration, price liberalisation achievements as well as the subsidy/GDP ratio have been in line with targets.

Performance with respect to the structural adjustment indicators can also be considered as broadly satisfactory. A relatively rapid process of transformation of state owned enterprises into joint stock or limited liability companies has been implemented in 1990, in preparation for their subsequent privatisation. Figures referring to the number of newly established joint ventures and small and medium-sized enterprises show a positive trend. The growing number of companies engaged in retail trade reflects the first positive impact of the pre-privatisation programme started in 1990.

Finally, information on bankruptcy and liquidation procedures started in 1990 or completed during 1990 illustrates progress on the micro-economic transformation process.

ANNEX 1

EC MEDIUM TERM LOAN TO HUNGARY

Performance criteria

	1990 Target (January 1990)	Achievement (end 1990)	Comment
1. Current Account (Convertible currency)	- 550 mill. US$	+ 127 mill. US$	Result better than foreseen
2. Reserves (- = increases)	- 1900 mill. US$	- 1338 mill. US$	The condition that the net reserve position should improve by at least 4[illegible]0 million US$ is met.
3. Participation of private creditor banks			
. issue of bonds	1000 mill. US$	994 mill. US$	The amount of the borrowing programme has been slightly lower than targeted. However the condition is broadly fulfilled
. trade finance	300 mill. US$	250 mill. US$	
. bank-to-bank and syndicated loans	300 mill. US$	200 mill. US$	
4. Price liberalization	77% of consumer prices	about 80% on average*)	The condition is broadly fulfilled (the trend towards a further liberalization continues).
5. Subsidies/GDP ratio	9%	9%	The condition is fulfilled.

Source: National Bank of Hungary

(*) In November 1990 with a new Pricing Act a futher round of price liberalization has been introduced which will reduce official price fixing to some 10% of consumer and producer prices in 1991.

ANNEX 2

EC MEDIUM-TERM LOAN TO HUNGARY
Structural adjustment indicators

1. Number of public sector enterprises and cooperatives (economic organizations) which have been transformed into joint stock or limited liability companies (as of 31.12.90).

A. Joint stock companies : 646

of which :

. industry	217
. internal trade	133
. economic services	121
. external trade	50
. construction	50
. social services	23

B. Limited liability companies : 18,317

of which:

. Internal trade	5408
. Industry	4670
. Construction	2608
. Economic services	1684
. External trade	1103
. Transport	575

As of beginning of 1989 the total number of joint stock and limited liability companies was 10.811. At the beginning of 1990 the number totalled 15.235.

2. Number of enterprises (end of 1990)

. Less than 50 persons	16465
. 20-50 persons	4129
. 50-300 persons	4469
. Over 300 persons	2599
Total	27662

3. Total number of joint ventures with foreign partners

During the first 12 months of 1990 some 3814 joint ventures were established in Hungary with the following breakdown:

- Companies founded by firms from exclusively convertible area	230
- Companies founded by Hungarian firms and by firms from convertible area	3539
- Companies founded by firms from non-convertible area	12
- Companies founded by firms from convertible area, from non-convertible are and from Hungary	33
Total	3814

As of end of 1990 the total (cumulative) number of joint ventures with foreign partners established in Hungary totalled about 5000.

As of end of 1990 the total (cumulative) initial capital invested in Hungary by these companies amounted to 70.8 bn forints equivalent to about 980 million US$ (the initial capital in foreign exchange was 5.3 bn forints equivalent to about 350 million US$).

4. Number of private enterprises engaged in retail trade (end of 1990): 77.280 (66.680 as of end of 1989)

Under the pre-privatization programme starting from 1.1.1991 all catering establishments with less than 15 employees and retail shops with less than 10 employees are offered for sale through auction. The number of establishments which qualify for the programme is estimated to be 10,000.

5. <u>Number of companies entering bankruptcy or liquidation procedures</u>:
   - applications received (Jan-Dec 1990) : 630
   - total liquidation procedures underway (31.12.1990) : 782
   - number of companies effectively gone bankrupt or liquidated (Jan-Dec 1990): 206

6. <u>Number and value of procurement contracts awarded</u> after competitive bidding in 1990 : no reliable statistical information is available.

7. <u>Number of telephone lines in operation as of end of 1990</u>

   (total of main stations and extensions) : 1,871.600 (1,769.900 as of end of 1989)