

## I. THE ECONOMIC ENVIRONMENT

### (1) BACKGROUND

1. Hungary was the first of the former CMEA (COMECON) countries to begin broad economic reforms, as early as 1968, however, its active transition to a market economy began in 1988. That year marked the establishment of the right of all companies and private persons to engage in trade with the convertible currency area, the adoption of legislation on foreign direct investment (FDI) guaranteeing investment protection and providing investment incentives, and the introduction of comprehensive price and tax reforms, including introduction of a VAT and personal income tax. Building on these and other measures, in 1990 the newly elected Government launched its Programme for National Renewal, the key objectives of which were macroeconomic stabilization and structural adjustment aimed at transforming Hungary into a market economy.<sup>1</sup>

2. The Programme included a fiscal austerity package designed to reduce a rising budget deficit, measures to contain Hungary's large and growing foreign debt, and a tight monetary policy to check inflation. Among the main structural features of the Programme were greater currency convertibility, the further opening of the economy to international trade (*inter alia* through reduction in the scope of import licensing) and intensification of links with western Europe, together with new legislation designed to facilitate FDI, a radical privatization programme, and additional price and wage liberalization. Other reforms included major changes in company law, the establishment of a stock exchange and the adoption of a new competition law. Moreover, the reduction of subsidies and the process of deregulation were accelerated. These reforms were supplemented by social policies designed to alleviate the heavy unemployment initially associated with structural adjustment and facilitate the restructuring of the Hungarian economy.

3. Following the collapse of trade with former CMEA members, one of the most striking features of Hungary's structural adjustment during the period under review has been the continuing shift in trade to more advanced industrialized countries, particularly EU members, and CEFTA partners. Clearly, this re-orientation has been greatly facilitated by the Europe Agreement and the creation of the CEFTA as well as by the WTO Agreements. Other important features of Hungary's structural adjustment have been the liquidation of a large number of companies owing to the implementation of a strict bankruptcy law, large-scale privatization of state-owned enterprises and a prominent role for foreign direct investment, not just in privatization but in the transition process generally. Privatization, together with much reduced levels of subsidization, has greatly reduced the intrusiveness of the Government in economic decisions.

4. Among the principal macroeconomic developments at the beginning of the period under review was a marked deterioration in overall economic performance, notably a 15% decline in real GDP during the period 1991-93, as well as high inflation and rising unemployment. Another major development was the emergence of large and rapidly increasing budget and current account deficits. However, the introduction of a major stabilization package in March 1995 appears to have restored macroeconomic balance, paving the way for sustained improvements in Hungary's economic performance.

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<sup>1</sup> GATT (1991).

**(2) MACROECONOMIC DEVELOPMENTS**

5. The Programme for National Renewal notwithstanding, among the most noteworthy developments since the previous Trade Policy Review in 1991 was the sharp initial deterioration in Hungary's macroeconomic performance (Table I.1). Real GDP shrank by a cumulative amount of roughly 15% during the period 1991-93, before growing by 2.9% in 1994. Real domestic demand also declined in 1991-92, before growing by 9.9% and 2.2% in 1993 and 1994, largely associated with a surge in imports. At the same time, although on the decline, the rate of inflation remained within the range of 20-30%, which may well have contributed to Hungary's poor output performance.<sup>2</sup> In addition, officially registered unemployment rose from 7.5% in 1991 to over 12% in 1993, before falling to 10.4% in 1994.

6. Another major macroeconomic development was the emergence of a large and rapidly increasing budget deficit. By 1994, the consolidated government deficit (excluding privatization receipts) reached 8.4% of GDP. This development too may have adversely affected output. By contributing to the gap between gross national saving and gross investment, which had greatly widened in 1993-1994 owing to the decline in gross national saving and rise in gross investment as a percentage of GDP,<sup>3</sup> the rise in the budget deficit also resulted in a seriously deteriorating current account deficit, which rose to over 9% of GDP in 1994. At the same time, gross government debt was in the range of 85-90% of GDP while net external debt was around 46% of GDP. In early 1995, therefore, the Hungarian economy appeared to be on the brink of a debt trap, which threatened to result in rising net domestic and foreign indebtedness as a proportion of GDP as interest payments on government debt outstripped government revenues.

7. Faced with this prospect, the Hungarian Government introduced a major stabilization package in March 1995. The package contained several macroeconomic elements, including a 9% devaluation of the Hungarian forint (Ft) and the establishment of a crawling peg exchange rate regime, cuts in government consumption, and wage restraint, particularly in the public sector. At the same time, a temporary import surcharge was imposed; the surcharge, initially set at 8% from March 1995, was reduced progressively during 1996 and phased out by 1 July 1997.<sup>4</sup> This package - which brought about a marked shift of resources from the domestic to the export sector on the supply side, together with a sharp reduction in domestic demand - constituted an important turning point in Hungary's macroeconomic policy during the period under review.

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<sup>2</sup> According to Sarel (1996), slow progress in reducing inflation could have reduced Hungary's growth rate by two percentage points.

<sup>3</sup> The household saving rate increased sharply at the beginning of the transition period in 1990-91, thereby partially cushioning the economy from the decline in saving elsewhere, notably by enterprises. This increase in household saving was due to the rise in the share of income going to households as wage indexation and increased social welfare contributions by employers eroded business profits. High household saving during this period may also have been in response to inflation and associated capital losses on the stock of private wealth. After 1991, however, the household saving rate halved within a two-year period before rebounding somewhat in 1994. This drop was a key factor contributing to the deterioration in the aggregate saving-investment balance in period 1993-94. (See European Bank for Reconstruction and Development (1996), p. 82).

<sup>4</sup> This measure was notified to, and discussed in, the WTO Balance-of-Payments Committee (documents WT/BOP/R/3, WT/BOP/R/17 and WT/BOP/R/23). Hungary's reserves at end-1994 were estimated at around seven months of imports in convertible currencies, on a rising trend. The BOP Committee, in September 1996, concluded that there was no longer an "imminent threat of a serious decline in the level of Hungary's monetary reserves" (WT/BOP/R/17, paragraph 11).

**Table I.1**  
**Selected macroeconomic indicators, 1991-97**

	1991	1992	1993	1994	1995	1996	1997
Real economy (% change)							
Real GDP	-11.9	-3.1	-0.6	2.9	1.5	1.0	3.5
Real domestic demand	-9.1	-3.6	9.9	2.2	-3.8	-0.8	2.9
Of which: Private consumption	5.6	0.0	1.9	-0.2	-5.7	-2.2	-2.0
Gross fixed investment	-10.4	-2.6	2.0	12.5	1.2	-1.0	12.0
Exports (real) of goods and services	-13.9	2.1	-10.1	13.7	15.4	12.3	9.9
Imports (real) of goods and services <sup>a</sup>	-6.1	0.2	18.6	8.8	-0.7	6.6	9.3
CPI (end-year)	31.0	24.7	21.1	21.2	28.3	19.8	18.2
GDP deflator	26.0	21.5	24.2	19.5	24.2	20.9	17.1
Employment	-3.2	-10.6	-10.2	-5.2	-2.3	-1.8	..
Unemployment rate (end-year, in % of labour force)	7.5	12.3	12.1	10.4	10.4	10.5	..
Public finance (% of GDP) <sup>b</sup>							
Consolidated government balance <sup>c</sup>	-3.0	-6.2	-6.2	-7.6	-3.5	-0.8	-1.8
(Excluding privatization receipts) <sup>c</sup>	-3.0	-7.0	-6.5	-8.4	-6.6	-3.1	-4.6
Primary balance, excluding privatization <sup>d</sup>	2.9	-2.6	-2.9	-2.7	1.7	4.3	3.6
Public debt (central government)	74.1	78.5	89.7	87.1	85.2	72.4	66.2
Money and credit (end of year, % change) <sup>e</sup>							
Domestic credit	8.0	10.3	16.8	16.2	-0.8	28.3	..
Broad money (M2)	29.4	27.3	16.8	13.0	18.5	20.9	19.8
M3	35.9	27.6	15.3	13.0	20.2	22.1	17.6
Interest rate (90-day treasury bill level, end-year)	36.6	15.5	26.6	35.6	33.7	23.5	..
Gross national savings <sup>f</sup>	18.1	15.3	10.6	14.4	20.4	22.4	23.4
Gross investment <sup>f</sup>	20.5	16.1	20.0	22.2	24.1	24.5	25.4
Trade (% of GDP)							
Exports of goods and services	32.6	31.4	26.4	28.9	34.4	39.8	..
Imports of goods and services <sup>a</sup>	33.7	31.7	34.6	35.4	36.6	41.0	..
Balance-of-payments							
Current account (% of GDP) <sup>f</sup>	0.8	0.9	-9.0	-9.5	-5.6	-3.8	-3.7
(US\$ billion)	0.3	0.3	-3.5	-3.9	-2.5	-1.7	-1.7
Reserves in convertible currencies							
(National valuation of gold, US\$ billion)	4.0	4.4	6.7	6.8	12.0	9.8	9.1
(In months of merchandise imports)	5.2	5.2	7.1	7.2	9.4	7.0	5.6
Foreign direct investment (net) in US\$ billion	1.5	1.5	2.3	1.1	4.5	2.0	2.0
Gross external debt in convertible currencies (end-year)							
In % of GDP	68.0	57.7	63.8	68.9	71.2	62.4	57.9
In US\$ billion	22.7	21.4	24.6	28.5	31.7	27.6	26.5
Net external debt in convertible currencies (end-year)							
In % of GDP	43.7	35.1	38.8	45.8	36.8	32.2	30.2
In US\$ billion	14.6	13.1	14.9	18.9	16.3	14.3	13.8
Exchange rate (annual average)							
Nominal effective rate (1990 = 100) <sup>g</sup>	88.8	84.9	81.3	72.0	56.1	48.1	47.5
CPI real effective rate (1990 = 100) <sup>g</sup>	111.6	120.9	132.1	131.0	125.9	128.6	132.3

.. Not available.

a In 1993, includes imports of military equipment from Russia in lieu of outstanding claims by Hungary.

b The fiscal deficit in 1997 includes the cost of cleaning up the NBH balance sheet (about 1.5% of GDP); this has to be deducted to facilitate comparisons with 1996.

c The figure for 1997 includes the cost of cleaning up the NBH balance sheet and additional hedging costs on external debt; the figures for both 1996 and 1997 are also adjusted for some items (mostly sale of assets) that should be regarded as financing items.

d Overall balance, excluding interest expenditure and other debt charges. 1997 figures also exclude profit transfers from the NBH.

e The growth rate for 1997 is relative to 1 January 1997.

f The current account deficit is on a settlements basis and differs from the saving-investment balance which is on a national accounts basis.

g May figures for 1997.

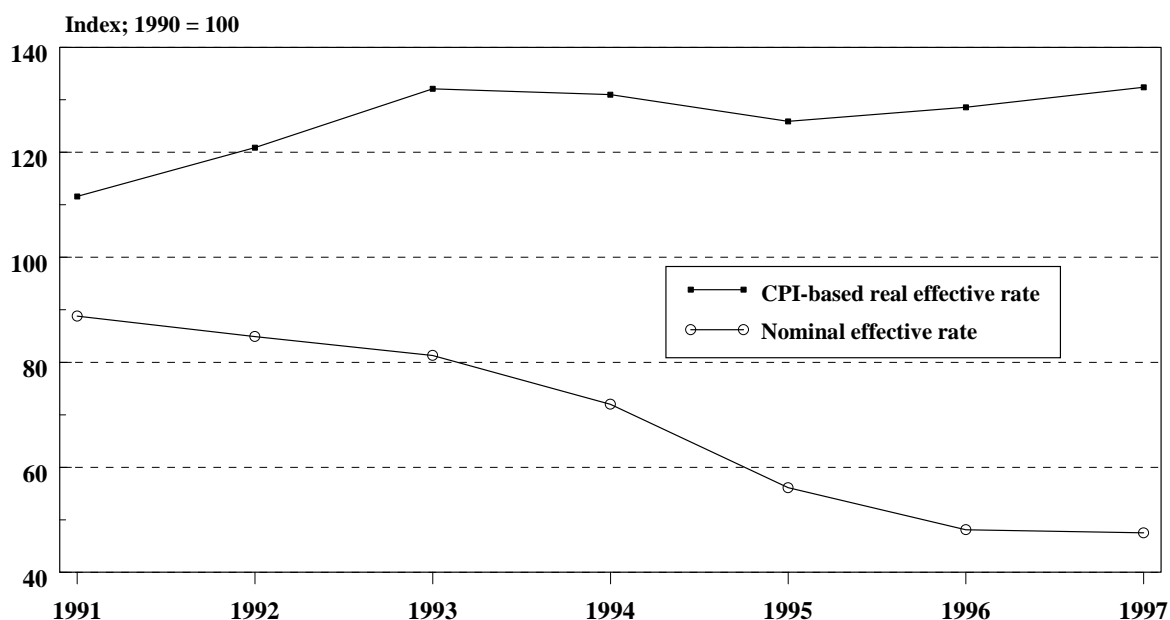
Source: Data provided by the Hungarian authorities and the IMF.

(i) Exchange rate and monetary policies

8. Among the principal elements of the package were the immediate 9% devaluation of the forint and the adoption of a crawling peg exchange rate regime, set within a narrow band (2.25%) of a central parity related to a currency basket. The basket initially consisted of 70% ECU and 30% US\$, reflecting the shares of trade with EU and non-EU countries; beginning in 1997, the basket was changed to 70% Deutsche mark and 30% US\$. The crawling peg involved a pre-announced monthly devaluation of 1.9% from April to June 1995, 1.3% for the rest of the year (approximately the expected rate of inflation) and 1.2% in 1996. Thus, after the blip attributable to the initial 9% devaluation, the crawling peg served as an effective anchor for inflation expectations, the main aim being to secure a sustainable decline in inflation, through a gradual lowering of the rate of crawl, and therefore a more predictable macroeconomic policy environment. The monetary authorities did not wish to achieve a faster pace of disinflation because of the perceived vulnerability of external equilibrium and economic growth. There were fears that if a lower rate of inflation were targeted by means of tighter monetary policy, with higher interest rates, the outcome would have been a strong real appreciation of the forint (as observed in 1992-93), which would contribute to the erosion of Hungary's competitiveness and therefore to an unsustainable deterioration in the current account deficit. In the event, the real exchange rate has remained relatively stable since 1993 (Chart I.1). At the same time, consistent with the crawling peg and reflecting an accommodating monetary stance, slightly positive real interest rates have, by and large, been maintained so as not to discourage private saving.

**Chart I.1**

**Nominal and real effective exchange rate indices, 1991-97**



**Source:** IMF Staff Country Report, October 1997.

9. As a result of the new Act on foreign exchange, which entered into force in 1996, and subsequent government decrees, all restrictions on current account transactions on residents and non-residents alike were lifted. The provisions of the Act are in line with the convertibility standard of

Article VIII of the Articles of Agreement of the International Monetary Fund, which Hungary accepted as of 1 January 1996. The Hungarian authorities have indicated their intention of gradually liberalizing remaining restrictions in the Act, especially those concerning short-term capital movements. The foreign exchange regime was further liberalized as a result of Hungary's accession to the OECD and its adherence to the OECD Codes on Capital Movement and Current Account Transactions.

10. With the National Bank of Hungary (NBH) having become fully independent on 1 January 1997, permanent financing of the government deficit through the creation of money is now prohibited. Moreover, the NBH no longer has obligations for the foreign debt of the Government.

**(ii) Fiscal policy**

11. Another main element of the March 1995 package was the consolidation of fiscal policy with a view to achieving a better balance between this and monetary policy. On the government expenditure side, large cuts were made, mainly through public sector wage restraint but also including reductions in the number of civil servants, as well as reduced social security payments, particularly family allowances. As a consequence of these cuts and further measures contained in subsequent budgets, the share of government expenditure in GDP fell from 54% in 1994 to 40.5% in 1996.

12. The principal revenue-raising measures apart from the import surcharge (which gave a yield of over 1% of GDP in 1996), were higher excise taxes, especially on cars, and increased social security contributions, as well as new charges for higher education. Despite these tax and social security contribution increases together with measures contained in subsequent budgets, government revenues fell from 51.3% of GDP in 1994 to 45.9% in 1995 and to 44.8% in 1996.

13. One of the most fundamental and long-standing problems facing the authorities in collecting tax revenue concerns tax avoidance and evasion.<sup>5</sup> It has been estimated that as much as one third of economic activity may be escaping tax through evasion.<sup>6</sup> Non-payment of taxes in connection with unofficial activities tends to favour these at the expense of official activities that are subject to tax.<sup>7</sup> Tax avoidance and evasion are also both the result, and the cause, of high marginal tax rates, which tend to further distort economic decisions, including those concerning work and saving.<sup>8</sup> With tax revenues as a share of recorded income well below the revenues that should be generated by official

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<sup>5</sup> See, for example, OECD (1995a), p.43. Tax avoidance is conventionally defined as the outcome of legitimate tax planning operations (and therefore legal); tax evasion involves the concealment of income from tax authorities and is thus illegal.

<sup>6</sup> This estimate is consistent with the fact that the unofficial economy is thought to constitute the equivalent of nearly one third of GDP (Johnson, Kaufman and Schleifer (1997)). According to estimates by the Hungarian business courts, one third of businesses are registered under false names in order to evade taxes.

<sup>7</sup> Likewise, arrears on tax and social security payments by business are tantamount to implicit subsidies inasmuch as taxes are deferred indefinitely, or forgiven, and penalty interest on such arrears falls short of the appropriate market interest rate. According to OECD (1995a), p. 44, the bulk of arrears concern social insurance contributions. Such arrears rose from Ft 135 billion in 1993 to Ft 205 billion in June 1995. Some large state-owned firms, especially the railways, were among the largest debtors. These estimates should be regarded as approximate, however, because the undeveloped accounting and information systems do not allow an accurate accounting of unpaid enterprise obligations.

<sup>8</sup> According to OECD (1997a), the average production worker faced a marginal tax rate of 43.5% on additional income.

tax rates, the Government is clearly concerned by these problems and has actively pursued measures aimed at addressing them. These include the allocation of more resources to tax audit and compliance functions together with presumptive minimum taxes on entrepreneurial income in an effort to reduce what is considered to be widespread non-payment of tax from this source. Clearly, solving the problem of non-compliance is of central importance for, and would be assisted by, a settled and satisfactorily functioning tax system.<sup>9</sup> At the same time, however, government attempts to introduce measures to address tax evasion are constrained by newly introduced privacy laws.

14. The Government has also taken steps to contain deficits in the social security funds. In the case of the Health Insurance Fund (HIF), the measures involved greater control of pharmaceutical subsidies and health expenditure together with enhanced cooperation between social security and tax authorities in the collection of social security contributions. Following Parliamentary approval of its proposal in 1997, the Government is now in the process of implementing a major reform of the pension system. This involves transforming the existing pay-as-you-go (PAYGO) pension system into a three-tiered system consisting of a scaled back PAYGO first tier, a fully-funded, mandatory and privately operated second tier and a third voluntary fully funded third tier. As a result, the annual contribution of the pension fund to net national savings is expected to average 0.5% of GDP over the next 50 years or so, as against an average outflow of 0.7% in the absence of such reform.

### **(iii) Incomes policy**

15. While a substantial part of the cut in the budget deficit in 1995 and 1996 (as a proportion of GDP) was due to public wage restraint, the latter's effects were not solely fiscal. Such restraint also extended to wage bargaining in the business sector, as a result of the Government's direct influence on remaining state-owned enterprises, and moral suasion effects on private enterprises. Subsequent central wage agreements falling within the guidelines of the Interest Reconciliation Council (IRC) and the rising level of unemployment helped to reinforce this restraint. The outcome was substantial falls in real wages in 1995 and 1996, which greatly improved business profitability and thus its capacity and willingness to invest. However, wage growth in the business sector during the early part of 1997 was well above IRC guidelines, reflecting one-off factors (such as a wage increase that had been postponed by 13 months in 1996) and stronger than expected productivity growth.

### **(iv) Effects on macroeconomic performance**

16. It would appear that the March 1995 package, together with measures contained in subsequent budgets and a stand-by arrangement with the International Monetary Fund, have been successful in restoring macroeconomic balance to the economy. The budget and current deficits (as a proportion of GDP) have diminished considerably; the consolidated government deficit fell to 3.5% in 1996 before rising to 5.1% in 1997, while the current account deficit declined to 3.7% in 1997. Moreover, gross government debt dropped from 85% of GDP in 1995 to 66% in 1997 and is projected to fall to 60% by the end of 1998 (thereby satisfying one of the Maastricht criteria for European Monetary Union). Likewise, the Government's net external (foreign currency) debt has fallen substantially, from around 45% of GDP in 1994 to 30% in 1997.<sup>10</sup> The spectacular drop in government indebtedness has been due not only to tighter fiscal policy but also to privatization receipts, much of which has been used to repay domestic and foreign debt, thereby reducing interest

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<sup>9</sup> According to OECD (1997a), p. 43, "changes to tax policy have been too frequent and implemented without sufficient consultation, with the result, on several occasions, that major tax initiatives have been withdrawn or substantially altered very shortly after implementation".

<sup>10</sup> National Bank of Hungary (1997), p. 71.

payments on such debt; the cost of servicing foreign debt as a percentage of export value dropped from 42% in 1995 to 21% in 1997.<sup>11</sup> Hitherto, privatization has yielded more than Ft 1,400 billion (US\$7 billion) (Chapter III(4)(v)).

17. The restoration of macroeconomic balance together with radical restructuring of the economy have greatly improved Hungary's economic performance in several respects. Although the immediate impact of the March 1995 package was to cause domestic demand to drop in both 1995 and 1996 and a sharp slowdown in GDP growth, the latter remained positive because of strong growth in net exports (Table I.1). The devaluation of the forint, combined with the crawling peg, was instrumental in increasing exports, while the fall in domestic demand in conjunction with the import surcharge was the main restraining influence on imports. Real GDP growth subsequently recovered to 3.5% in 1997 and is expected to be within the 4-5% range in 1998. After reaching 28.3% in 1995, as a result of the depreciation of the forint and sharp increases in regulated energy prices, inflation dropped to 18.2% in 1997 and is forecast to fall to 12-13% in 1998. With the drop in inflation, the central bank (National Bank of Hungary) has cut the monthly currency depreciation rate from 1% in 1997 to 0.9% in 1998. Officially registered unemployment has remained around 10%, however<sup>12</sup>. While manufacturing has experienced double-digit growth rates in labour productivity since 1992, owing to investment in state-of-the-art production facilities,<sup>13</sup> productivity growth in the economy as a whole has gradually declined, from 7.2% in 1992 to 1.6% in 1996.<sup>14</sup>

### **(3) MAIN STRUCTURAL DEVELOPMENTS**

18. The deterioration in macroeconomic performance in the early 1990s coincided with a marked slow-down in the process of structural reform from 1993 to mid-1995, when little headway was made in dealing with loss-making enterprises, privatization and the restructuring of the financial system. Structural reform resumed, however, in the latter part of 1995, and encompassed these and several other areas. It also involved implementation of WTO and regional agreements. Indeed, trade and trade-related policies, notably those pertaining to foreign direct investment (FDI), have played key roles throughout Hungary's transition to a market economy.

#### **(i) Merchandise trade**

19. Perhaps the most dramatic feature of Hungary's structural adjustment has been the collapse of trade with former CMEA members, and the shift of the geographical pattern of trade from former socialist countries to industrialized countries, particularly European Union (EU) members, as well as to CEFTA partners. This re-orientation of trade was greatly facilitated by the Europe Agreement, which removed tariffs and quantitative restrictions on most trade between Hungary and the EU, and the creation of the CEFTA. Between 1990 and 1996, the share of Hungary's trade with former socialist countries (other than CEFTA partners) roughly halved (Chart I.2). By contrast, the EU's share of Hungary's total exports grew from 45.4% to 62.8%, while its share in Hungary's imports increased from 49.1% to 59.7%. During the same period, CEFTA countries' share of Hungary's total exports grew from 1.7% to 8.7%, while its share in Hungary's imports increased from 2.4% to 7.2%.

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<sup>11</sup> The fall in the Government's indebtedness also contributed to an improvement in its credit rating, which reduced the cost of borrowing.

<sup>12</sup> Around 1.5 million people have left the labour market since 1990.

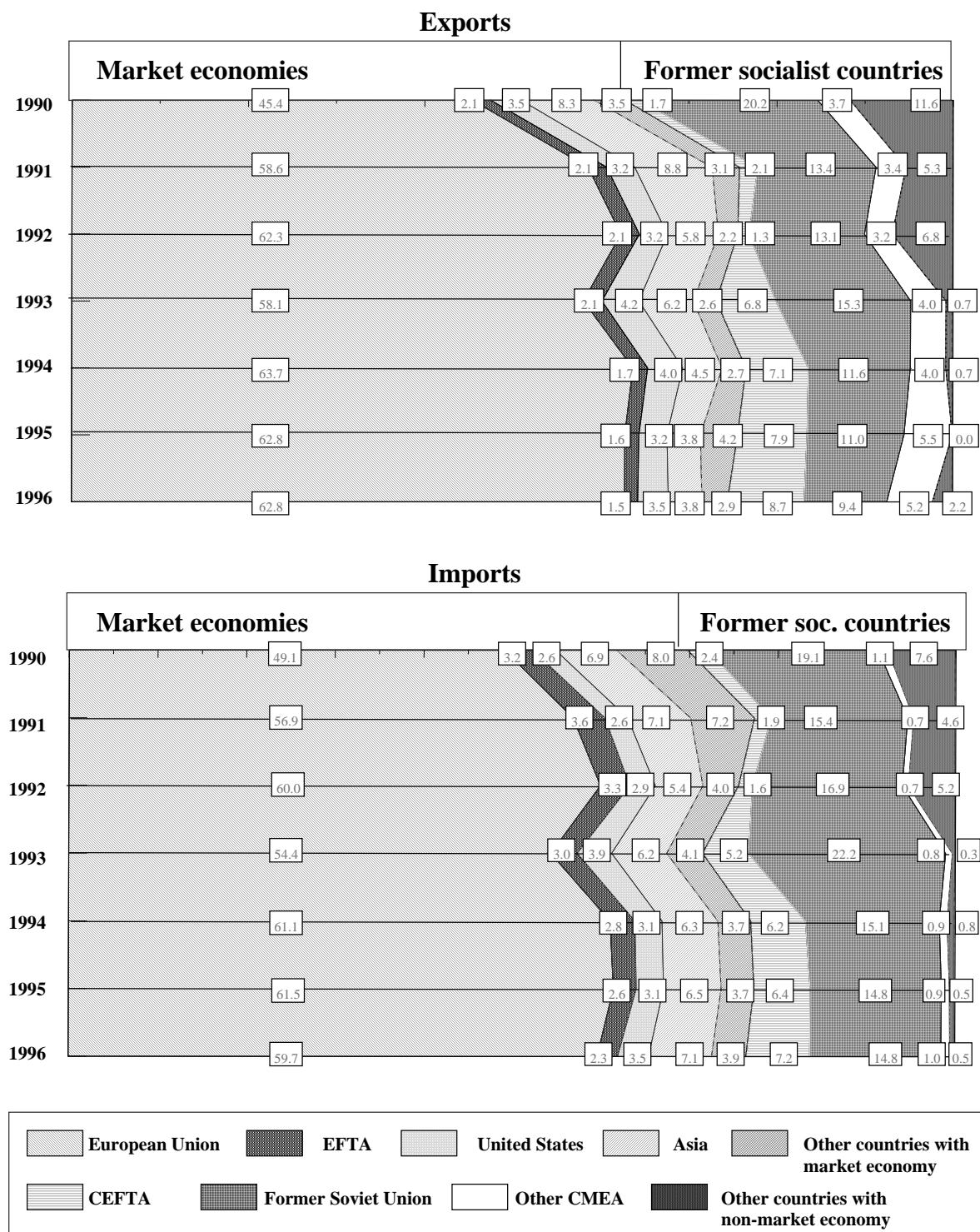
<sup>13</sup> European Bank for Reconstruction and Development (1996), p.118.

<sup>14</sup> OECD (1997a), p. 22.

**Chart I.2**

**Changes in direction of exports and imports of Hungary, 1990-96**

(Per cent)



Source: UNSD, Comtrade database.

20. With the tariffication of quantitative restrictions on agricultural products and relaxation of other non-tariff measures (NTMs) as a result of the Uruguay Round, the proportion of tariff lines affected by NTMs declined from almost 20% in 1991 to under 8% in 1997, with the global quota on consumer goods and the prohibition of imported used cars over four years old being the principal remaining NTMs (Chapter III(2)(iii)). During the same period, however, the overall simple average level of applied MFN tariff protection increased from 11% to 14.3%, largely as a result of agricultural tariffication.

21. Judging from the growing shares of imports and exports in GDP, the Hungarian economy has become considerably more open during the period under review. Imports rose from nearly 34% of GDP in 1991 to 41% in 1996, while exports increased from almost 33% of GDP to approximately 40% (Table I.1). Reflecting the re-orientation of policy, however, this increased openness to trade has been much stronger in relation to EU and CEFTA countries than to MFN partners such as the United States, Asia, and non-European market economies. Whereas exports to EU and CEFTA countries rose from 15.5% to 28.6% of GDP between 1990 and 1996, exports to the United States, Asia, and non-European market economies fell from 5% to 4.1% of GDP. During the same period, imports from EU and CEFTA countries rose from 17.5% to 26.8% of GDP while imports from the United States, Asia, and non-European market economies increased marginally from 5.6% to 5.9% of GDP. Given that Hungary's real GDP shrank by around 7% during the period 1990-97, this suggests that there has been a degree of diversion of actual and potential trade among market economies as a result of Hungary's preferential agreements with EU and CEFTA countries.

22. As a consequence of the general contraction of production and trade in the first half of the 1990s followed by the recovery of competitive sectors, the sectoral composition of Hungary's imports and exports also changed considerably during the period under review (Chart I.3). The shares of clothing and electrical machinery in total exports increased substantially while the shares of non-electrical machinery, transport equipment, chemicals and meat products declined. As regards imports, whereas the shares of textile yarn, gas and other mineral fuels (except petroleum) rose, the shares of non-electrical machinery, transport equipment, chemicals and petroleum dropped.

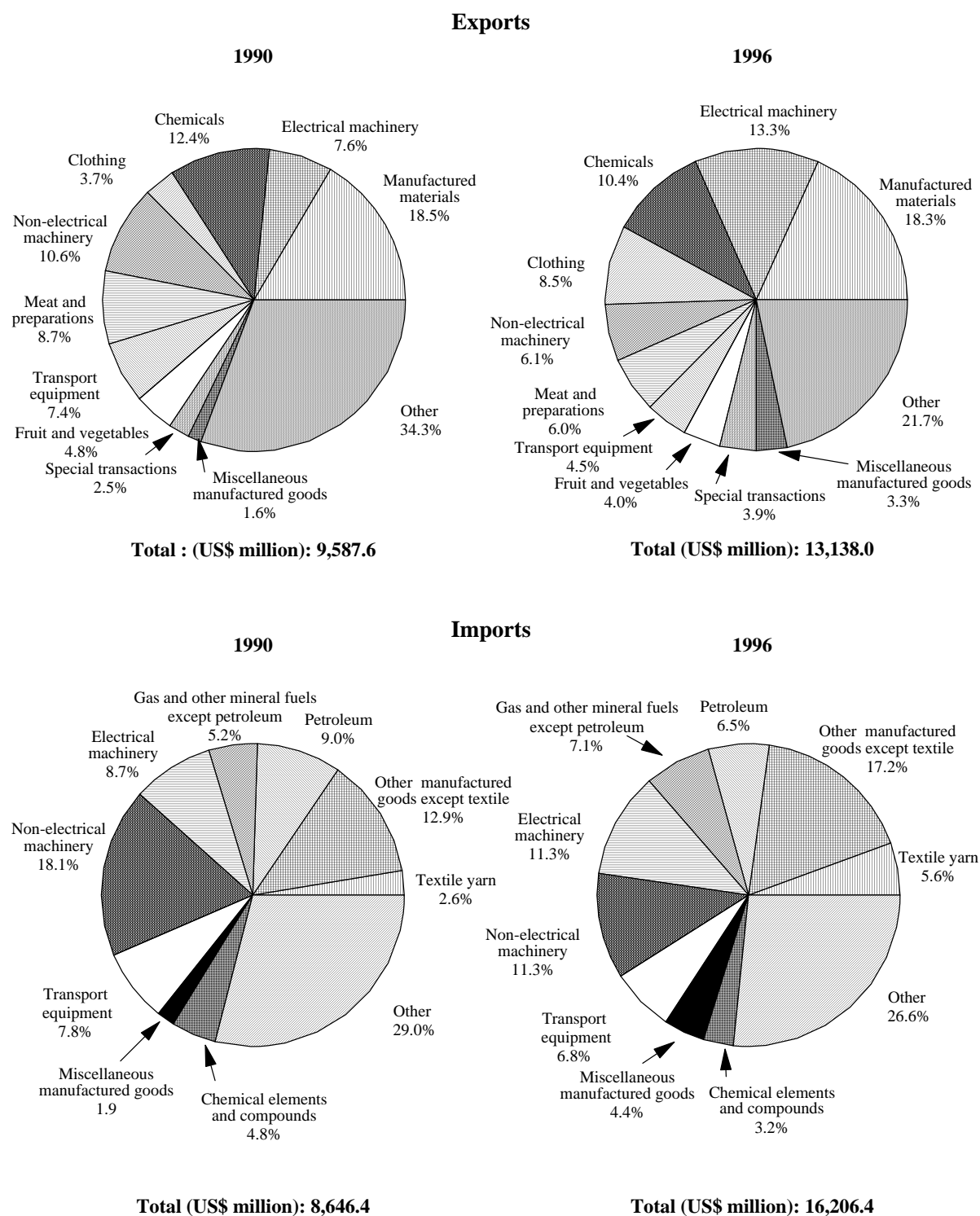
## **(ii) Foreign direct investment**

23. Foreign direct investment (FDI) has made a major contribution to Hungary's economic and trade restructuring, amounting to roughly US\$2 billion in 1997, thereby reaching a cumulative level of US\$18 billion,<sup>15</sup> which is roughly double the Government's net external indebtedness. FDI has been attracted by a skilled labour force with relatively low wage costs, and by Hungary's growing policy orientation towards European markets. Hungary's success in attracting FDI is highlighted by its 40% share of total FDI in central and eastern Europe. FDI has largely been directed to processing industry, gas and electricity, retail trade and banking. The main sources of FDI are Germany, the United States and Austria. With two thirds of the 200 largest companies now foreign-owned, multinational enterprises dominate the Hungarian economy. Companies with foreign participation currently account for 14% of GDP and 16-17% of total employment. The same group of companies also accounts for 70% of Hungary's exports of industrial goods.

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<sup>15</sup> This value does not include an estimated \$3 billion of profits reinvested by multinational companies (*Financial Times*, Survey - Hungary, 9 December 1997, p. 1).

**Chart I.3**  
**Merchandise trade by sector, 1990 and 1996**



**Source:** UNSD, Comtrade database.

**(iii) Privatization**

24. A large proportion of FDI (two thirds in 1995 and roughly one third in 1996 and 1997<sup>16</sup>) has involved the purchase of formerly state-owned enterprises under the Government's privatization programme. This programme has hitherto involved the sale of over 450 large state-owned enterprises to strategic investors, mainly in return for cash (Table I.2). It has encompassed not only firms engaged in manufacturing, but those providing services (including financial services, telecommunications, electricity and gas). In the case of financial services, foreign participation in the privatization of the banking sector has helped to place banks on a much sounder footing and thereby contributed to the smooth functioning of financial markets, which is essential for both the mobilization and efficient allocation of savings and investment. As a consequence of the privatization of three quarters of total state assets since 1990, the private sector currently accounts for around 75-80% of GDP compared to 10% a decade ago. As pointed out earlier, a large part of the proceeds of privatization have been used to pay off government domestic and external debt, thereby improving fiscal balance.

**Table I.2**  
**Revenue from privatization, 1990-97**  
**(In billions of forint)**

	1990	1991	1992	1993	1994	1995	1996	1997 <sup>a</sup>
Total revenue	0.7	31.4	74.3	173.8	130.3	474.0	158.0	349.8
Cash	0.7	30.4	63.0	134.9	36.9	451.6	113.9	317.2
Foreign exchange	0.5	24.6	41.0	110.7	12.9	412.1	77.5	208.4
Forint	0.1	5.7	22.0	24.2	23.9	39.5	36.4	8.8
Credit	0.0	1.0	9.1	21.7	29.3	3.9	2.4	0.3
Compensation vouchers	0.0	0.0	2.3	17.3	64.2	18.5	41.6	22.7

a Estimate.

Source: State Privatization Agency.

**(iv) Incentives/subsidies**

25. Although the Government acknowledged in the course of this review that incentive programmes play a relatively minor role in attracting FDI, it maintains an array of tax and non-tax incentives. Some of the incentives that have been used entail elements of discrimination in favour of foreign investors. Examples are the duty-free status for equipment and other goods deemed to be in-kind capital contributions, which was abolished in 1996, and the corporate tax concession for companies with foreign participation, which is now being phased out. Some other investment incentives are conditional upon export performance; for example, corporate tax is currently halved for companies investing Ft 1 billion and increasing exports by at least 25%.

26. However, total budgetary subsidies as a percentage of GDP dropped from 11% in 1988 to 3.9% in 1991. Since then they have fallen further, to 1.9% of GDP in 1997 (Table I.3). While no information is available concerning trends in overall tax expenditures (that is, revenues forgone as a

<sup>16</sup> National Bank of Hungary (1997), p. 75.

consequence of tax incentives), the value of corporate taxes paid (1.9% of GDP in 1996) is largely offset by the value of subsidies.<sup>17</sup> This tends to have adverse repercussions on fiscal balance.

**Table I.3**  
**Subsidies, 1991-97**

	1991	1992	1993	1994	1995	1996	1997
	(In billions of forint)						
I. Total subsidies to enterprises, of which:	56.4	54.2	60.2	101.1	96.4	114.1	103.0
Production subsidies	23.8	21.6	14.7	37.2	28.3	41.1	45.9
Reorganization subsidies	0	0.4	1.2	5.0	7.5	10.9	0
Other subsidies	4.8	2.0	1.6	2.3	1.5	0.6	0.6
Agricultural export and marketing subsidies	26.8	22.9	25.5	46.7	47.5	45.1	38.6
Agricultural production subsidies	1.0	7.3	17.2	9.9	11.6	16.4	18.6
II. Consumer subsidies	42.3	19.1	21.7	27.0	32.5	44.9	55.0
<b>Total</b>	<b>98.7</b>	<b>73.3</b>	<b>81.9</b>	<b>128.1</b>	<b>128.9</b>	<b>159.0</b>	<b>158.0</b>
<b>Total as percentage of GDP</b>	<b>3.9</b>	<b>2.5</b>	<b>2.3</b>	<b>2.9</b>	<b>2.3</b>	<b>2.3</b>	<b>1.9</b>
<b>GDP</b>	<b>2,499</b>	<b>2,943</b>	<b>3,548</b>	<b>4,365</b>	<b>5,614</b>	<b>6,846</b>	<b>8,370</b>

Source: Hungarian authorities.

#### (v) Price controls

27. While the scope of price controls has been considerably reduced in comparison with the earlier period covered by the previous Trade Policy Review, the share of prices subject to controls has nevertheless increased from just under 11% in 1992 to 16% in 1997 (Table AIII.9).

#### (vi) Other structural developments

28. Among the other major structural achievements were the adoption of a strict bankruptcy law which, together with banking sector reform, contributed to additional financial disciplines on businesses, the establishment of a regulatory framework for privatized utilities that retained a degree of monopoly power, and the strengthening of competition laws. These have contributed significantly to the restructuring of the economy and its improved competitiveness.

#### (vii) Sectoral trends in output and employment

29. As a result of the above structural developments, the distribution of output and employment has considerably changed (Table I.4). In broad terms, production in agriculture and resource-based industries dropped in relation to manufacturing and especially services during the period 1991-95. More specifically, the combined share of the primary sector (agriculture, forestry, fishing and mining) in gross value added fell from 11.1% in 1991 to 6.6% in 1995, while the share of construction dropped from 4.9% to 4.4%. By contrast, whereas the share of manufacturing in gross value added remained close to 20% of GDP, the share of services increased from 52.6% to 54%.

<sup>17</sup> National Bank of Hungary (1997), p. 67.

**Table I.4**  
**Gross value added by sector at current prices, 1991 and 1995<sup>a</sup>**

Sectors <sup>b</sup>	1991		1995	
	Current prices (Ft billion)	% of GDP	Current prices (Ft billion)	% of GDP
Agriculture, hunting, forestry and fishing	195.1	7.8	347.4	6.2
Industry	666.5	26.7	1,294.1	23.3
Mining and quarrying	81.8	3.3	22.4	0.4
Manufacturing	494.2	19.8	1,108.3	19.9
Electricity, gas, steam, and water supply	90.5	3.6	163.4	2.9
Construction	123.5	4.9	246.3	4.4
Transport, storage and communication	209.9	8.4	474.4	8.5
Wholesale and retail trade; repair of motor vehicles and household goods	307.2	12.3	528.7	9.5
Other services	796.7	31.9	2,001.7	36.0
Hotels and restaurants	48.5	1.9	84.8	1.5
Financial intermediation	101.8	4.1	260.3	4.7
Real estate, renting and other business activities	234.8	9.4	666.5	12.0
Public administration and defence, and compulsory social security	147.1	5.9	345.6	6.2
Education	110.0	4.4	255.6	4.6
Health and social work	95.8	3.8	220.3	4.0
Other	58.7	2.3	168.6	3.0
<b>Total</b>	<b>2,298.9</b>	<b>92.0</b>	<b>4,892.6</b>	<b>88.0</b>
Imputed bank charges	-107.7	-4.3	-219.3	-3.9
GDP at basic prices	2,191.2	87.7	4,673.3	84.0
Net taxes	307.1	12.3	888.6	16.0
GDP at market prices	2,498.3	100.0	5,561.9	100.0

a Based on the new System of National Accounts (SNA).

b From 1992 the mining activity of MOL Rt. is accounted for within the chemical industry. From 1993 the production of the collieries belonging to the electric energy complex is accounted for in electricity, gas, heat and water supply.

Source: National Bank of Hungary.

**(4) EU ACCESSION**

30. As the Hungarian economy has entered an advanced stage of transition, the Government has intensified its preparations for accession to the EU. Clearly, such preparations will involve further far-reaching structural and institutional adjustments for the economy. In this regard, much of Hungary's legislation concerning internal measures (notably regulations and standards, intellectual property rights, government procurement, competition) is being adapted to conform with EU legislation. In some instances, such as the protection of intellectual property, adaptation to EU legislation involves Hungary assuming obligations exceeding those contained in WTO Agreements. The relationship between Hungary's participation in the WTO and other multilateral fora and its moves towards EU membership (Chapter II) will be a determining factor in the formulation of Hungary's future trade policies.