COMMISSION OF THE EUROPEAN COMMUNITIES

COM(91) 83 final

Brussels, 26 March 1991

Proposal for a

COUNCIL DECISION

providing further medium-term financial assistance
for Hungary

(presented by the Commission)

EXPLANATORY MEMORANDUM

The request for additional financial support

During the past two years Hungary made substantial progress in implementing a comprehensive adjustment and reform programme aimed at replacing central planning with market based mechanisms.

In March 1990, in support of this programme the International Monetary Fund agreed on a 12-month stand-by arrangement. Following this, the European Community decided to grant Hungary a medium-term balance of payments loan of ecu 870 million. The first tranche of this loan was disbursed in April 1990 and the second in February 1991. During 1990 some members of the Group of Twenty-Four (G-24) made commitments for additional financial support including a US$200 million World Bank cofinancing arrangement from Japan and short-term credit and bridge loan facilities from Germany and the Bank for International Settlements.

Notwithstanding encouraging progress towards adjustment and reform in 1990, Hungary's financial situation remains fragile in 1991 when the country will be faced with a number of major external shocks including the reform of trade prices within the COMECON area, the partial breakdown of trade relations with other COMECON partners and the impact of Gulf crisis. As a result, the financing requirement is expected to increase considerably.

To meet the increase in its financing requirement, Hungary has requested further assistance from the IMF in the form of an Extended Fund Arrangement (EFF) as well as access under the oil excess window of the Fund's Compensatory and Contingency Financing Facility. The agreement on the latter was reached in January 1991 and the EFF was approved by the Fund's Executive Board on 20.2.91.

However, barring any significant increase in net private flows to Hungary, the envisaged assistance from the Fund will not be sufficient to cover the financing needs. Although direct investment inflows and banks make it difficult to envisage any substantial increase in bank lending. Accordingly, to help cover its overall financing requirement and enable it to maintain the policy of remaining current on its external obligations, Hungary has submitted a request for complementary financial assistance from the Community and the Group of Twenty-Four. The need for such assistance has been assessed by the Commission Services in close cooperation with the staff of the IMF and is estimated at some US$ 500 million.

The Ecofin Council of January 28 agreed in principle on the Community's participation, up to an amount of 50% ($250 million) of a G-24 effort to assist Hungary. On this basis the Commission has initiated discussions with non-EEC G-24 and other third countries with a view to ensuring the mobilisation of the overall amount. Some non-EEC G-24 members have already made firm pledges; most others have revealed a positive attitude towards participation in the support scheme, but are not yet in a position to commit themselves. It is expected that they will announce their final commitments during the next few weeks.

<u>The Hungarian reform process</u>

In September 1990 the government issued its "Economic Programme of National Renewal". This programme, which outlines the broad framework of the medium-term economic and administrative reform process, is now in the process of implementation.

In particular, greater fiscal discipline and new tax rules are being introduced. The tax base and tax rate have been modified in the framework of the revised budgetary policy in vigor since mid-1990 to help meet requirements under last year's stand-by arrangement with the IMF. The budget proposed by the government for 1991 foresees a deficit corresponding to 1.5 percent of GDP as compared with an estimated outcome of 0.7 percent of GPD in 1990. To achieve this target the government is committed to cutting subsidies and reducing government transfers for tourism, regional development and social organisations. A system of monitoring to better control developments in public expenditure an revenues will be set up in 1991.

As regards price regime as of January 1991 almost 90 percent of consumer goods will be fully liberalised as compared with 80 percent in January 1990. A tight monetary and credit policy will continue to be pursued to contain the potential inflationary consequences of price reform.

Further steps towards current account convertibility for 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.

Hungary still maintains some degree of restriction on foreign trade. Imports of some goods continue to require joint import/foreign exchange licenses. The availability of foreign exchange for services and transfers is also subject to restrictions; a 87 percent tranche liberalisation target for 1991 was recently approved in the framework of the three year Economic Programme.

Reform in banking will proceed in 1991. About thirty 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. A bill on the new role of National Bank of Hungary as an autonomous body accountable only to the Parliament is being discussed for adoption in 1991.

At enterprise level privatisation programme involving 20 large state companies was completed in 1990. At the end of the year a second phase of the programme was initiated concerning another 20 medium-sized state companies with plans to process another 100 in five programmes during 1991 with an estimated book volume of about 100 bn forints. In addition, a programme to transfer the ownership of a large number of retail and service outlets is under way. The privatisation programme is managed by the State Property Agency, which has the goal of cutting the public sector's share of the economy to 40 percent by 1995 from around 85 percent at present.

In addition some 5000 new joint ventures have been established so far, many of them fully owned by non residents. Their total capitalisation is about 1 bn US$. Incentives are offered to non residents include full repatriation of profits.

The need for additional financial support

Notwithstanding a projected further increase in exports to Western markets, the current account is expected to deteriorate sharply in 1991 due to the exceptional combination of negative shocks mentioned above. The IMF's latest estimates point to a (consolidated) current account deficit of $1200 million in 1991. This projection incorporates measures under the government's current policy programme aimed at offsetting roughly half of the balance of payments impact of the new shocks, in addition to maintaining the adjustment achieved already in 1990.

Hungary continues also to face a large debt servicing burden and a considerable need for refinancing. Thus, with scheduled amortisation payments amounting to $2.4 billion in 1991 and allowing for a minimum build up of foreign exchange reserves and a need to increase Hungary's export credits, the total gross financing requirements for 1991 amount to $4.3 billion.

It is assumed that Hungary's private borrowing ($1.5 billion) will continue to be largely based on borrowing from capital markets, which are expected to remain a more important source of new credit than commercial banks. Official lending already committed includes the second tranche of the Community's medium term loan approved in early 1990 (and disbursed in February 1991), a World Bank structural adjustment loan, Japan's cofinancing of the World Bank and project financing from the European Investment Bank. Direct investment inflows are also expected to increase somewhat. In addition, it is assumed that Hungary will be able to draw on some of its outstanding claims on the Soviet Union (may be as much as 200 million US$) stemming from accumulated transferable ruble surpluses from recent years as payment for imports of oil and raw materials.

With the IMF's assistance to Hungary expected to reach some US$ 1.4 billion in 1991 (about 300 million under the Compensatory and Contingency Facility and about 1.1 billion under a new 3-year Extended Fund Arrangement approved by the Executive Board on 20 February 1991) the remaining financing gap to be covered through new official lending amounts to some $500 million (see table below).

Hungary : External financing requirement in 1991
(estimates in US$ million)

	Current account deficit	-1200
	Debt amortisation	-2400
	Build up of reserves (- = increase)	- 700
I.	Total gross financing requirement	-4300
	Private borrowing	+1500
	Borrowing from official sources already committed	+ 900
	IMF facilities	+1400
II.	Total capital inflows	+3800
III.	Residual financing gap (I + II)	- 500

Given the significant degree of adjustment already achieved in 1990 and the additional adjustment envisaged by Hungary under the new Policy Programme the Commission considers any further import compression that would be required to close the financing gap in the absence of Community and G-24 support could seriously jeopardize the achievements of the policy objectives underlying the government's reform effort.

This further and additional financial assistance in 1991 from the Commission and the Group of Twenty Four is specifically aimed at helping Hungary to overcome in 1991 the negative impact on its Balance of Payments of some exceptional external shocks largely unforeseen only few months ago. In this respect this loan, which has the nature and takes the form of a Balance of Payment support, has a different nature from the previous one approved by the Commission in early 1990 with the aim to overcome the difficulties of structural adjustment of the Hungarian economy. Therefore these two forms of financial support should be seen as complementary and not as substitutes.

Main features of the loan

The Commission is proposing that the Community should grant Hungary a new medium-term loan for 1991 at a maximum amount of ecu 180 million to help the country face a number of adverse external shocks that were not taken into account when the Community's ecu 870 million medium-term loan was approved in early 1990.

The loan the Commission is envisaging would be closely linked to the IMF Extended Financing Facility Arrangement and would be disbursed in two tranches, the first tranche being subject to approval of the IMF Arrangement, the second one -- which is to be disbursed in the third or fourth quarter of the year - subject to compliance with a number of performance criteria which are to be discussed with the Hungarian government in consultation with the Monetary Committee.

The Community would provide the funds through market borrowing with a guarantee by the Community budget; Hungary would subsequently borrow from the Community. The borrowing and lending operations will be perfectly matched and without any commercial risk for the Community.

II

(Preparatory Acts)

COMMISSION

Proposal for a Council Decision providing further medium-term financial assistance for Hungary

(91/C 97/07)

COM(91) 83 final

(Submitted by the Commission on 20 March 1991)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 235 thereof,

Having regard to the proposal from the Commission submitted following consultation with the Monetary Committee,

Having regard to the opinion of the European Parliament,

Whereas Hungary is undertaking fundamental political and economic reforms and has decided to adopt a market economy model;

Whereas the said reforms are already under implementation with the financial support from the Community and will strengthen mutual confidence and bring Hungary closer to the Community;

Whereas Hungary and the Community have entered into negotiations for the conclusion of Europe Agreements establishing a relationship of association;

Whereas by Decision 90/83/EEC (1) the Council decided to grant to Hungary a medium-term loan facility of a maximum amount of ECU 870 million in order to permit that country to overcome the difficulties of structural adjustment of its economy;

Whereas, however, following the changes in the international environment, Hungary, like other Central and Eastern European countries, is now facing additional external shocks which might jeopardize its financial stability and cause its balance of payments to deteriorate sharply;

Whereas the Hungarian authorities have requested financial assistance from the International Monetary Fund (IMF), the G-24 and the European Community, and whereas, over and above the estimated financing which could be provided by the IMF, the World Bank and official bilateral creditors, a financial gap of some ECU 360 million remains to be covered in 1991, in order to prevent a further erosion of Hungary's reserve position and avoid an additional degree of import compression which could seriously jeopardize the achievement of the policy objectives underlying the government's reform effort;

Whereas the Commission as coordinator of assistance from the Group of 24 industrial countries has invited them and other third countries to provide medium-term financial assistance to Hungary as an appropriate measure to support the balance of payments and to strengthen the country's reserve position;

Whereas the Community loan should be managed by the Commission;

Whereas the Treaty does not provide, for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS:

Article 1

1. The Community shall grant to Hungary a medium-term loan facility of a maximum amount of ECU 180 million in principal, with a maximum average duration of seven years, with a view to ensuring a sustainable balance-of-payments situation and strengthening the reserve position.

2. To this end the Commission is empowered to borrow, on behalf of the European Economic Community, the necessary resources that will be placed at the disposal of Hungary in the form of a loan.

(1) OJ No L 58, 7. 3. 1990, p. 7.

3. This loan will be managed by the Commission in full consultation with the Monetary Committee and in a manner consistent with any Agreement reached between the IMF and Hungary.

Article 2

1. The Commission is empowered to negotiate with the Hungarian authorities, after consultation with the Monetary Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreements referred to in the third paragraph of Article 1 and with arrangements made by the G-24.

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close coordination with the G-24 and the IMF, that the economic policy in Hungary is in accordance with the objectives of this loan and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to Hungary in two instalments. The first instalment shall be released as soon as an Extended Arrangement has been concluded between Hungary and the IMF and the second instalment after a period of at least two quarters subject to the provisions of Article 2 (2).

2. The funds shall be paid to the National Bank of Hungary.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest-rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Hungary so decides, to include in the loan conditions, and also to exercise, an early repayment clause.

3. At the request of Hungary, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average duration of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Hungary.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

FINANCIAL RECORD

1. Budget line concerned

Article (BO-2102) loan guarantee for aid to Hungary (to be created through an amending and/or supplementary Budget).

2. References (legal base)

Article 235 of the Treaty

3. Classification of the Expenditure

Obligatory

4. Description and Justification for the action

a) Description of the action

Provision of a guarantee from the Community for a loan to Hungary in view of supporting its balance of payments and strengthening the country's reserve position.

b) Justification for the action

- The G24 and the Council of the EEC have endorsed the principle of providing assistance in response to a request from Hungary.

- The budget entry is intended to provide a budgetary support for guarantee offered by the European Community to cover a loan extended to Hungary.

5. Nature of the expenditure and method of calculation

a) Nature of the expenditure

A guarantee to a loan to Hungary.

b) Method of calculation

A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

6. Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at Brussels,

For the Council
The President

7. <u>Financing of intervention expenditure</u>

- Endowment of the line by transfer, by reutilisation of reimbursed amounts (Article 27(3) of the Financial Regulation of 1977), or by amended and/or supplementary budget.

- In order to fulfill its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, Euratom) no. 1522/89 of 29.5.1989 will apply.

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