

IV. TRADE POLICIES AND PRACTICES BY SECTOR

(1) OVERVIEW

1. The pattern of production and trade in Hungary has altered considerably since the last review, as a result of contraction and selective recovery noted in Chapter I. In broad terms, production in agriculture and resource-based industry has dropped in relation to manufacturing and especially services; between 1991 and 1995, the share of the primary sector in gross value added fell from 11.1% to 6.6%, while the share of manufacturing remained close to 20% and that of services increased from 52.6% to 54% (Table I.4). This shift reflects several factors: the move away from a structure of ownership and planned production based on the former COMECON towards western European markets under the free-trade agreements with the EU and EFTA (Chapter II); redistribution of land, leading so far to a sub-optimal structure of ownership and production, and reduction of support to agriculture; liberalization of services, notably financial and telecommunications services; and an active industrial policy¹, linked to the new pattern of trade, which has encouraged some sectors at the expense of others.

2. Within this active policy, average MFN tariffs are relatively high for imports of agricultural products and prepared food; preferential access for EU and EFTA sources is not accorded in these areas and all external sources are treated on an equal footing. Higher than average MFN tariffs (but with preferential access for EU, EFTA and CEFTA members) also apply to textiles, clothing and footwear, and to automobiles; while NTMs in the form of non-automatic licensing and/or the global quota on consumer goods (the latter now in the process of phase-out) have applied principally to textiles, clothing and footwear, new and used cars and precious stones. Subsidies to agricultural exports are covered by a waiver under the WTO Agreement; tax and non-tax incentives are also targeted at particular activities; and other domestic measures, including regulations conceding a certain degree of monopoly or monopsony power, still apply to certain service sectors, particularly energy.

3. The effects of these various measures give a mixed picture, but one which emphasizes the Euro-centred stance of Hungary's current trade and industrial policies. For example, the relatively high MFN tariffs together with quantitative restrictions on new and used automobiles favour Hungary's two domestic car producers (Opel Hungary and Magyar Suzuki), which produce both for the domestic market and for export to the EU and EFTA, and other European manufacturers selling in the Hungarian market. The application of the Europe Agreement and the similar free-trade agreement with EFTA has encouraged European and other foreign manufacturers to locate in Hungary, with its low-cost, skilled labour force, for export throughout the European Economic Area (EEA) under common rules of origin; these trends can be seen particularly in the automotive, textiles, and chemical industries.

4. The redirection of Hungary's policies has been assisted by the process of privatization (Chapter III) and the liberalization of commercial services such as banking, insurance and telecommunications, which have been among the most rapidly growing sectors of the Hungarian economy. Liberalization of these sectors has generally taken place on an MFN basis, with substantial concessions by Hungary under the relevant WTO Agreements and protocols. This has encouraged substantial foreign direct investment in, and modernization of, these sectors.

¹ Ministry of Industry and Trade (1996b), p. 3.

(2) PRIMARY SECTOR

(i) Agriculture

5. During the early phase of Hungary's transition to a market economy at the beginning of the 1990s, the agricultural sector went through a deep crisis. This was caused by the loss of export markets in former COMECON countries as well as by severe droughts in 1991-93, and by uncertainties created by the rapid, albeit partial, privatization and the consequent fragmentation of the ownership structure of arable land.² Unlike in other sectors, privatization in agriculture has not usually involved direct cash sales of large-scale estates. Instead, a compensation-bill system was used as part of a restitution programme, with land being auctioned to compensation bill holders. Arable land remains one of the few assets that cannot be acquired by corporate investors.³ The outcome of the privatization process so far is that roughly half of privatized arable land has been redistributed to 800,000 Hungarian citizens, *inter alia*, whose property had been expropriated during the Communist period. The other half has been sold to cooperative members as well as to farmers who had been renting land from state-owned farms. The outcome of the privatization process is that there are now around 2 million landowners, with very small holdings; the average farm size is no more than 3.5 hectares. In most cases, such a situation reduces the scope for economies of scale in production and the mechanization of agriculture, thus hampering the sector's ability to improve efficiency and thereby increase its competitiveness and profitability. One of the Government's main agricultural policy objectives is to promote the development of competitive land sizes by, among other things, providing landowners with financial assistance to merge plots of land and supporting land purchases of up to 300 hectares of farmland per person.

6. As a result of the fragmentation and decline in profitability of agricultural production together with the severe droughts in the early 1990s, the relative importance of agriculture in the economy has declined markedly. Indeed, gross agricultural production in 1994 was only 65% of its 1989 level, a much greater fall in production than in the economy as a whole. Consequently, the share of agriculture (together with the food industry and forestry) in GDP dropped from 14.2% in 1991 to 11.6% in 1995.⁴ This was accompanied by an even sharper fall in agriculture's share of employment from 18.5% in 1992 to 11.8% in 1996.⁵ Although still strongly export-oriented, agriculture's share of exports also declined, from 27.5% in 1991 to 21.5% in 1996. Nevertheless, agricultural exports remained three to four times as large as agricultural imports during the period 1990-96. The importance of agricultural trade with the EU is highlighted by latter's large share of Hungary's exports and imports (48% and 44%, respectively, in 1996).

² Whereas 82% of the total agricultural area was cultivated by cooperatives and state-owned farms in 1990, this proportion had dropped to 46% by 1996 (Ministry of Agriculture, 1997).

³ Arable land cannot be purchased by corporations, whether domestic or foreign; it can be acquired only by natural persons. The ban on foreign acquisition of land is justified by the authorities on the grounds that its ownership structure is still in transition and prices remain unrealistically cheap by western European standards. It is feared that a lifting of the ban could lead to a foreign monopoly of the arable land market before realistic prices are established (presumably, once Hungary accedes to the EU), thereby depriving Hungarian citizens of the chance to acquire land in the future.

⁴ The share of agriculture, excluding the food industry and forestry, fell from 8.6% to 7.1% of GDP during the same period (Ministry of Agriculture, 1997).

⁵ Research and Information Institute for Agricultural Economics (1997).

7. Government assistance for agriculture is provided by means of border measures and internal measures involving, *inter alia*, budgetary support, tax concessions and a system of guaranteed prices. Border measures affecting agricultural products involve import tariffs for all products, tariff quotas for some products, and export licensing for grains and sugar beet. As a consequence of tariffication of non-tariff measures in accordance with the WTO Agreement on Agriculture, the simple average applied MFN tariff on agricultural products increased from 22% to 45%, which is nonetheless low in comparison with some other European countries. Lower rates apply within certain tariff quotas (Table AIII.4). The average applied MFN tariff has since declined to 37% in 1997, which is more than four times the average for industrial products. It will fall even further, to no more than 29%, once the reductions agreed under the Uruguay Round are fully phased in.⁶

8. In exceptional cases, as defined in Article II.2(a) of the Agreement on Agriculture, export restrictions are used to prevent critical shortages. In this context, temporary restrictions on exports of some grains, cereal products and animal feeds were introduced in August 1996 to prevent serious domestic shortages of the products in question and to avoid disruption of the domestic animal feed market.

9. Export subsidies are granted for some agricultural products. The rate of subsidization per tonne is fixed at the beginning of the calendar year and varies little with changes in world prices. As discussed earlier (Chapter III(3)(iv)), as a result of an error in its Schedule of Commitments, export subsidies in 1995 and 1996 were considerably higher than Hungary's Uruguay Round commitment. The ensuing dispute with several WTO Members was resolved in October 1997, with Hungary being granted a waiver. Under the waiver, the base value was set at the 1995 level of Ft 51 billion (less than half the 1986-90 base level), dropping to Ft 42 billion in 1997 and subsequently falling in stages to Ft 22 billion in 2001. Wheat, beef, pigmeat, poultry, fruit, vegetables and wine currently account for the bulk of the export subsidies. In addition, Hungary agreed not to enter non-traditional markets with subsidized agricultural exports during the transition period. Unlike some other countries, Hungary has bound its export subsidy levels in domestic currency rather than in U.S. dollars. Given that it operates a crawling peg exchange rate system, which has resulted in a gradual depreciation of the forint vis-à-vis the dollar as a consequence of Hungary's continuing high levels of inflation, levels of export subsidization are expected to decline even faster in dollar terms. With the reduction in export subsidies pursuant to the WTO Agreement on Agriculture, the Hungarian authorities indicated their intent to compensate producers partially by means of "green box" subsidies/support measures, including income support measures. Veterinary costs for pigs, chickens, cattle, sheep and game are partly defrayed by the Government; these measures are exempt from WTO reduction commitments.⁷

10. Further budgetary support includes direct payments from various agricultural funds, which involved various types of grants as well as interest rate subsidies and amounted to over Ft 14 billion in 1996, together with a 70% refund of the tax on diesel fuel (amounting to a further Ft 0.7 billion) in 1996.⁸ Farmers with annual incomes below Ft 1 million also currently receive social insurance subsidies. In addition, the Agriculture Market Regulation Act of 1993, which came into effect in April 1994, directly regulates markets for wheat (for human consumption), feed maize, milk, live cattle and pigs for slaughter, by setting minimum guaranteed prices, paid up to a production quota limit, and government purchases in the event of market instability. Although Ft 7.5 billion was

⁶ The overall simple average of bound tariff rates for all agricultural products is 29%.

⁷ Green Box subsidies/support measures are those that have "no, or at least minimal, trade-distorting effects or effects on production" and do not have the "effect of providing price support to producers".

⁸ The refund was increased to 85% in 1997.

budgeted for such payments in 1994 and 1995, in practice, no intervention purchases have ever been made because market prices have hitherto remained above the guaranteed prices owing to other measures, notably high import duties and export subsidies. In 1997, however, the price of maize was below the minimum, which resulted in support amounting to Ft 660 million. Hungary does not have any marketing boards. Budgetary payments and tax concessions are also provided for environmental improvement and rural development. In accordance with the WTO Agreement on Agriculture, Hungary is committed to reducing domestic support ("amber subsidies") by 20%. However, it has not yet notified the WTO regarding current domestic support measures and associated cuts therein.⁹ Hungary notified domestic support for 1995 as *de minimis*.

11. According to the OECD, for 13 major agricultural products, which together account for around three quarters of the total value of agricultural production, the producer subsidy equivalent (PSEs) corresponding to total support fell from 23% in 1989-91 to an estimated rate of 11% in 1996, among the lowest of all OECD members.¹⁰ However, estimated PSEs for sugar, milk and sheepmeat

⁹ Hungary has notified domestic support measures for 1995 only (WTO document G/AG/N/HUN/10, 11 December 1997).

¹⁰ OECD (1997c), p. 49. More recent estimates for 1996 (and 1997) indicate a slightly higher rate of 15-16%. The PSE is an indicator of the total value of monetary transfers to agriculture (per unit value of production) resulting from several broad categories of agricultural policy measures (market price support, direct payments, reduced input costs, general services and other support).

in 1996 were much higher than the overall average.¹¹ The drop in the overall PSE is largely due to the decline in market support, whose share in total support fell from 67% in 1993-95 to 24% in 1996. Assistance involving reduced input costs has accounted for a rising share of total support, 65% in 1996 compared to 27% in 1993-95. The share of direct payments (other than those on inputs) increased from 5% to 11% over the same period.

12. At the end of 1997, the Government implemented new legislation concerning procedures for plant seed approval and certification, which is in accordance with EU laws. The Government is also formulating new legislation concerning genetically modified organisms, which will also be harmonized with EU laws.

13. Undoubtedly, Hungary's future agricultural policies will be dominated by preparations for its eventual integration into the EU. An agenda for these preparations is set out in the National Agrarian Programme introduced in 1997. It includes a continuation of the process of bringing Hungarian laws and regulations into conformity with those of the EU and the establishment of the necessary institutional framework. The key question that arises in this regard is how Hungary's agricultural policies can be adapted to the EU Common Agricultural Policy (CAP), which, judging from the magnitude of its overall PSE in 1996, provides roughly four times the rate of assistance currently prevailing in Hungary. While significant reform of the CAP, envisaged in the Commission's Agenda 2000, may well reduce the overall rate of assistance in the EU, a considerable gap between the overall rates of assistance in Hungary and the EU is likely to persist in the near future. In the light of such a gap, it remains to be seen whether Hungary's efforts to bring its agricultural policies into line with the existing or a reformed CAP overshadows its attitude to future multilateral negotiations aimed at securing further liberalization of agricultural trade.¹² These negotiations are expected to commence at the WTO in 1999.

(ii) Mining

14. With the exception of natural gas, production of all raw materials has declined since 1990. Total mining output fell by more than half between 1990 and 1995. Hungary is a net importer of most raw mineral materials apart from hydrocarbons, bauxite and some building materials.

15. Coal mining is one of the main activities, accounting for roughly one quarter of total raw mineral production. During the period 1990-96, however, coal production dropped from almost 18 million tonnes to 15 million tonnes, while its contribution to total energy production declined from 31% to less than 25%.¹³ This trend is expected to continue. In 1993-94, almost all coal mines (representing about 90% of coal production) were integrated into the coal-fired electric power plants. Half of these enterprises have been privatized and negotiations are under way with potential investors with a view to privatizing the remainder.

16. The remaining three mines, which are not economically viable, have been transferred to three regional public bodies with the intention of closing them down in the near future. These three public bodies report to the Centre for the Restructuring of Coal Mining (SZÉSZEC), which is responsible for restructuring, including the provision of government assistance. The latter involves subsidies to cover

¹¹ OECD (1997d), p.87.

¹² Hungary recently withdrew from the Cairns Group of agricultural exporters, whose primary aim is to press for multilateral liberalization of agricultural trade.

¹³ Central Statistical Office (1997), p. 175.

the costs of closing mines and cleaning up the environment. In 1997 these subsidies amounted to Ft 3.2 billion. There are no border controls on the export and import of coal other than special authorization, which involves licensing.

17. On the basis of commercial considerations, exploitation of uranium ended in 1997 and the Government is now in the process of closing uranium mines, a process that is expected to take several years.

(3) MANUFACTURING

18. By virtue of the Europe Agreement and Hungary's agreement with EFTA and CEFTA countries, which abolished, or provided for the phasing out of, tariffs and quantitative restrictions on Hungary's manufactured imports and exports, trade with these partners has grown considerably during the review period. Part of this growth is the consequence of foreign companies finding it advantageous to move the production of components or finished goods to Hungary, where labour costs are relatively low, and for export to the EU/EFTA/CEFTA market.¹⁴ This so-called "outward processing trade" (OPT), which accounts for a quarter of Hungary's exports, has proved to be particularly attractive for clothing and automotive components. OPT currently accounts for around 15% of total imports and 21% of total exports¹⁵, although there are no special OPT provisions under the present agreements. The Europe Agreements have also provided firms from non-European countries with a relatively low-cost base from which they can export to the EU, CEFTA and EFTA countries.

19. The establishment of operations in Hungary has obviously necessitated a large amount of FDI. Sectors with the highest export growth are those dominated by enterprises with foreign partners.¹⁶ Some foreign companies, in return for investment and employment guarantees, have occasionally negotiated with the Government a degree of protection of their local market or other forms of assistance.¹⁷ Such protection or assistance may entail tariff or non-tariff border measures or incentives, which are sometimes linked to export performance.

(i) Prepared food and beverages

20. Between 70% and 80% of Hungary's agricultural production is processed by the domestic food industry, with the result that the development of agriculture and the food industry are closely related. During the early 1990s, several branches of the food industry faced problems, notably a shift in trade patterns, a decrease in domestic demand, insolvency of some large enterprises, changes of ownership, etc. The volume of production dropped considerably at the beginning of the 1990s, although during the past three years there has been a moderate increase. The outcome was a fall in the industry's share of GDP from 5.3% in 1991 to 4.2% in 1995. Nevertheless, processed food, beverages and tobacco products account for about 20% of Hungary's total exports and 5% of imports. Around 40% of total exports are currently destined for central and eastern Europe as a result of the

¹⁴ As of 1 January 1998, Hungarian industrial exports to the EU and EFTA countries are free of duty and quantitative restrictions.

¹⁵ OECD (1997a), p. 129.

¹⁶ OECD (1997a), p. 68.

¹⁷ Ministry of Industry and Trade (1996c), p. 7. More specifically, tariffs were raised on passenger cars, fertilizers and colour T.V. sets in 1991 in response to requests from foreign investors. (OECD, 1995).

industry's success in reclaiming markets lost following the collapse of the former COMECON trading bloc.

21. Privatization of the food industry was more successful and accomplished more rapidly than in other areas, and is now almost complete. Less than 10% of the food processing industry remains in State hands and nearly two thirds is foreign-owned, with multinationals having invested a total of US\$3 billion since privatization began, thereby providing significant improvements in technology as well as new marketing channels.¹⁸ In several branches of the industry (e.g., brewing and distilling, soft drinks, tobacco, canning, confectionery, and vegetable oil production), large-scale investment has contributed to significant modernization, renewal of product structure and quality improvement. As a consequence, productivity has greatly improved (by over 10% annually in recent years), especially in sectors where foreign ownership is above average.

22. Prepared food and beverages are the products most protected by MFN tariffs: bound and applied tariff rates in 1997 were more than three times the averages for all products (Chart III.1). Not surprisingly, therefore, applied MFN tariff "spikes" are concentrated in this sector. On the other hand, following the removal in 1995 of all food (except fish), beverages, confectionery and tobacco products from the global quota on consumer goods, non-tariff measures are currently less pervasive in this than in several other sectors (Chart III.3). Furthermore, a large proportion of imports of prepared food and beverages were subject to tariff quotas that provide a significantly lower level of tariff protection. Investments in domestic food processing, like those in other industries, have qualified for various forms of tax and non-tax incentives, some of which are aimed at export promotion.

(ii) Chemicals and pharmaceuticals

23. The chemical and pharmaceutical industries have traditionally been among the most important manufacturing industries. Following privatization and intense restructuring, foreign involvement is especially high in these two industries. As a consequence, foreign-owned firms account for nearly two thirds of domestic sales of cosmetics and household chemicals, including detergent and soap. Recently privatized pharmaceutical companies, such as Gedeon Richter and Egis, are also prominent; both of these companies depend heavily on exports to former COMECON countries.

24. Applied MFN tariffs on imported chemical and pharmaceutical products are lower than the overall average. Moreover, these products are relatively free from NTMs. One notable exception, however, is household detergent, which is still subject to the global quota on consumer goods. In addition, narcotics and dangerous chemicals and explosives require import and export licences (Chapter III(2)(iii)(c)). At the same time, some pharmaceutical products receive price subsidies under the social security system.

(iii) Textiles and clothing

25. The textile and clothing sector has been particularly affected by the collapse of former COMECON markets, which resulted in a sharp decline in output and employment (Table IV.1). On the other hand, attracted by relatively low labour costs, FDI has brought about an increase in outward processing trade with the EU, whereby firms import goods, add value domestically, and then export the goods. As noted earlier, activity in this regard is concentrated in apparel and clothing accessories,

¹⁸ Some US\$1.2 billion was spent on acquisitions and the remainder on technology and other general improvements (Eurofood, 29 January 1998, p. 9).

where Hungary appears to enjoy a strong revealed comparative advantage (RCA).¹⁹ Higher value-added activities (innovation, design and marketing) have tended to remain in the EU, however. About 85% of EU textile imports from Hungary were due to OPT, thus making it the most important element of EU-Hungary textile trade. Such trade was undoubtedly greatly facilitated by the Interim Europe Agreement, which provided for the removal of EU customs duties on clothing products manufactured in Hungary and re-exported under an OPT contract.

Table IV.1
Production and employment in the textile and clothing sector 1990-97

	1990	1992	1992	1993	1994	1995	1996	1997
Gross production (volume 1990 =100)								
Textiles	100	69.3	50.9	51.8	53.0	52.7	49.6	50.6
Clothing	100	99.2	90.4	94.2	100.7	97.6	99.0	96.4
Employment ('000 persons)								
Textiles	75.3	62.0	52.0	50.8	49.9	45.8	38.0	38.0 ^a
Clothing	61.6	58.6	58.9	58.7	58.2	57.5	55.1	55.7 ^a

a Preliminary data.

Source: Hungarian Statistical Office, MITT, Association of Textiles and Clothing Producers.

26. While applied MFN tariffs on imports of textiles and clothing are close to the overall average, certain textile and clothing products are still among the items subject to the global quota on consumer goods (Tables III.7&8). Moreover, the sensitivity of trade in textiles and clothing is such that, in general, like the WTO Agreement, bilateral and regional trade agreements provide for a slower pace of liberalization than in other areas. As of 1 January 1998, however, textile and clothing products are no longer subject to global quota. Investments in domestic textile and clothing production facilities, like investments in other industries, have qualified for various forms of tax and non-tax incentives, some of which are aimed at export promotion. Hungarian exports of textiles and clothing to the United States and Canada face quantitative restrictions under the WTO Agreement on Textiles and Clothing.

(iv) Cars and automotive components

27. Under the previous regime, automobile production was virtually non-existent, with only a few automotive components being manufactured by Hungarian companies. These components included dash boards, windscreen wipers and batteries for Lada, Polski Fiat or Zastava cars. By contrast, Hungary was central and eastern Europe's biggest bus maker through Ikarus. During the early 1990s, however, the automotive industry was transformed, becoming one of Hungary's fastest growing industries and thus one of the key elements in the restructuring of the manufacturing sector. In particular, parts manufacturing increased two-and-a-half times and output of electric devices for vehicles rose five-fold between 1992 and 1995. At the same time, Hungary became an important producer of automobile parts and components for the European market. In 1995, for example, over 60% of vehicle parts and more than 86% of car electric articles were destined for foreign assembly plants. Consequently, exports of car parts increased ten-fold while imports increased four-fold during the period 1991-95. This rapid growth is largely due to FDI, attracted, among other things, by a highly skilled workforce, relatively low labour costs and, in the case of completely built-up passenger cars, a protected market. More than half of the industry is now foreign-owned.

¹⁹ RCA indicators for women's and men's clothing (of textile fabrics) are among the highest (OECD, 1997c, p. 65).

28. In 1992, greenfield assembly operations were established by two major foreign car companies, Opel and Suzuki, which dominate the market with a combined share of nearly 50%. Opel only operates a rather low volume car production facility, however, assembling around 10,000 cars from CKD (completely knocked down) kits supplied by its German plant.²⁰ Production is planned to continue at least until the end of 1998, although its future may be somewhat in doubt, depending on whether Hungarian import tariffs fall.²¹ On the other hand, Opel is making Hungary one of its principal manufacturing locations both for engines and engine components. Production at its engine plant, located in a customs-free zone close to the border with Austria, has risen from around 20,000 units in 1992 to nearly 400,000 in 1997, virtually all for export. In 1996, Opel commissioned a new plant to produce cylinder heads (both machining and assembly) with a three-shift capacity of up to 460,000 units a year, a level that should be reached in 1998. Consequently, in less than five years, Opel Hungary has become Hungary's fourth-largest company based on net sales, one of the top three exporters and among Hungary's most profitable companies. (Like Suzuki, it currently enjoys a ten-year tax holiday with regard to income earned on its earlier investment.) It had a workforce of close to 1,000 by the end of 1997 with a further 2,000 or so employed in its 63-strong franchised dealer network. After the first phase of "screwdriver" investments of foreign car producers aiming at the local market, the Hungarian automotive industry is becoming increasingly integrated into the international network of car production and manufacturing.

29. Suzuki established its factory with the dual aim of supplying the Hungarian market, and exporting cars to the EU. The company has gradually increased its local content from 25% to 53% with a view to meeting the EU requirement of 60% European origin attached to duty-free importation. Production has risen from less than 1,000 cars in 1992 to over 50,000 in 1997, three quarters of which are exported. Production is expected to double in 1998.

30. Several other foreign companies, notably Audi, Ford and United Technologies Corporation have also opened plants (often in customs-free zones) for the manufacture of automotive components, including engines. Audi, for example, sends components overnight to its engine plant at Győr in western Hungary, where they are assembled and sent back by a train link which goes directly onto the factory floor. It produced 600,000 engines in 1997 (triple the number in 1996) and expects to reach one million in 1998. These engines supply 90% of all new Audi cars.

31. Whereas tariffs on automotive components are relatively low (6-10%) and such products are free from quantitative restrictions, built-up passenger cars are subject to high levels of tariff and non-tariff protection. MFN tariffs on passenger cars currently unbound in the WTO, with no commitment having been made by the Hungarian Government to lower them in the future; in addition tariff rates are high for cars with a large engine capacity as well as for those not equipped with a catalytic converter. For example, a 43% MFN tariff applies to cars with an engine capacity exceeding 2,000 cubic centimetres, and equipped with a catalytic converter. Tariffs on imports of passenger cars from countries with which Hungary has preferential arrangements are considerably lower, however, and will be abolished by 2001. Furthermore, imports of new and used cars are subject to quantitative restrictions, namely the global quota on consumer goods, and used cars over four years old are prohibited, ostensibly for reasons of environmental protection and safety (Chapter III(2)). Investments in domestic production facilities qualify for various forms of tax and non-tax incentives, some of which are aimed at export promotion (Chapter III(3)).

²⁰ Judging from estimates of its real comparative advantage (RCA), Hungary still appears to have a strong comparative disadvantage as far as production of passenger motor vehicles is concerned (OECD, 1997c, p. 63).

²¹ Financial Times "Survey - Hungary" 16 December 1996, p. III.

32. In contrast to the thriving passenger car component sector, commercial vehicle construction, Hungary's traditional automotive industry, is in a state of crisis, having undergone serious drops in production. For example, less than 1,000 buses were produced in 1996 compared to almost 8,000 in 1990. None the less, Ikarus Rt., the partly state-owned bus manufacturer, continues to be an important exporter, largely to the central and eastern European market. Attempts are currently under way to privatize state-owned firms such as Rába, the truck maker as well as Ikarus, in order to make these enterprises viable.

(v) Iron and steel

33. Although currently moderate in size, iron and steel production faces serious economic problems and is among those industries in decline and in need of restructuring. During the period 1990-95, crude steel production dropped by 37%, while rolled steel production stagnated. State-owned iron and steel producers have proved to be among the most difficult enterprises to privatize, and thus to modernize, because of their heavy losses and need of large capital injections. At the same time, they are located largely in the depressed north east of Hungary, where unemployment is high by national standards.

34. In order to maintain employment, therefore, iron and steel producers continue to receive substantial subsidies from the Government; these amounted to Ft 8.2 billion in 1995 and Ft 10.8 billion in 1996. Subsidies have also been used to restructure and thus, in an attempt to secure privatization, as in the case of the Diósgyőr steel works (DAM) - after two attempts failed, a majority stake in DAM was sold to VSZ Kosice for a nominal sum of US\$1, and the Government agreed to guarantee loans of Ft 2 billion and invest Ft 2.5 billion.²² By contrast, the iron and steel industry receives little assistance from tariff and non-tariff border measures. Tariffs on iron and steel products are low in comparison with other industrial products and no licensing or quantitative restrictions apply to imports from WTO Members. Quantitative restrictions have been directed at imports from some non-Members (Chapter III(2)).

(4) SERVICES

35. The establishment of an efficient financial sector, particularly a banking system and stock exchange, lies at the heart of Hungary's transition to a market economy. A well-functioning financial sector is essential both for the mobilization and the efficient allocation of savings and investment. The establishment of infrastructure on a commercial basis is also an indispensable aspect of transition because of its pervasive effect on the whole economy. The services provided by such infrastructure, notably telecommunications, transportation and power, contribute to improvements in living standards, they are also used in the production processes of virtually all sectors and are necessary for the movement of goods, services, people and capital. Telecommunications and transportation are also important for forging links between businesses, particularly within multinationals. Together with financial services, they are also among the fastest growing sectors in Hungary.

36. Under the previous largely command approach to the economy, financial intermediation played a limited role in the allocation of savings and investment. Moreover, with the emphasis on industrial production, particularly heavy industry, and production targets, there was a tendency to attach a low priority to the provision of most services, particularly telecommunications, and certain types of infrastructure. Among the exceptions was energy, where usage was wasteful owing to unduly low and unsuitably structured prices. Consequently, the service sector was largely deprived of

²² The Budapest Sun, "Steel Works sold at last", 18-31 December 1997, p. 10.

capital, and in the early 1990s, Hungary had a fragile financial system, one of Europe's least developed telecommunications system, an aging transport infrastructure and fleet, and a profligate energy sector. The need for major capital injections into these and other sectors prompted the Hungarian Government to adopt an outstandingly liberal approach both to the privatization of the service sector and the participation of foreign investors. As a result all major banks, almost three quarters of the Hungarian telecommunications company (MATÁV Rt.) and most power companies have been privatized. Moreover, encouragement of foreign participation in the privatization process was such that foreign investors now control more than half of the banking and insurance sector, the main telecommunications company, and several electric power generating companies.

37. A further reflection of its remarkably liberal stance with regard to the service sector is the fact that Hungary made substantial international commitments in most areas covered by the GATS during the Uruguay Round, with no or few sectoral limitations except in financial services, telecommunications and transportation (Tables AIV.1 and AIV.2). Hungary has also signed the Fourth Protocol to the GATS on basic telecommunications services, and it took part in the Second Protocol on financial services. In addition, only a few reservations were tabled in the OECD under the Code of Capital Movements and Invisible Operations. Commitments for improving market access in services were also made in the Europe Agreement. The prohibition on the supply of financial services in Hungary from branches, was removed as of 1 January 1998 in accordance with Hungary's offer in the recently concluded WTO negotiations on financial services. This offer was among the most liberal of all countries. The main broad restriction remaining is that natural persons are not permitted to provide financial (or any other) services in Hungary, a situation that is common in many other countries. In addition, the revised MFN exemption states that commitments made with respect to commercial presence may still be subject to a reciprocity requirement.

38. Given Hungary's geographical position and the rapid modernization of its infrastructure, the Government has stressed the objective of becoming a "hub" for regional finance, telecommunications and transportation. Promotion of the "hub concept" will require reforms in sectors still closed to competition. After the elimination of monopoly rights for international, long distance and local services granted to MATÁV (until 31 December 2002) and to local telephone operators (until 31 December 2003), telecommunications services will be open to competition. Further liberalization in financial services can be expected upon the entry into force of the new commitments under the GATS, including the removal of restrictions on cross-border branching.

39. Hungary's liberal attitude to foreign investment and the consequent strong involvement of foreign investors in the privatization process has apparently contributed to the effective governance of privatized companies.²³ However, to improve the performance of these enterprises, privatization must be accompanied by effective corporate governance, and by a stable and predictable regulatory framework where monopolies or exclusive rights are well regulated. This is especially important because of the typically high capital intensity of infrastructure such as telecommunications, energy and transportation and the associated "sunk" costs; once the capital investment has been undertaken it cannot be moved elsewhere. This makes such investments especially susceptible to fears about the adverse effects of arbitrary regulatory decisions in the future.²⁴

²³ Török (1995).

²⁴ European Bank for Reconstruction and Development (1996), p. 62.

(i) **Financial sector**

(a) **Banking**

40. A competitive banking and finance sector is crucial for the smooth functioning of a market economy. In particular, it is needed both to ensure an adequate level of saving and to channel savings into those investments that contribute most to economic welfare. Competition between banks ensures the highest possible returns on deposits, thus encouraging saving. Competition also ensures the lowest possible lending rates to creditworthy borrowers, consistent with interest payments to depositors and overhead costs, thereby fostering investment. At the same time, if they are to be competitive and financially sound, banks must, as far as possible, enforce prompt and full repayment of loans and thus impose "hard" budget constraints on those enterprises to whom they have extended loans. The importance of the banking sector in the transition was such that the Government attached the highest priority to the restructuring of state-owned banks, by means of recapitalization, restructuring, privatization and foreign investment. It also quickly established the necessary legal and regulatory framework.

41. The most formidable problem facing the Hungarian banking system in the early 1990s was the large build-up of non-performing loans associated with the financial difficulties encountered by corporate customers and the implementation of a strict bankruptcy law in 1992 (Chapter III(4)(vii)). The build-up of non-performing loans threatened to eliminate the capital of most major banks. Indeed, an independent audit in 1993 concluded that eight banks, including three of the five largest, were technically insolvent. In order to address the problem, the Government implemented several rounds of bank recapitalization during the period 1992-94, which involved a total injection of Ft 360 billion (8% of 1994 GDP) into the banking sector. The resulting dramatic improvement in banks' balance sheets paved the way for the subsequent privatization of the major banks.

42. Bank privatization began in 1994, with the sale of an approximately 80% stake in Magyar Kulkereskedelmi Bank, the Hungarian Foreign Trade Bank, to Bayerische Landesbank. Subsequently, Budapest Bank was sold to GE Capital and the EBRD and the Magyar Hitel Bank was purchased by ABN Amro.²⁵ With the sale of the last of the five big previously state-owned commercial banks, Kereskedelmi and Hitel Bank, and of the smaller Penzintezeti Kozpont Bank 1997, the Hungarian banking sector is now almost entirely privatized. The State has retained substantial minority stakes or "golden shares" in some of the largest banks and has also retained full ownership in two specialist banks, the Hungarian Development Bank and EXIMBANK. The State has a stake of 37% in the newly established Land and Mortgage Credit Institution.

43. One of the most striking features of bank privatization has been the strong participation of foreign investors, who have acquired large stakes in the country's main banks. New, 100% foreign-owned banks, such as Deutsche Bank Ltd., Rabobank and Opel Bank, have also been established. The result is that foreign-owned banks' share of registered share capital is now 75 to 80%, compared to around 16% in 1991; 19 banks are completely foreign-owned.

44. In order to meet international and especially European standards, the legal and institutional framework governing banking, established in the early 1990s, was extensively modified in 1996 with the adoption of a new package of legislation. The package consisted of the Act on Credit Institutions

²⁵ The Government was heavily criticized by the opposition and a State Audit Office (ÁSZ) report for the Budapest Bank privatization because of the Ft. 10.6 billion buy-back guarantee for bad assets agreed by the State when it sold the bank (*The Budapest Sun*, "The great 10-year Hungarian sell-off nears the end of the line", Business Plus Supplement, March 1998, Issue 1, p. IV.)

and Financial Undertakings, the Act on Hungarian Banking and Capital Market Supervision, as well as the Securities Act and the Act on Home Savings and Loan Associations, all of which entered into force in on 1 January 1997.²⁶ The package was aimed at enhancing the transparency of financial institutions, ensuring a more secure banking system, more stringent monitoring of banking activities and the integration of money and capital markets.

45. The Act on Credit Institutions defines two types of financial institutions: "credit institutions", including banks, specialized credit institutions and cooperative credit institutions (savings cooperatives and credit cooperatives); and, "financial undertakings". Only credit institutions are allowed to collect deposits and other repayable funds exceeding their equity, whereas financial undertakings are only entitled to collect repayable funds up to the value of their capital. While confirming the legal separation between the two types of entities, the Act provides for gradual increases in the powers of banks, with the long-term objective of establishing a universal banking system. Since the beginning of 1997, banks have been allowed to trade in government securities and derivative products, but not corporate securities (other than those that are privately placed). As of 1 January 1998, banks are allowed to provide full investment services.

46. The Act on Credit Institutions also introduced significant changes to the system of licensing. In particular, the Government dropped its previous discretionary powers concerning the licensing of foreign institutions.²⁷ Authorization is subject to greater control by the regulator, however, particularly in respect of prudential requirements. The minimum registered capital necessary to establish financial institutions was also increased for prudential purposes and to compensate for inflation. The minimum capital requirement for banks, irrespective of the nationality of ownership, was doubled to Ft 2 billion, quadrupled to Ft 100 million for a cooperative credit institution, and for a financial undertaking raised to Ft 20 million. Moreover, rules concerning collateral, conflict of interest with respect to bankers in managerial positions, and the independence of external auditors were strengthened. In addition, the maximum share that can be held by an individual, the State, or economic entities other than financial institutions, investment firms or insurance companies was reduced from 25% to 15%.

47. The Ministry of Finance has primary responsibility for the regulation of banks. Its task is the preparation of laws and by-laws. The National Bank of Hungary (NBH) and the State Money and Capital Markets Supervisory (SMCS) body, which are independent of the Government and supervised directly by Parliament, have the right to participate in the process, or to initiate a new regulation. The NBH regulates the payments system and capital movements while the SMCS is responsible for the issuance and withdrawal of licences, market entry, inspection of operations and prudential control.²⁸ The SCMS body was the product of a merger in 1997 of the two supervisory authorities that previously regulated banking and financial markets (the State Banking Supervision and the State Securities and Stock Exchange Supervision, respectively), in accordance with the Act on Hungarian Banking and Capital Market Supervision. The newly-created body was given greater independence,

²⁶ The package also contained an Amendment to the Act on the National Bank of Hungary, and the Act on Mortgage Credit Institutions and Mortgage Bonds.

²⁷ The rules pertaining to ownership do not make any substantial distinction between residents or non-residents or the State, or between natural persons and legal entities.

²⁸ The SMCS is also entitled to conclude cooperation agreements with similar foreign organizations in its field of competence.

and its authority was extended to the entire financial market in order to facilitate the trend towards universal banking.²⁹ Financial services may be provided only under licence from the SMCS.

48. During the period under review, cross-border supply of services by foreign banks was not allowed. Moreover, foreign banks wishing to operate in Hungary had to incorporate under its laws and be established in the form of joint-stock companies (or, in the case of savings banks, joint-stock companies, savings cooperatives or credit cooperatives). Foreign branches were not permitted. Branching is now allowed as a result of Hungary's commitments under the Fifth Protocol on Financial Services recently concluded at the WTO.

49. As reflected in Hungary's GATS schedule of specific commitments attached to the Fifth Protocol, there are no foreign ownership limits to the acquisition of an existing Hungarian-based bank or for the establishment of a new institution. The requirement of government approval for the acquisition of over 10% of the registered capital has been abolished.

50. The Hungarian banking system currently comprises 46 credit institutions together with 243 smaller savings cooperatives and 8 credit cooperatives. The seven largest banks, three of which (National Savings Bank (OTP), the Hungarian Credit Bank and the Credit and Commerce Bank) were previously state-owned, account for about two thirds of all assets, compared to almost four fifths in 1993. Furthermore, the share of OTP, which previously held a monopoly in deposit collection, has been reduced to less than one third of total deposits. While the present degree of concentration is not high in comparison with other smaller EU countries, spreads between deposit and lending rates do remain large, particularly in retail banking³⁰, suggesting that competition is not yet fully developed as a result of foreign investors' lack of interest in this sub-sector where costs are usually high.³¹ On the other hand, the continuing consolidation of the banking system as a result of privatization together with strong foreign presence would tend to increase competitive pressure in the future.

(b) Securities

51. The Budapest Stock Exchange (BSE) was the first to be reopened in central and eastern Europe, in June 1990.³² It has since become one of the world's best performing stock markets. Following the re-opening of the BSE, preparations began on a new regulatory framework as set out in Act XCI of 1996 on offering securities, investment services and the stock exchange (Securities Act). The Act requires a minimum amount of start-up capital for the establishment of investment companies, securities dealers and securities brokers. For foreigners, there is non-discriminatory access to brokerage licences issued by the Hungarian supervisory authority. Moreover, in a marked

²⁹ More specifically, banks heading towards universality may deal in government paper, derivative transactions and privately issued securities as investment service providers and may partially return to the stock exchange.

³⁰ According to OECD (1997a), p.51, the overall interest rate spread was 5-6%. The average spread in the highly competitive corporate sector is reportedly down to 3% (compared to 7-8% two years ago), but spreads in retail banking remain at 7-8% (*Financial Times*, "Hungary" page II, 9 December 1997).

³¹ High costs are also partly due to a mandatory reserve requirement, which, although down from 17% to 12%, is still high by western European standards. Once non-resident banks are allowed to open branches, such a high reserve ratio places Hungarian banks at a disadvantage compared to non-resident banks (National Bank of Hungary, 1997).

³² A commodity exchange and a derivatives and futures market were also established in 1989 and 1994, respectively.

departure from the past, when company accounts were virtually secret, the BSE established strict rules concerning transparency and disclosure for listed companies, which contribute to effective corporate governance. More specifically, category A companies are required to publish quarterly reports while smaller companies must publish biannual reports. The Act also contains tighter rules on insider trading and bans price manipulation. It does not include a take-over code, however; rules on take-over are instead established in the new Company Act, which will enter into force on 16 June 1998.

52. By the end of 1997, the capitalized value of shares listed on the BSE reached Ft 3,058 billion, compared to Ft 38 billion in 1991 (Table IV.3), with foreign investors accounting for about two thirds of the total value. The principal reason for this increase was the unparalleled surge in share prices, although a rise in the number of listed shares (as a consequence of privatization) also contributed to the increase.

Table IV.2
Capitalized value of shares listed on the BSE, 1990-97
(Ft billion)

	1990	1991	1992	1993	1994	1995	1996	1997
Value	16.4	38.2	47.2	81.7	181.5	327.8	852.5	3,058.4
Index value (1990 = 100)	100	233	288	498	1,107	1,999	5,198	18,649

Source: Hungarian authorities.

(c) Insurance

53. The development of a modern, private insurance market meeting international standards has been a priority in Hungary. Like the banking sector, insurance has attracted significant foreign interest. In 1998, 12 of the 20 Hungarian insurance companies were 100% foreign-owned and six were partly foreign-owned.

54. In January 1996, a new law entered into force governing insurance institutes and activities (Act CLVI of 1995 on Insurance Institutes and Insurance Activities). The law introduced a separate incorporation requirement for life and non-life insurance branches. The law also provides national treatment to foreign insurance investors. The 1997 amendment to the Act allows foreigners to establish and operate branches in Hungary under the same conditions as Hungarian insurance companies; financial guarantees, material and personnel requirements are the same as those for domestic insurers in connection with the establishment and operation of branches.

55. Established under the 1996 Insurance Law, the State Insurance Supervisory Authority (SISA) is an independent regulatory body overseeing adherence to the law and reporting to the Ministry of Finance. It issues licences, after approving a regulated business plan, and can also impose fines, restrict activity, withdraw licences and institute liquidation procedures. Although SISA has not established any official actuarial rules for the calculation of premiums, the latter must be agreed by both SISA and insurers through a compulsory licensing system for new products. Since 1996, permits to market insurance products, except life insurance products, are no longer required from the regulatory authority.

56. According to the Act, a licence is required for, *inter alia*, commencing, terminating and amending insurance activity. The application for the licence must contain:

- (i) the statutes (deed of association);
- (ii) certification of the availability of the capital;

- (iii) a business plan; and
- (iv) certification of existence of material and personal conditions.

The business plan mentioned under (iii) must explain the scope of insurance activities as well as facts and information on:

- the name of the branch and the section or risk group at which the insurer's operations are aimed;
- the definition of the field of operation;
- in case the product is subject to licensing, a description of the product;
- the value and composition of the capital required;
- a requirement for developing the administration, sales and claim settlement network, its estimated costs and financial instruments; and
- a preliminary draft balance sheet.

Until 31 December 1998, a licence of the supervisory authority is required to commence the distribution or the amendment of some products, such as accident, sickness, life insurance and compulsory insurances defined by law for private individuals, legal entities and unincorporated economic associations.

57. Prior to the conclusion of the Fifth Protocol, commercial presence (in the form of a joint-stock company, insurance cooperative or insurance association) was required in order to offer insurance services in Hungary. The cross-border supply of services was not permitted, although companies engaged in foreign trade could take insurance abroad. While there was no specific foreign ownership limit, for prudential reasons the establishment of a wholly or partially owned insurance company was subject to government approval and a minimum capital requirement (Ft 250 million).³³

58. Insurers' choice of investments is closely circumscribed by the Insurance Law. As a general rule, insurance reserves as well as the minimum solvency capital of an insurer may be invested only in Hungary. At least 30% of the sum of liquid assets serving as collateral for their actuarial reserve and "security" capital must be invested in Hungarian government bonds. While this requirement, like others, is justified by the authorities on prudential grounds, it nevertheless ensures a flow of otherwise investable funds into the domestic market for government securities, thereby tending to reduce the cost of government borrowing and the returns that insurance companies can obtain on their assets.³⁴

(ii) Telecommunications

59. Since December 1993, MagyarCom, a joint venture between Ameritech Corp. and Deutsche Telecom AG, has acquired a total stake of 67% of MATÁV Rt., the former state-owned monopoly. This was reduced to simple majority (50% plus one vote) in 1997, when MagyarCom and ÁPV Rt. (the state holding company), respectively, sold 17% and 8% stakes in an initial public offering (the country's largest), which resulted in the listing of MATÁV on the New York Stock Exchange, the first central European company to do so. While the Government has hitherto retained a golden share of 25% shares plus one vote in the company through ÁPV Rt., this stake may well be reduced by a further international public offering in the future.

³³ This minimum requirement has two elements: an "organizational" capital requirement of Ft 100 million and a "security" capital requirement of Ft 150 million.

³⁴ By contrast, much looser limits are placed on pension fund investments.

60. The privatization of MATÁV was accompanied by the enactment in 1992 of a new Telecommunications Act (LXXII), which introduced limited and phased competition in the sector. While, in principle, the Act does not preserve a monopoly for any sector, it introduced a system of exclusive territorial concessions for basic telecommunications (including public telephony, public mobile radiotelephone, national public paging services and national or regional broadcasting of public radio and television programmes together with related frequencies) with similar effect. In accordance with the provisions of the 1991 Concession Act, however, these concessions are granted on the basis of competitive tenders. A concession contract (a legal instrument) is then drawn up between the successful bidder (the concession company) and the Ministry of Transport, Communications and Water Management (KHMV). By contrast, value-added services such as facsimile, telex, data transmission and satellite services are not subject to exclusive concessions and are fully open to competition.

61. MATÁV owns a 25-year concession (beginning in 1993) for the supply of international, national and, for most of Hungarian territory (36 out of 54 "primary" districts), local telephone services. For these services, territorial exclusivity is guaranteed by the State in the first eight years of the concession. National and international telephone services will be open to competition on 1 January 2002 and local services on 1 January 2004. This exclusive right for a limited initial period, and the resulting monopoly profit, was accorded to the foreign joint venture not only as an incentive to purchase its majority stake in the company but also for it to undertake further investment. Hitherto, the concession has allowed MATÁV to retain control on the Hungarian telephone market (100% of the long-distance and international telephone market and 75% of the local market through exclusive rights, and 65% of the mobile telephony market). In the remaining 18 "primary" (local) districts, concessions to provide local services have been granted to new privately owned companies. In the field of mobile telephony, three licences were issued, one to a joint venture between MATÁV and US West Corp., which dominates the market. For paging services, two licences were granted.

62. Although concession agreements explicitly forbid cross-subsidization, such a practice cannot be ruled out within MATÁV, as the latter is a vertically integrated company providing local, long-distance and international services as well as other non-concession services. According to the authorities, however, it is very difficult to verify the degree, if any, of cross-subsidization owing to the lack of proper accounting or structural separation and the lack of rules for obtaining necessary information from service providers.

63. There is no independent regulator for telecommunications services in Hungary. Instead, regulatory functions, such as licensing, compliance with technical, quality and delivery requirements, frequency allocation, etc., are performed by the Communications Authority of Hungary (HIF), under the auspices of the Ministry of Transport, Communications and Water Management (Chart IV.1).³⁵ The Telecommunications Act and a government decree on the rules regulating network contracts guarantee non-discriminatory free access to the basic network for concession holders and regulate cooperation between the various concessionaires so that the telecommunications network forms a single harmonized system. The regulations in force allow any entrepreneur to participate in the enhancement and extension of Hungary's telecommunications infrastructure. Any entrepreneur is also permitted to provide services, such as data transmission on public telecommunications networks (except those of sound-phones), provided it obtains authorization from the HIF. The latter authorizes the creation of telecommunication connections, the development, winding up or interconnection of networks, as well as marketing, implementation and operation of terminal equipment. Manufacturers, distributors and equipment operators are required to apply for this type of authorization. There are no

³⁵ The HIF also regulates broadcasting and postal services.

sector-specific laws or regulations that would favour the use of Hungarian equipment or services (other than preferences provided by government procurement regulations).

64. Telecommunications prices are approved jointly by the Ministry of Transport, Communications and Water Management and the Ministry of Finance. In the case of liberalized services, operators are generally free to set their prices, although this freedom may in some circumstances be limited by the Prices Act (LXXXVII) of 1990. As regards services subject to concession (in particular telephones), the Government implements a price cap system, which is reviewed every four years. The original concession contract with MATÁV established a price formula whereby annual cost increases were determined by cost increases minus an efficiency factor, which was initially set at zero. In 1996, the Government had the opportunity to adjust the efficiency factor, but did not do so. While this pricing formula would have permitted prices to be raised by as much 23.3%, the operator instead raised prices by 19.3%. This suggests that the current regulated price formula may, in fact, allow the operator to charge prices that considerably exceed the profit maximizing price.³⁶ It might also be a reflection of competition on the local telecommunications market not only among local suppliers of traditional services but also wire-based and cellular technologies and service suppliers. The tariff plans prepared annually by the service providers are approved and published by the Government.

65. There is no competition law applying specifically to the telecommunications service sector to prevent the abuse of market power; competition issues fall under the Competition Act and are overseen by the Office of Economic Competition. During the period 1991-97, the latter passed 13 rulings in cases of abuse of dominant position directed at six business entities in the telecommunications sector. Eight of these rulings found infringements of the law.

66. Stronger competition may be in the offing, however, as a result of the establishment of a new Hungarian telecommunications consortium, MKM-Tel, by Hungarian railways (MAV) and the state oil company (MOL). MKM-Tel started offering business service in 1998 and from 2002 will compete with MATÁV across the board. (The Government also recently injected Ft 3.5 billion (US\$17 million) of capital into another potential competitor, the state-owned Antenna Hungária.) The Government's encouragement of the establishment of MKM-Tel may well reflect its concern over the dominance of MATÁV and its desire to satisfy EU competition laws.

67. The outcome of privatization together with the regulatory and competitive framework is that, after being long underdeveloped, Hungary's telecommunications infrastructure and services are now rapidly catching up to modern standards. During the period 1994-96, capital injections from foreign partners helped MATÁV to invest nearly US\$2 billion in network development and modernization. As a consequence, the number of telephone lines has jumped from 1.3 million in 1993 to 2.4 million in 1997. Concurrently, a telephone waiting list of 800,000 customers has been virtually eliminated, raising main line penetration (teledensity) from 14% in 1993 to 32% in 1997 (48% in Budapest). In addition, judging from the increase in the number of phonelines served per employee, which rose from 78 in 1994 to 163 in 1997, MATÁV's productivity has greatly improved since privatization. Furthermore, 70% of the Hungarian network is currently digitalized, and mobile telephone and value-added services are expanding rapidly.

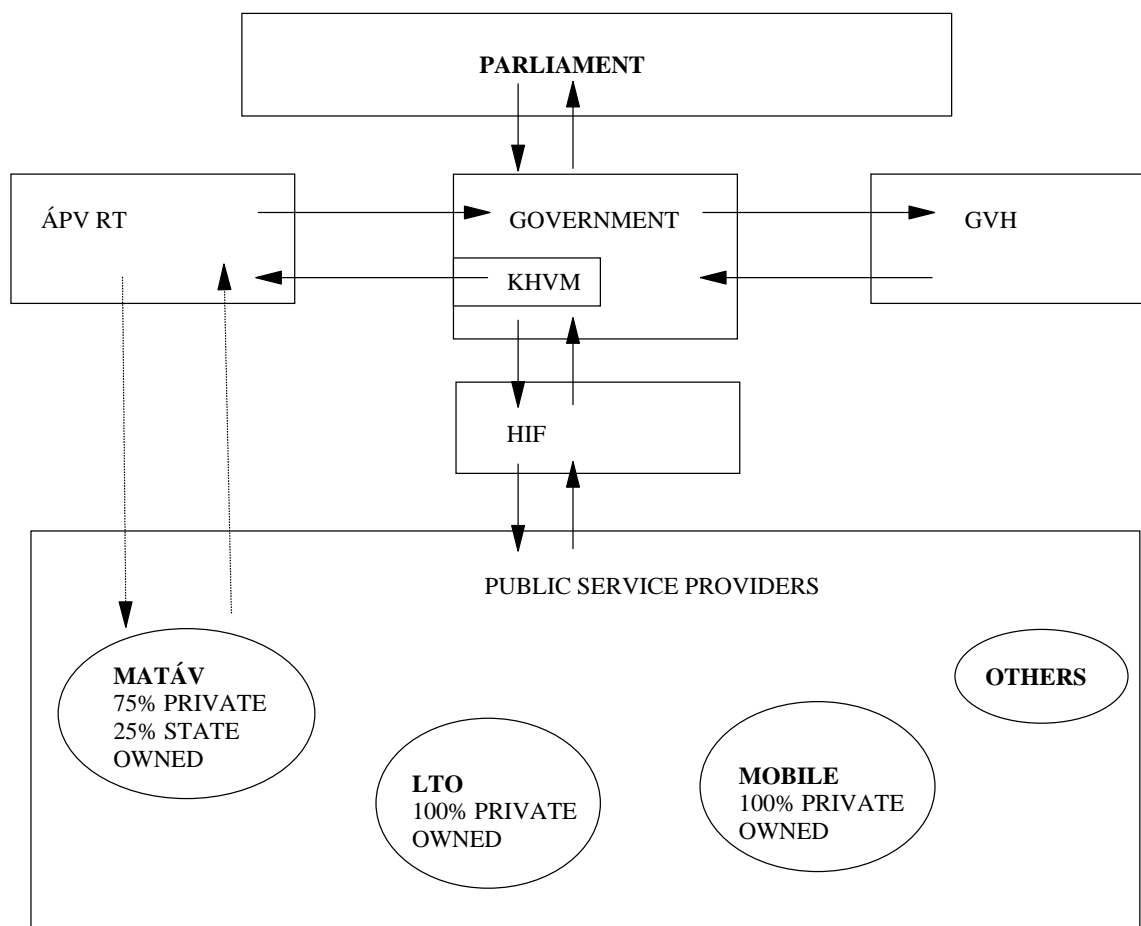
68. Hungary signed the WTO Agreement on Basic Telecommunications Services in September 1997. The Hungarian offer is one of the most liberal in the region. It has not imposed limitations to national treatment with respect to cross-border supply, consumption abroad and

³⁶ OECD (1997a), p. 118.

commercial presence in any of the areas covered by its schedule. However, it placed some limitations on market access, reflecting essentially its current domestic regime, as described above. Therefore, the main limitations concern the exclusive rights granted to MATÁV on international long-distance and domestic services until 31 December 2002 and for local calls until 31 December 2003; the attribution of licences only to companies registered in Hungary; and a foreign-ownership limit of 75% minus one vote for MATÁV Rt. and Antenna Hungária Rt.

69. Hungary is a Member of the International Telecommunications Union and implements the relevant regulations and conventions. It is a party of EUTELSAT, Intelsat and INTERSPUTNIK.

Chart IV.1
Institutional Structure of Hungarian Telecommunications



Abbreviations:

KHVM	Ministry of Transport, communications and Water Management
HIF	Communications Authority of Hungary
ÁPV RT.	Hungarian Privatization and State Holding Company
GVH	Office of Economic Competition
MATÁV	Hungarian Telecommunications Company
LTO	Local Telephone Operators

Notes:

	Ownership relationship
	Communication relationship

Source: Data provided by Hungarian authorities

(iii) Air transportation

70. Long overshadowed by rail, road and water transport, aviation is not a major mode of transport in Hungary.³⁷ Its development was impeded in the past few decades by poor infrastructure and the relative isolation of the Hungarian economy. International air traffic fell sharply in 1991 due to both the recession in Europe and the restructuring of the industry. It has since recovered to reach a total of 3.3 million passengers transported in 1996 (an increase of 31% over 1990 and 13% over the 1995). In order to meet market demand, Malév, the state-owned national flag carrier, increased the number of its scheduled flights by 13% in 1996 and is planning further expansion. While Malév's share of passengers (and cargo) is more than half, intensified competition on air fares by foreign carriers (mainly Lufthansa, KLM and Swissair) has resulted in a 5% reduction of revenue per passenger and per kilometre.

71. Conscious that internationalization of the Hungarian economy, the rise in living standards, and the development of tourism are likely to result in future expansion of air transport activities, the Government and the industry have engaged in wide-ranging modernization of the sector. This involves, *inter alia*, the recapitalization of Malév, including the purchase and leasing of new aircraft, the expansion of the Budapest-Ferihegy airport (the only airport in Hungary capable of meeting international transport needs), and the transformation of the former Soviet military air-bases into domestic and cargo airfields.³⁸ Recapitalization of Malév is considered to be essential if the national carrier is to compete internationally and is therefore a prerequisite for the complete opening of air transportation to foreign competition. While no direct subsidies are given to Malév, it does receive other forms of assistance, including a reduction in customs duties on spare parts and equipment as well as a tax exemption for fleet renewal.

72. Commercial air transportation is largely confined to international scheduled flights. Domestic air passenger transport, which was suspended in 1964, was resumed only in 1994 albeit to a limited extent (a few services during the summer months). The largest cities maintain domestic airports for private aircraft, and the transfer of former military airports should provide additional capacity. Foreign participation in domestic air transport commercial activities is subject to authorization. According to the 1995 Act on Air Transport, licences for domestic transport of persons and goods are granted only to companies with Hungarian majority both in terms of capital and management control. The authorities justify this restriction on the grounds that there is a need to provide extensive air transportation services in a small domestic market and to foster domestic air transportation companies. In the case of Malév, while privatization is envisaged³⁹, the Government will retain a golden share of 25% plus one vote, and another 25% of the company's shares must remain in private Hungarian hands. In order to reflect this situation, Hungary has listed a reservation in the OECD for market access and national treatment in respect of the acquisition of a licence for domestic air transportation.

³⁷ Air transport has been selected here for a sector-representation, given the pace of reforms and the potential for international expansion in this area. Aviation is Hungary's fourth-largest transport sector, behind rail, road and water transport.

³⁸ A second terminal was completed at Budapest-Ferihegy airport in 1993. Further expansion is under way, involving the construction of a third terminal, which will be operated by a foreign-owned company.

³⁹ A 35% stake in Malév was sold to Alitalia in 1992. In 1997, however, the EU Commission forced Alitalia to sell its stake, which was subsequently purchased by a consortium of two leading banks. The next step in Malév's privatization process will be a substantial injection of capital in 1998 with a view to complete privatization by 2000.

73. Multilateral liberalization of air transport services was achieved only to a very limited extent during the Uruguay Round; consequently, Hungary undertook only the basic liberalization commitments (i.e. maintenance and repair of aircraft and computer reservation servers) under the GATS. (See GATS Annex on Air Transport Services.) International air transport is thus largely governed by a network of bilateral agreements. Hungary has signed such agreements with all EU countries and most members of the International Civil Aviation Organization. In general, agreements allow carriers of both parties to operate "fifth freedom" routes but not to conduct cabotage operation with the partner country. Hungary is also negotiating an air services agreement with the EU. In addition, work is being undertaken with a view to bringing Hungarian civil aviation law into line with EU requirements, particularly in the area of air safety and air navigation.

74. The main regulatory body is the General Directorate of Civil Aviation (GDCA), whose head reports to the Minister of Transport, Telecommunications and Water Management through the Deputy State Secretary for Transport. An independent Civil Aviation Authority (CAA) was established in Government Decree 142/1995. The CAA is responsible for technical, health and administrative issues as well as matters of navigation, accident prevention and investigation.

75. Access to Budapest-Ferihegy international airport remains subject to a number of restrictions. Airport slots are regulated by the 1996 Act (CVII) on the Prohibition of Unfair Restrictive Practices. Although slots are allocated by an independent Airport Coordinating Committee in accordance with EU Commission Decision 95/93, prime-time landing and take-off slots are largely reserved for Malév as a consequence of "grandfathering". Such preferential treatment constitutes a "regulatory" subsidy for Malév. Foreign airlines still have to petition to get their flight plans approved. It remains to be seen whether the opening of the third passenger terminal at the Budapest-Ferihegy airport increases foreign airlines' share of prime-time slots.

76. In accordance with the tendering procedure in Section 45 the 1995 Aviation Act Section, the Air Transport and Airport Administration (ATAA) is authorized to provide ground handling services at Budapest-Ferihegy international airport, which it undertakes for general aviation flights. All other flights are served by Malév on the basis of an agreement with the ATAA. The resulting lack of competition for such services means that operational costs at the airport are relatively high.⁴⁰ Furthermore, the integration of ground handling and air services may provide opportunities for cross-subsidization. It would appear that this situation is about to change, however, with the inauguration of the new terminal, where the provision of services will be exposed to greater competition.

77. While Malév aims to develop its international operations through marketing or code-sharing arrangements (for example, with Delta Airlines), the maintenance of market-access restrictions and possible inefficiencies in the provision of ground handling services might, in a context dominated by reciprocity, ultimately limit the ability of Hungary's national airline to expand its operations abroad.

⁴⁰ Competition is confined to tendering for the concession of exclusive rights to provide ground handling and catering services, in accordance with the provisions of the 1991 Concession Act.

(iv) Electricity and gas

78. Prior to its transition to a market economy, Hungary, like other centrally planned economies, attached a high priority to abundant supplies of energy for industrial production and household consumption, with energy supply being shaped primarily by quantitative planning requirements rather than attention to costs.⁴¹ The pricing structure was inverted in the sense that prices charged to households were often below those charged to industrial users, whereas the cost of supplying energy to the former tends to be more than for the latter.⁴² Energy prices were often below levels consistent with cost recovery, resulting in a level of energy used per unit of output well above that in industrialized market economies. Furthermore, Hungary has become heavily reliant on imports, which currently account for more than half of its energy sources. In this regard, it is particularly dependent on Russia for oil and gas as well as for the uranium used by its Paks nuclear power plant that generates about 40% of its electricity. In addition, the electric power sector was a major source of air pollution due to its high dependence on coal-fired generating plants.

79. Following earlier failed attempts to privatize the energy sector, in 1995 and 1996 the Government sold about 50% of public shareholdings in electricity and gas distribution and four out of seven electricity generating companies (excluding the nuclear generator). These shares were sold to foreign investors, many of them western European public utilities. At the end of 1997, a tender procedure was initiated aimed at privatizing the three remaining coal-fired electric power generators (Pécs, Vértés and Bakonyi), which account for 15% of total generating capacity. Pécs and Bakonyi were privatized, but no offer was received for Vértés. In 1995, the Government also sold a minority stake in the main producer/importer of oil and gas, MOL, a large portion of which was purchased by foreign investors. Further privatization involving MOL is expected. However, it is envisaged that the State will retain golden shares (25% plus one vote in MOL and 50% plus one vote in MVM, the electricity distributor), thereby enabling it to veto decisions on such matters as capital increases, new share issues, changes of activity, merger and de-merger.

80. The legal and regulatory framework applying to the Hungarian electricity and gas sectors was established by the Electricity and Gas Acts adopted in 1994, prior to the above privatizations. The Electricity Act identifies three types of actor in this industry: generators, distributors and local suppliers. The generating companies (power stations) are obliged to offer their electric power for sale to the distributor, MVM, who must observe the principle of minimum cost in procuring the electric power from competing generators. MVM then provides power to the suppliers, who are obliged to meet consumer demands. The supplier has exclusive right of operation in its territory. Export and import activities may be handled solely by the distributor. Similarly, gas activities may be pursued by gas distributors and gas suppliers. The latter have exclusive right to supply gas to consumers in given geographical areas and must buy gas exclusively from the gas distributor. Only a company with the necessary infrastructure and gas source, that is to say MOL, may engage in the gas distribution activity. Under the Gas Act, MOL is also the sole importer of natural gas and owner of transportation

⁴¹ European Bank for Reconstruction and Development (1996).

⁴² The reasons include the higher distribution costs to households and the fact that households contribute disproportionately to peak-load demand, which is normally supplied by the production capacity with the highest marginal costs.

and storage facilities.⁴³ The result is that, although access of producers to the electricity and gas networks is open, transmission/distribution and suppliers are treated as natural monopolies.

81. The Hungarian Energy Office was created as the independent regulator in accordance with the 1994 Electricity and Gas Acts. The Office has the authority to grant concessions for distribution areas and the construction of new power plants, and to propose maximum prices and the price structure.⁴⁴ The Minister of Industry, Trade and Tourism retains responsibility for setting prices, however. In August 1995 a Government decree was issued containing a series of price increases up to 1997 and a medium-term framework for setting prices. This framework was designed to ensure full cost recovery and to allow a real rate of return of 8% on capital from 1 January 1997.

82. In the autumn of 1996, however, a great deal of controversy arose when the Government decided not to accept the price increase of 39% recommended by the Energy Office and requested the energy commissioner to review the Office's recommendation.⁴⁵ The commissioner scaled back the price increases to 24.5% for electricity and 18.8% for gas, effective 1 January 1997, by ignoring a wide variety of costs that had been taken into account by the Energy Office.⁴⁶ Subsequently, the Government asked the Office to include these costs gradually over the next five years. A number of firms in the energy sector considered the price revision a breach of contract and threatened to sell off or reduce their holdings despite a provision in the initial sales contracts prohibiting subsequent sales for five years. Nevertheless, the Government agreed to allow some firms to do so. While price increases in 1997 of about 40% (more than double the rate of inflation), have gone a long way towards meeting the requirement of full cost recovery, the precise nature of the costs to be included in the price formula is apparently still under discussion. Also under discussion is a new price structure, which would phase out cross-subsidization, particularly of household energy consumption. Uncertainty over prices tends to undermine investors' confidence in the regulatory regime and deter long-term investment. On the other hand, as a result of their relatively high capital intensity, energy companies would tend to be among the main beneficiaries of the various tax and non-tax incentives accorded to investment.

83. Privatization of energy utilities together with a regulatory regime that allows pricing in accordance with all costs will undoubtedly contribute to the more efficient production and use of energy. This, in turn, should substantially reduce sulphur dioxide emissions from coal-fired power plants and enable firms to meet stricter environmental standards. Hitherto these standards have tended to be enforced only in the case of new investments in power plant. Insofar as environmental (and safety) standards are applied less strictly to existing power plants, a "regulatory" subsidy is involved. Between 1990 and 1995, energy-related carbon dioxide emissions dropped by 15%.

⁴³ MOL also has a dominant position in oil imports, production and refining as well as a market share of roughly one third of the retail market.

⁴⁴ The Hungarian Energy Office is also responsible for overseeing business relations between distributors and suppliers, and consumer protection issues.

⁴⁵ OECD (1997a), p.p. 118-119.

⁴⁶ Among the costs disallowed by the commissioner were: insurance costs (estimated to account for a 1 percentage point drop in prices), environmental costs (1.9 percentage points), accumulation of strategic reserves (1.1 percentage points), costs associated with delayed maintenance (1.4 percentage points). Increased efficiency accounted for 2.2 percentage points off gas and 1.6 points off electricity; modifications to depreciation rules accounted for 1.9 and 2 points. The halving of so-called guaranteed rate of return on capital to 4% accounted for a decline of 5.8 points. Finally, producer growth equal to 19% instead of 14% added back 3 percentage points (*ECONIEWS*, 26 November 1996).

84. Hungary is increasingly linking up its electricity and gas networks with those of EU and CEFTA countries, thus facilitating cross-border trade in energy and therefore competition. In 1992, Hungary together with the Czech and Slovak Republics and Poland formed an association, the Central European Electricity Network (CENTREL), which then joined the west-European electricity grid (UCPTE) in 1995. In October 1996, Hungary also established a gas pipeline connection with Austria, thereby linking Hungary to the western-European gas grid and enabling it to reduce its dependence on imports from Russia.⁴⁷

85. It would appear that Hungary's energy policy objectives now correspond to those of the EU, which include security and diversification of energy supplies, increased reliance on market principles, improved efficiency and environmental protection. Moreover, the competition framework applied to the energy sector, notably the 1994 Electricity and Gas Acts, together with the 1996 Competition Act (Chapter III(4)(viii)), is moving in the direction of the EU directives pertaining to the internal energy market and EC competition law.

⁴⁷ It is expected that by 2010, around 20% of natural gas imports will come from sources other than Russia.

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