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Fiscal Policy in Hungary under Transition

vol. I

by

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I. MACROECONOMIC DEVELOPMENT

Transformation of the centrally planned economy to a market based system in Hungary has been a more gradual process than in other transitory economies, although 1990 - when the new democratic government was elected - is considered as an 'official' starting point of the transition period. Since 1968 Hungary experienced a quite long period of reforms. Between 1968 and 1988 due to these reforms (aiming at the establishment of a market based socialist system) the state-owned enterprises became virtually free in decision making concerning production, investment, marketing and also finance and the State's decisions concerned mainly on nationally important projects and on the formation of market conditions.

During the eighties the economic policy was fluctuating: period of restrictions was followed by loosening and inversely. The further deterioration of foreign equilibrium was thought to be prevented by measures to curb domestic demand. Based on a false evaluation of the first, partial results and prospects, in 1985 strict targets of restrictive economic policy were abandoned. Expansion of the domestic demand coupled with a strengthening tendency of export surpluses in non-convertible currency crowded out the convertible currency exports. The growing external imbalances forced the government to return to the restrictive domestic demand policy in the mid-1987. The ineffective system of regulation, the badly oriented subsidies etc. made the adjustment process very slow if any, hence the unfavourable trends continued: the exports to CMEA had been increasing while convertible exports continued to decline. By the end of 1989 Hungary's creditworthiness had weakened critically and Hungary faced its most severe foreign exchange liquidity crises since 1982.

Since the mid-eighties a series of laws had been enacted and institutions indispensable for a market economy had been established. The further development of legal conditions and institutional structure of the economy is a permanent task in the transition period, but some of the major changes making the transformation process irreversible had already taken place before 1990, in 1988-1989.

- *Company Law* regulated newly established firms. *Foreign Investment Law* defined foreign investors' rights and benefits and the *Transformation Law* regulated the transformation of state owned enterprises and privatization initiated by enterprise management which provided the basic legal conditions of the economy based on private property.

- Implementation of a new *tax system*: corporate tax, personal income tax, and value added tax.

- *Price liberalization process* started in the early eighties by the introduction of the so-called world market price following system which in reality was not more than a bureaucratic simulation of the market price system. It could serve, however, as a basis for the price liberalization process coupled with the significant reduction of subsidies. (From 1988 on by now beyond 90 per cent of commodity prices have been liberalized and subsidies are restricted mainly to agriculture.)

- *Foreign trading rights* - used to be absolute state monopoly in the CPE were liberalized. The range of goods to be imported were gradually liberalized. (In 1989 about 40 per cent of total imports were liberalized. The range was expanded to 70 in 1990, and to 90 per cent in 1991.)

- *The establishment of the two tier banking system* in 1987 was the first step of crucial importance in the transformation of the 'centrally financed' system to a market based one.

At the official starting point of the transition period, *in 1990, the Hungarian economy was burdened by serious crisis phenomena*. The main macroeconomic indicators reflect that at the moment of the regime change Hungarian economy was undoubtedly in a recession phase (Table-I.1). The accelerating inflation reached the critical 30 per cent rate by the end of 1990. The scope of economic policy was significantly tightened by international indebtedness, the gross convertible debt to GDP ratio was nearly 70 per cent at the end of 1989.

The *new Government program* declared the *crises management* as a primary objective by reorientation of foreign trade, by reducing inflation and without rescheduling the external debt. The main strategy of Hungarian external debt management was to meet debt service obligation in order to enlarge the access to international markets. A longer-run restructuring program based on privatization and liberalization was announced as well. The weak adjustment capability of the economy on enterprise level was thought to be improved by diminishing the State's participation in the economic activity and by increasing the price and cost sensibility of enterprises. The growing competition was boosted by the liberalization process and the foreign capital inflow which contributed to the creation a favourable climate for the quick adjustment. At the same time it was an urgent task to make the necessary changes in the regulation in order to strengthen financial discipline (bankruptcy law, act on the financial institutions etc.).

Following the regime change in 1990 two different periods of the economic development can be distinguished.

- In 1991-1992 the primary target was to restore creditworthiness and to improve the foreign equilibrium position of the country.

- Since 1993 the targets have been changed several times and the development can not be characterized by one trend, but it can be said that the ups and downs are stemming from the different - sometimes contradictory - efforts, all aiming at the switch to a sustainable growth path.

The international environment and the internal economic situation as well as the profile of the economy differed a lot from those of the eighties, but some problems well known from the previous regime - the stop-go cycle by tightening and loosening, decided and postponed basic reforms in public finance etc. - were somehow 'preserved' during the first period of transition. This statement does not want to neglect neither the differences between the new and the previous regime nor the results of the transition, but it stresses the inefficiency of some of the efforts.

In 1991 and 1992 the primary tasks of economic policy was to improve the external *equilibrium, to stop the increase of foreign debt and to curb the acceleration of the inflation.* These goals were to achieve by a restrictive economic policy. Taking into account that due to the collapse of the CMEA a significant fall in Hungarian exports was unavoidable and in order to meet the target to improve the current account the economic program set the target that the domestic demand had to decline at the same rate as the exports in 1991. The actual development reflected the main directions of government program, but the size of recession was larger than had been expected. The GDP and the exports declined at a higher rate than target (12 and 14% resp.). The export shortfall was not accompanied by the deterioration of the current account. This latter improved by USD 1 billion more than the target due to the decreasing domestic absorption and the fall of demand for imports.

Table- I.1. :Macroeconomic indicators

	1990	1991	1992	1993	1994*
	(Year-to-year rate of change in per cent, at constant prices)				
GDP	-3.5	-11.9	-3.0	-0.8	2.0
Consumption	-2.7	-5.1	+0.8	4.9	0.7
- private	-3.6	-5.6	-0.1	1.5	1.5
- public****	2.6	-2.7	+6.4	+25.3	..
Gross capital formation	-4.2	-21.1	-21.7	+35.5	+20.0
Domestic use of GDP	-3.1	-9.1	-3.6	+9.7	+2.0
Exports	-5.3	-13.9	+2.1	-10.1	13.5
Imports	-4.3	-6.1	+0.2	+20.2	10.5
	(Year to year rate of change in per cent)				
GDP deflator	26.0	26.0	21.8	24.2	18.9
Industrial PPI	22.0	32.6	12.3	10.8	11.3
CPI	28.9	35.0	23.0	22.5	18.8
Terms of trade	0.4	-10.4	-0.5	2.3	..
Broad money (M2)	29.2	29.4	27.3	16.8	13.7
Saving ratio**	5.0	16.0	10.6	5.5	9.1
Unemployment rate ***	1.4	7.8	14.7	13.9	11.1
Current account (in Million USD)	127	267	324	-3,422	-3,900
Foreign debt of Hungary (in Billion USD)	21.5	22.8	21.7	24.6	28.5
External debt / GDP (%)	64.6	73.3	58.7	64.2	69.1

Source: Main indicators of economic development, 1994, CSO Budapest, and National Bank of Hungary Annual Reports

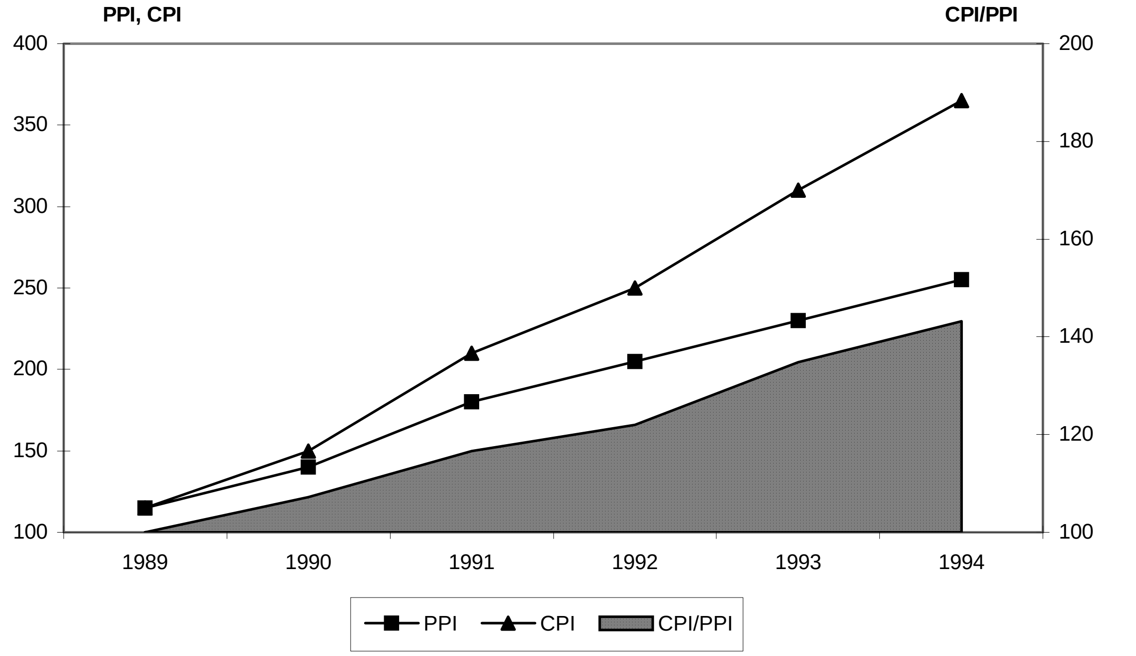
* Preliminary data.

** Household net savings in percentage of the disposable income.

*** Ratio of unemployed at the end of the year to the sum of employed and unemployed in the same period.

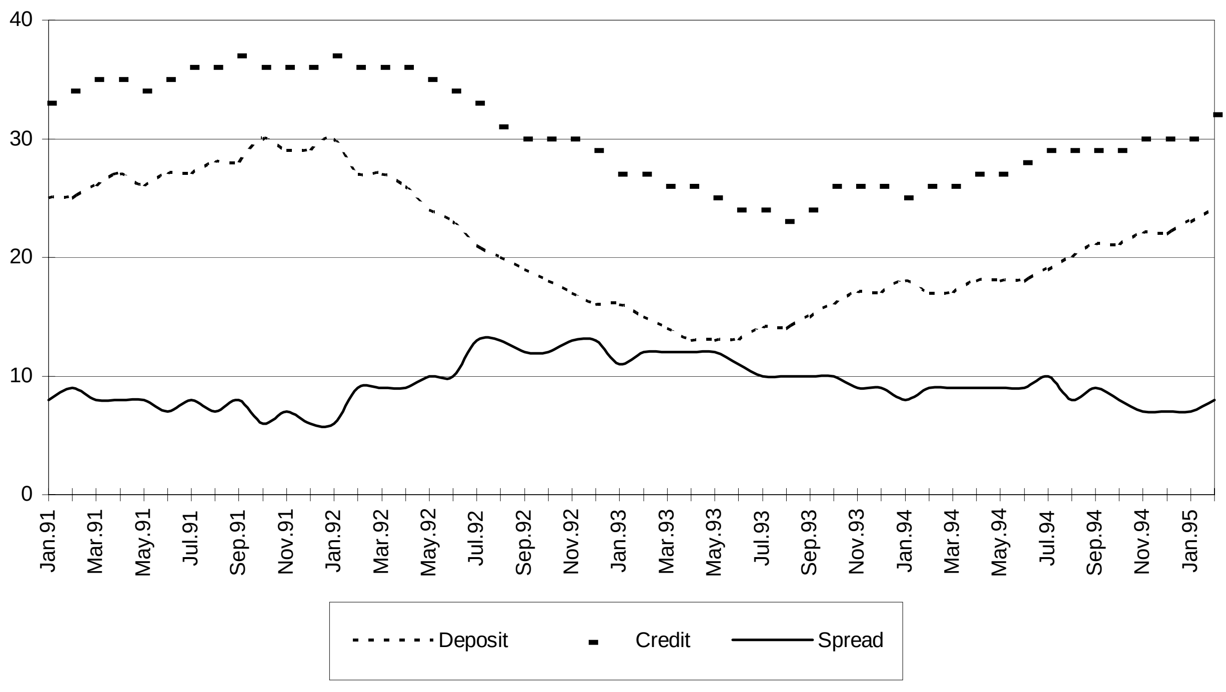
**** Including the effect of Roubles debt repayments by airplanes delivery in 1993. Excluding the imports of military aircraft, the government final consumption expenditures could have remained at the level of previous year.

Figure I.1: Price indices and the ratio (1988=100, per cent)



PPI- whole industrial price

Figure I.2: Interest rates and the spread (per cent)



Short term credit and deposit interest rates in the corporate sector
(maturity less than one year)

The interest rates followed the inflation process with a lag. The credit rates for the business sector reached a pick by the end of 1991 (see Figure I.1) although the industrial PPI showed a decelerating trend since the mid-1991. The real interest rates turned to positive and remained high (above 10%) making the profitability constraint effective for the investors which contributed to the further decline in the domestic demand. In addition, the import liberalization and the increased cost sensitivity of enterprises resulted in a sudden fall in the input and output stocks. At the same time the saving ratio jumped up to 16% from the average annual 5-6% before. The increasing saving rate was considered as an important result although it has to be taken into account that the increased savings covered the households' loss of wealth due to the high rate of inflation.

It can be said that the micro level adjustment process starting in 1991 was of great importance leading to the creation of a market oriented enterprise sector. The supply side reaction, however, can be judged slow. It was slow in the sense that the external shocks and the internal restriction could only achieve the liquidation of the non-competitive (or competitive only in the former CMEA markets) activities, but could not promote sufficiently the creation of longer-run and in the world market competitive businesses that could have been the core of the recovery in the following period.

These imperfections in the adjustment process coupled with the weakening profitability of enterprises - which could not be anticipated when setting the targets - resulted that in 1992 the target of slight increase in the GDP failed. In addition, due to the shortfall of budget income stemming from the poor economic performance in 1991 and the implementation of a market based system of deficit financing, it turned out that the conservation of public finance system inherited from the previous regime would lead undoubtedly to serious disequilibrium problems contrary to the medium term goal of stable and moderate growth.

Taking all this together, the period *1991-1992 was successful from the point of view of curbing the external indebtedness, but also the roots of the present diseqilibrium problems may be found in this period.* The current account exhibited slight surplus, foreign exchange reserves reached a secure level and the inflow of foreign direct investment was continuous. By the end of 1992 net debt of Hungary decreased by nearly USD 3 billion to USD 13.3 billion, comparing to 1990. The debt service ratio (from 43.2% to 31.9%) as well as Hungary's access to the international capital markets improved significantly. First signs of equilibrium problems were shaded by these partial results and by the relatively unfavourable external conditions. The coincidence of the bad externalities made policy-makers less attentive to the structural problems stemming first of all from the too long postponed transformation of the budget and public finance. While the framework of market economy has been completed by the new developments of legal and institutional conditions (the acts on financial institutions and stock exchanges, accounting and bankruptcy, act on the central bank) at the same time this 'triggered' a wave of selection among nonviable enterprises and the emerging sector was hindered by the high cost of capital[1]. Unfavourable signs were manifested in the sluggishness of the modernization and in the increasing size of non-performing debts and in the growing

[1] Bonin, J.P.-Schaffer M. E. (1995): Banks, Bad Debts and Bankruptcy in Hungary, Manuscsript

borrowing requirement of the public sector threatening by crowding out private sector in the competition for funds.

At the beginning of 1993, based on the evaluation of the previous years' performance, there was a shift concerning the main goals of macroeconomic policy. Taking into account the improving current account in 1992 the target rate of increase of domestic demand was set higher than the target increase in exports in order to let the investments recover which seemed to be necessary to turn up the trend of falling GDP prevailing since 1990. The first unfavourable signs of exports decline were attributed to exogenous factors and were thought to be temporary. It was expected that increasing domestic demand would contribute to the increase of investments rather than to the increase of imports. According to these objectives the monetary policy aimed at lowering interest rates by reducing mandatory reserve requirement and by not sterilizing excess liquidity.

Behind the failure of 1993 economic performance different reasons can be identified. unfavourable exogenous factors, false evaluation of previous years' developments, confused - sometimes precautious, sometimes delayed - measures both in fiscal and monetary policy destroying the public confidence and fueling inflationary and devaluation expectation.

- It was thought too long that the decline in exports which manifested first in November-December of 1992 was exclusively due to exogenous factors like slow recovery of business cycle in developed countries, embargoes because of war situation in the former Yugoslavia and slowly increasing demand of former CMEA countries, bad weather hitting agricultural production and resulting in a shortage of exportable goods etc.. These factors contributed to the shortfall of Hungarian exports but there were some more inherent problems which were not identified in time.

- The exchange rate policy played an important role in the anti-inflationary policy during 1991-1993. The pressure to export stemming from the declining domestic demand in the early nineties provided the possibility for the policy makers to use the exchange rate as a major tool to reduce higher than 30 per cent and accelerating inflation. The significant real depreciation which had taken place during the eighties was evaluated as some kind of 'reserve' for the exchange rate policy followed in 1991 as a result of which the Hungarian forint was appreciated by more than 10% higher in real effective terms.

From 1992 to the mid-1993 the size and the timing of devaluations (according to the pegged but adjustable exchange rate system) was determined by taking into account two main goals - to reduce inflation and to keep competitiveness of the tradable sector - with changing priority. In spite of the more and more frequent declarations of maintaining the competitiveness of Hungarian exporters the anti inflationary goal had the first priority especially when due to some fiscal measures (modification of tax rates) the inflationary pressure renewed. Finally, according to the main indicator used in decision making process of the exchange rate policy - computed on the basis of the industrial domestic wholesale prices - the real effective exchange rate was roughly maintained between 1991-1993.

- From the mid-1991 the difference between the CPI and PPI has been widening mainly due to the shift to a market based pricing system. This tendency which has been prevailing longer run than it had been expected, can be explained by the price liberalization and by the transformation of the agricultural and services prices from the previous, officially determined, artificially low level to a cost based mark-up system and by the transformation of the so called financial bridges (turnover taxes, elimination of producer and price subsidies etc.). The inflation reached the peak in 1991 (annual rate 35% and 32% of CPI and PPI resp.). This was followed by a period of significant decline (in 1992 annual rates were 23% CPI and 12% PPI) which could not became, however, a longer 'trend'. In 1993 yearly inflation was 22.5% which was only slightly less than in 1992. The large spread between CPI and PPI had consequences of great importance on the economic development.

- Maybe the most important of these consequences is the deterioration of the interest rate structure. The deposit rates should be set according to the high CPI: a moderately positive real interest on deposits is indispensable to get household savings which increase the average cost of liabilities. On the other side credit rates exceeded deposit rates by 6-10% percentage points during 1991-1994. This is partly due to the relatively high reserve requirement ratio, partly to the high operation costs of the Hungarian financial institutions and also the high lending risk is reflected by the large differences between lending and borrowing rates. All these reflect immanent factors of the transition economy and therefore the high cost of intermediation - being one of the main impediment of the development and manifested in the large spread of interest rates - may be reduced gradually. Lowering the general (real) interest level may threaten by the fall in savings, at the same time the high interest rates make the investments a priory unprofitable. The activity of better firms is hindered by high real interests while the danger of moral hazard is increasing.

  The relative sluggishness of interest rate adjustment caused by the imperfections in the transmission mechanism[2] of monetary policy is an other major problem making the adjustment slower than would be necessary to increase efficiency of economic policy. The month to month inflation rates started to decline from the second half of 1991 (they reached 22% by December), however, the stickiness of interest rates was proved by the fact that business sectors' deposit and credit rates of the early 1992 were still over 30% and 35% resp.

The interest rate decline (which became significant only in the second half of 1992) was basically a right goal of the economic policy, but finally the size of decline turned to be 'exaggerated'. The fiscal and the monetary policy did not want to accept the adjustment lag of commercial bank's interest movement and both made steps promoting interest rate decline. The central bank purchased a significant amount of government bonds at the end of 1992 and reduced the rate of mandatory reserves in January 1993. Due to the excess liquidity the yields on government securities fell. The budget - neglecting that the PSBR was expected to increase - profited from the artificially low interest rates and issued government bonds at 21, 17 and 14% fixed interest rates for 3 years ahead. (Instead it would have been a good strategy to issue some more government securities than needed in order to smooth the cycle in borrowing requirement.) Investors (mainly commercial bank) purchased these securities having no better choice. The basic problem was that the government goals concerning the external and internal

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[2] More details are given in the part dealing with monetary policy and the financial system operations.

equilibrium and inflation were not consistent. The current account did not improve, the PSBR remained high and stemming from this the inflation and devaluation expectations of the market exceeded the government projections. The fixed coupon of government bonds were designed according to the ambitious goals of the medium term government program[3] the credibility of which was low, however. The yield on the less than one year government securities as well as the household' deposit real interest rates became negative in 1993. The household savings began to 'disappear'. It was unavoidable to turn back the trend of falling interest rates. The main lessons that can be drawn from the 1993 experiences was that market cannot be forced to believe what policy makers would like. The credibility may be built up by consistent and successful economic policy and stable economic environment.

Since 1992 it became a permanent practice to prepare supplementary budget each year which reflects the increased uncertainty concerning the forecast of different processes. Finally in 1993 the budget deficit could be kept in line with the supplementary budget (even it turned to be not too much exceeding the original budget) and the ratio of the general government borrowing requirement to the GDP slightly abated (from 7.1% in 1992 to 6.0% in 1993)

However, it was not recognized on time - or not accepted by policy makers - that in 1993 some special factors[4] temporarily veiled the immanent structural problems of the budget as well as the threatening 'snow ball' effect. (increased PSBR - interest costs - further increased PSBR etc.).

The following chapters are dealing with the structural, methodological and financing problem of the budget but it has to be mentioned already here, in advance that the most fundamental problem has been 'what is how much?'. Because of the lack of transparency even in the central budget[5] it is very difficult to set equilibrium macroeconomic targets. The aim of this paper is just to make the picture clearer on some basic fields.

When the problems of the real processes were undoubtedly recognized - mid-1993- the 'only slight' primary deficit was a very commonly used argument against those voices who required a significant cut in the PSBR. During these debates all the parties were paying little interest to the content of figures they were speaking about. The primary balance was computed from the Hungarian type budget with a correction by domestic amortization only, sometimes by deducting external amortization as well and it was estimated by different experts to be +/-1% of the GDP in 1993. The influence of the National Bank of Hungary quasi-fiscal

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[3] Taking into account the 20, 15, 12% inflation rate forecasts, zero % real interest rate for one year investment, 1-2% real interest rate for more than one year securities were provided.

[4] The interest decline at the beginning of the year allowed debt managers to lengthen the average maturity of the outstanding debt by 2-5 years maturity bonds which resulted lower debt service costs in the given year.

[5] According to the Hungarian methodology budget figures have comprised borrowing items as revenues and repayments as expenditues. There are 'missing items', like the so called out of budget obligations and the budget type incomes and expenditures going through such state institutions like State Holding Company, Privatisation Agency or State Development Institute. Due to the unclear structure of the budget sometimes it is not a simple task to distinguish between different types of debt service expeditures.

surplus/deficit[6] (the large part of which went directly to the budget) has not been carefully investigated, although it reflects a lot of very important features of the Hungarian system of financing (like foreign debt management, transformation of the refinancing activity of the central bank etc.). At the same time it was generally neglected that the profit of the central bank was taken into account as a part of the primary balance and the necessity to consolidate the budget and the central bank balance sheet[7] was not treated according to its importance. In order to determine the size of budget adjustment required for the short term stabilization and longer run growth it is absolutely necessary to distinguish clearly the stock and flows by main types. Recognizing this necessity a lot of efforts have been done both by Hungarian researchers[8] and international organizations (country studies of the IMF and the World Bank) to analyze these problems.

Table-I.2 Main indicators of imbalances in the government sector finance*

(in per cent of GDP)

	1990	1991	1992	1993	1994**
I. Central budget balances					
1. Hungarian presentation*	-0.1	-4.6	-6.7	-5.6	-7.4
2. GFS balance	+0.8	-3.8	-4.8	-3.6	-4.8
o/w: Primary balance	+3.8	-0.4	+0.3	+0.7	+1.9
3. SNA balance	+0.7	-3.9	-6.8	-5.0	-7.1
o/w Primary balance	+3.7	-0.6	-0.4	+0.7	+0.5
4. Domestic interest payments to total expenditures (%)	10.0	11.0	17.0	14.0	19.8
II. General government balances					
1. GFS	..	..	-5.0	-4.3	-5.7
o/w: Primary balance	..	..	-0.4	-0.2	+0.9
2. SNA	..	..	-7.1	-6.0	-8.5
o/w: Primary balance	..	..	-1.2	-0.3	-0.5

* Including some of the borrowing items and amortization as well.
** Preliminary data.

The above table contains the official data. In this study we try to make a lot of necessary corrections in order to get data reflecting the real fiscal position of the Government.

[6] It happened as well in 1992 that the central bank needed some budget support in order to keep its attractive image in the international capital markets.

[7] More details are given in part VI.

[8] Borbély L.- Neményi J. (1994): Az államadósság növekedésének összetevôi, Közgazdasági Szemle February. Oblath G. -Valentiny Á. (1993): Seigniorage és inflációs adó, Közgazdasági Szemle, November

During the transition it was not taken into account sufficiently that the borrowing requirement of the out of central budget public sector (extrabudgetary funds, Social Security, local governments) started to grow as well. In addition, the total influence of the off budget obligations of the government (like bank consolidation program) - including future determinations - were not taken into account. Neither the intertemporary nor the total effect of public sector borrowing were taken into account when setting the targets. The additional privatization incomes may help to ease the pressure in the domestic capital markets. The amount involved into the budget on general government level amounted to HUF 60 billion in 1994 and HUF 150 billion and 100 billion are planned in 1995 and 1996 respectively(near to 3% and 1.5% of GDP). By 1997 the reduction of PSBR is planned to be based on a new type of budget and treasury system and its effective operation.

In 1993 the targets of macroeconomic policy failed completely: the GDP continued to fall (0.8%), the domestic demand and imports grew strongly and the one year expansion of exports turned to an unexpected decline (10%) which became a major problem of the 1993-1994 development. Both domestic and foreign equilibrium deteriorated to a dangerous extent.

The current account deficit in 1993 exceeded USD 3.5 billion due primarily to the substantial foreign trade deficit. While the inflow of the foreign direct investments were continuous, the direct borrowing made by enterprises and by commercial banks in international markets became significant and as a 'result' the external debt of the country began to rise again.

It can be considered as *a main problem during the first years of transition that the credibility of economic policy diminished by the serial failures of targets even if they could have been explained*. The measures in fiscal and monetary policy did not always harmonize with each other which undermined credibility as well. (In summer 1993 the forint was devalued twice - 3 and 4.5% - in order to restore the decreasing competitiveness of exporters but by that time a real crisis in the budget finance had developed and central bank interest rates were increased as well in order to treat the saving propensity problem.)

Contrary to 1993, 1994 was an ambiguous year in the Hungarian development. This was the first year after the nearly 20% decline in GDP between 1989-1993 when the GDP growth rate turned to positive (2%). Household consumption was rising by nearly 2% in real terms but the investments were growing faster (20%). Since the first signs of the recovery in the mid-1993 manifested the investment demand had been increasing due to the improving financial position of enterprises (both Hungarian and joint ventures) and also due to the support provided by the government to some large enterprises in the form of state guarantee. The export activity began to get out from the crises during 1994, the problem resulted, however, from the increasing import demand which reflected the weakness of domestic supply being not able to meet increasing domestic demand. The equilibrium targets have been threatened by the expansion of imports in the supply side. The imports were rising faster than exports and this discrepancy might have been anticipated to continue which would have led to accelerating external indebtedness if corrective measures had not been taken to restore equilibrium.

Table-I.3: Components of supply and demand 1993-1994 (in per cent)

	Previous year =100		Distribution	
	1993	1994	1993	1994
Supply side				
1. Domestic	99.1	102.1	71.5	68.6
2. Imports	113.1	117.2	28.5	31.4
Total (1+2)	102.8	106.4	100.0	100.0
Demand side				
3. Consumption	103.2	100.7	62.5	59.1
4. Gross capital formation	128.1	120.0	15.1	17.0
5. Exports	89.9	113.3	22.4	23.9
Total (3+4+5)	102.8	106.4	100.0	100.0

Source: NBH Annual report 1994

The National Bank of Hungary continued to follow monetary restriction by increasing central bank rates several times. It was, however, evident that monetary instruments were not sufficient alone to treat the basic problem. Targets for PSBR exceeded evidently the size that would be in line with a sustainable growth path. During 1994 the necessary measures in the fiscal policy were postponed again for several reasons. 1994 was a year of general election in Hungary and this was not advantageous from the point of view of economic adjustment. The previous government was reluctant to face the deteriorating equilibrium and did not take any unpopular measure. In addition according to the economic philosophy of the previous government the disequilibrium problems might be 'outgrown' and its efforts were concentrated on giving impetus to the growth[9].

The new government needed some time to check the general situation and could not do more than a very quick devaluation of greatest size (8%) since 1991 in order to improve competitiveness. However, the necessary adjustment in the fiscal policy that would have been necessary to enhance effectiveness of the devaluation was not introduced in 1994. The late autumn preparation of the supplementary budget[10] lost all the time necessary to create a sound budget for 1995. The new government program treated the deteriorating external equilibrium as a first priority problem which could be solved by a restrictive economic policy: tight monetary policy and seriously constrained public sector borrowing requirement. This latter has to be the key element allowing the private sector to get more from the domestic savings. Moderated PSBR might result a more favourable interest rate level for investments and it promotes the starting growth. It has to be taken into account, however, that the 'normal' rate of import requirement (ratio) of investments became relatively high and since then the import might have been expected to be quite inelastic to price changes. In 1994 more than 60% of the import increase could be attributed to the increase in imports of machinery, semi-finished

[9] The Act on the central bank was amended by the 1994 budget in order to provide some more finance to the budget.

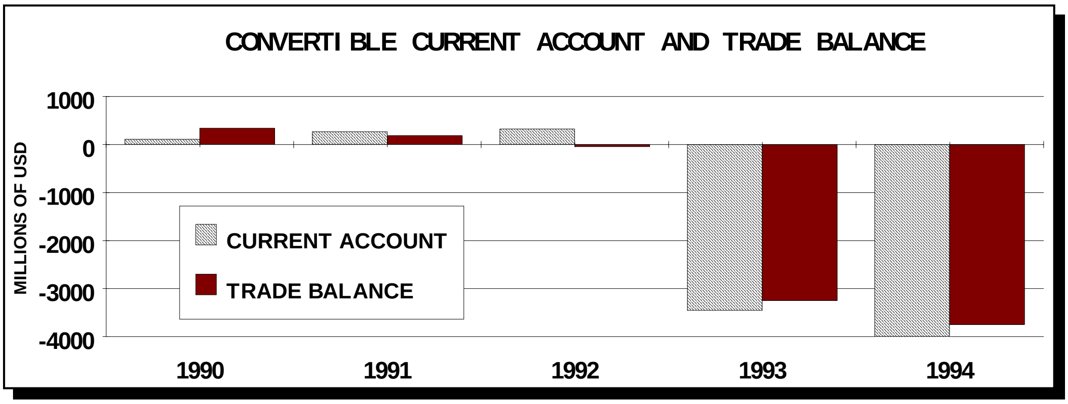
[10] It did not contain basic reforms, just tried to forecast the original budget. The only serious decision was the increase of the preferential rate of VAT - from January 1 1995.

goods and materials and only less than 20% to the increase in imports of consumer goods. Thus import increase in 1994 was supported mainly investments and productions.

Under the above circumstances - not unexpectedly - the credibility of economic policy was further weakening. Of course this resulted again a very difficult situation in budget financing. In summer the domestic forint funds practically were used up and nobody wanted to buy government papers at any yield due to the more than ever increasing convertible currency speculation of banking and non bank sectors until the devaluation took place (in August). There was some increase in selling more than 3 year maturity bonds to households but this was not a real result but a consequence the tax relief introduced by the previous government. The possibility of the deduction of these investments up to the 30% of the tax base meant a 60-70% average yield on these securities[11].

The medium-term economic program of the new government (prepared after the elections in 1994) aimed at the stabilization and modernization of the economy and by this way at the sustainable growth. According to this program the public sector borrowing requirement and indebtedness should have reached the European standards (3 percent deficit to GDP and 60 per cent debt to GDP) and in order to achieve the targets not only the structure of the budget but also the system of the public finance has to be reformed by setting up a Treasury.

The declining trend of inflation stopped in 1994. The average yearly inflation rate (19%) was lower than in the preceding year, but the month to month indices showed an acceleration again, the inflationary pressure could have been observed from February on. To keep the budget in line with the targets the government decided to increase some of the VAT and excise tax rates and the larger size of the devaluation (17 %) as well had its lagged effect in the price increase. The significant wage and income increase contributed as well to the renewal of the inflationary pressure (disposable incomes grew by 24% in 1994).



The increase in the domestic demand exceeded the target due to the high outflow of incomes which coupled with the rapid growth of investments resulted in import surplus. The deteriorating trade balance caused a high (3.9 billion) deficit in the current account. It is obvious that under these circumstances at the end of 1994 the high level of official reserves

[11] Some of the brokerage firms completed this possibility with very attractive credit facilities by which the yearly yield could be increased above 150%.

(approximately USD 7 billion, which was equivalent to 7 months of imports) was necessary to maintain the creditworthiness in the international capital markets of the country.

Table -I.4.: Main indicators of indebtedness in convertible currencies

	1990	1991	1992	1993	1994*
	in million USD				
Gross convertible debt	21 270	22 658	21 438	24 560	28 521
Net convertible debt	15 938	14 555	13 276	14 927	18 936
Debt service**	4 191	4 037	4 733	4 908	6 214
Pre-payment	42	296	568	699	1 016
Debt service ratios	*in per cent*				
Gross debt to GDP	64.7	72.5	58.7	64.2	69.1
Net debt to GDP	48.5	46.6	36.4	39.0	45.9
Debt service to GDP***	12.6	12.0	11.4	11.0	12.6
Debt service to imports of goods and services***	49.0	32.2	31.2	38.6	48.7
Reserves to monthly average imports of goods	2.3	5.3	5.2	7.1	7.2

* Preliminary data.
** Medium term repayments + gross interest payments (excluding pre-payments)
*** Debt service ratio do not include pre-payments.

The savings-investment balances summarize the main features of development during the transition and the current disequilibrium problems of Hungarian economy.

During the period of accelerating inflation (1989-1991) the households increased their savings which partly compensated the loss of real value of previous accumulations and also the so called 'precautionary' element were increasing due to the growing uncertainty concerning the general prospects of economic development and due to tensions in the labour market. There were some major changes the savers' behaviour were determined by. The social structure was completely transformed as a consequence of the regime change, there was a polarization in the social strata as well as in incomes. While in the previous regime the traditional savings resulted from wages and incomes of employees in the new system the emerging private sector of which the small and medium size enterprises saving behaviour became more and more relevant. Those households that were most hit by the recession (job-less people, pensioners etc.) were 'pushed towards consumption'.

Table-I.5: Savings-investment balances, 1990-1994

(In per cent of GDP)

	1989	1990	1991	1992	1993*	1994
Gross national saving	**25.0**	**27.3**	**17.8**	**14.5**	**11.2**	**13.6**
Households**	7.9	9.1	15.1	13.7	9.4	11.5
Enterprises	12.0	13.1	-0.4	2.3	7.0	7.1
Government	5.2	5.1	3.1	-1.5	-5.2	-5.0
Gross capital formation	**26.6**	**25.5**	**20.4**	**15.6**	**20.1**	**21.9**
Households**	5.2	3.9	5.4	4.5	4.6	4.6
Enterprises	15.5	18.0	10.7	5.3	10.6	12.6
Government	5.9	3.6	4.3	5.8	4.9	4.7
Net national saving	**-1.5**	**1.8**	**-2.6**	**-1.1**	**-8.9**	**-8.3**
Households**	2.7	5.2	9.7	9.2	4.8	6.9
Enterprises	-3.6	-4.9	-11.1	-3.0	-3.6	-5.5
Government	-0.7	1.5	-1.2	-7.3	-10.1	-9.7
Memorandum items						
Saving ratio (net household savings to disposable income, per cent)	0.8	5.0	16.0	10.6	5.5	9.1
Household disposable income (previous year =100)	117.3	130.7	127.6	117.7	116.6	124.0
CPI (previous year = 100)	117.0	128.9	135.0	123.0	122.5	118.8

* The effect of consolidation programs are not eliminated.
** Including small enterprises.
Source: NBH Annual report 1994

Taking into account that the household incomes in real terms declined by more than 16% between 1990-1995, it might be supposed that a larger part of the increase in the household savings resulted from a narrower, high income group of population. (Our knowledge about the situation and behaviour of the 'second' economy is still limited). On the other hand those who are able to save have become more and more sophisticated. The yield and portfolio considerations have been playing an increasingly important role in savers' decisions. This was reflected by the drop of savings in the first half of 1993 when interest rates felt and became negative again in real terms. The reaction was unusually quick and household savings dropped by nearly 4%. The increase of household savings in 1994 was promoted by several special factors. Among them the tax holiday on the investments in government bonds more than 3 year maturity provided an exceptional yield for the investors and exceptional losses for the budget. (It was abolished in November.)

During the output decline in the early nineties the enterprise savings were constrained both by demand and supply side effects. After the trade reorientation and when the main events of restructuring had taken place the ratio of gross capital formation of enterprises to GDP began to increase again as a consequence of starting recovery. The enterprises investment activity and replenishment of their stocks[12] was financed partly by increased retained earnings and the demand for credit has been increasing since then.

The government sector borrowing requirement was steadily increasing due to the lack of budget reforms (as explained above) and could not counterbalance neither the growing needs for funds of private sector nor the stop of increase in the household savings.

By the end of 1994 the double imbalances - high level of PSBR and current account deficit - became problems of primary importance of economic development. The new adjustment program launched by the government at the end of the first quarter of 1995 focused first of all on the 'twin deficits' and aimed at the reconciliation of different goals: to stabilize the financial stance and to strengthen discipline consistently with the targets of sustainable growth and inflation stability. One of the key elements of this program is the success of ownership restructuring.

II. TRANSFORMATION OF THE OWNERSHIP STRUCTURE

One of the main priorities of different government programs was to accelerate the transformation of the ownership structure. The share of the private sector in the production of GDP has been steadily increasing (from 15-20% in 1989 to 45-55% by 1995). *The private sector expansion has taken place in following forms*: by creation new enterprises, by privatization (equity or business right) and by special forms of 'compensation' (compensation vouchers for the victims, returning real estates to previous owners, transformation of co-operatives). The Hungarian State Holding Company (HSHC), the State Property Agency (SPA) and the Treasury Property Management Organization (TPMO) were established to deal with the ownership transformation but also the local governments, ministries, enterprises, liquidating organizations and co-operatives have been involved in the process. HSHC has been responsible for state-owned sector for longer run while SPA has been dealing with firms to be privatized. According to a very recent decision the two institutions are to be merged.

[12] The socialist economy of shortage had been operating with a high level of input and output stocks. During the recession these stocks hit a bottom in 1992 and the restoration of a normal stock level started in 1993.

Table-II.1.: Ownership structure of corporations belonging to SPA and HSHC (at the end of 1994)

(in per cent)

	SPA portfolio		HSHC portfolio	
	at the start	at the end of 1994	at the start	at the end of 1994
State owned	82.7	52.5	91.8	73.6
o/w for longer run	-		43.2	25.0
Local governments	4.7	4.5	2.0	4.6
Residents	6.7	30.1	6.0	16.1
o/w managers & employees	0.5	7.5		
Non residents	5.9	12.9	0.2	5.7

Source: National Bank of Hungary

Privatization practice in Hungary has been based on market-oriented approach. This may be characterized by mandatory property valuation and open sale, often by bidding, in which both organizations and entrepreneurs can participate and become owners. Resident and non residents are invited to participate to competitive biddings.

In the late eighties the privatization process started in a so called 'spontaneous way: the state owned company were sold upon the initiatives of investors and the enterprises involved. The first program aimed at privatization of small shops and service units. While this program completed successfully by now, the programs aiming at the privatizing state-owned firms have been slowly advanced in spite of several decisions declaring the speed-up of the privatization process as a first priority.

Since 1991 the self-initiated privatization was replaced by centrally directed programs. The special forms and financing lines have been provided in order to speed up the process. The property acquisition by employees, the leasing and the possibility of installment payments are to increase domestic demand. The Employee Stock Ownership Plan (ESOP) allows to keep the staff and managers which may help to make restructuring more effective. The so-called Existence Loan (E-loan) has been available for small investors since 1991 with very attractive conditions (3% rate of interest, +4% margin of commercial banks). The introduction of compensation voucher swaps to shares contributed as well to the acceleration of privatization although the quantity offered has been less than demanded. Special privatization loans are refinanced by the central bank and this means a special conversion of the long term government debt with the NBH to the debt of the private sector. At the end of 1994, these refinancing credits amounted to HUF 56.5 billion.

Although preferential privatization schemes can be considered successful there is a danger that large participation of retail investors in the privatization may create tensions in the future development of those companies that would need some more capital for successful restructuring. This problem of privatization on credit is reflected by the fact that the assets (capital) of companies privatized have so far been increased only in a few cases. Foreign investment continues to play an important role in Hungarian privatization. From USD 7.1 billion foreign direct investment, between 1990 and 1994, HUF 303 billion was related to the Hungarian privatization. Privatization incomes are expected to play an important role in the budget sector stabilization in Hungary. In 1994-1995 privatization revenue of HUF 250 billion (about 4% of GDP) is planned to be available for the central budget which would reduce PSBR and prevent (real) interest charges from further increase. It has to be emphasized that during this period the most important structural reforms (concerning the operation of Extrabudgetary Funds, Social Security Funds) have to be completed in the public sector and its financing system. By the time the extra-sources of financing stemming from the privatization will have been closed the public sector operation has to be improved significantly.

III. Development of the Financial Sector

Up to the mid-1980s the basic legal conditions as well as the elementary institutions had been missing in the emerging reform socialist system. In the early eighties the first securities issues were carried out but for the lack of markets these can be considered as some kind of market imitations. In the one tier banking system the central bank had been operating like a monopolized commercial bank. Outside the National Bank of Hungary there were only a few specialized financial institutions under the direct control of the NBH: the National Saving Bank (OTP) for households savings and the Hungarian Foreign Trade Bank (MKB) to finance foreign trade. Finance to the enterprise sector were provided centrally (since the income redistribution was also centrally directed) and the long term banking credits were the only source to investments.

The corporate bond issues to households started in 1984. Although the amount issued was not significant the corporate bond issues were of great importance because these were the only alternatives of bank credits for the socialist enterprises to get finance. The success of a number of fixed price corporate bonds was, however, destroyed by the accelerating inflation. (Also the few government bonds that were issued to cover the share of state in prime capital of different financial institutions had to be replaced later on, in the nineties by new issues at market terms.)

Parallel to these first steps of the capital market development the main event was the establishment of the two tier banking[13] system in 1987 which could be considered as the basis of the institutional and regulation development of money and capital markets during the transition. The number of financial institutions has doubled during the last seven years (there were 44 commercial banks at the end of 1994).

By 1990 the basic institutions of a market based financial sector had been established. There remained, however, some urgent tasks to improve legal conditions in the emerging money and capital markets and to develop tools of economic policy based on market signals as well as the institutional frames need a permanent improvement. The acts on financial institutions and activities, on the securities market regulation and on the stock exchanges (that were enacted in the early nineties) made the operating frames and rules more and more clear, although they have been subject to nearly permanent amendment.

[13] Hungarian Credit Bank, Commercial and Credit Bank and Budapest Bank were formed from earlier credit department of the NBH, the 4th large bank was the Hungarian Foreign Trade Bank already existing for foreign trade related operation.

During the transition period further institutions have been established in order to diminish the risk of both investors and creditors. (National Deposit Insurance Fund in 1993; the National Fund for the Institutional Protection of Savings Co-operatives in 1993; the Credit Guarantee Corporation; the Hungarian Export-Import Bank and the Hungarian Export Credit Guarantee Corporation in 1994.).

1. Development of the banking system

The Act on Financial Institutions and Activities (1991) provided the legal conditions for prudent and efficient operation of financial institutions. The aim of the law was declared to be the promotion of saving by strengthening the confidence of deposit holders on the one hand, and to create a more favourable climate for investors by efficient financial services on the other hand. Basic concept behind the regulation was to establish a specialized banking system. It has been devoted to facilitate the assumption of reasonable risk by adequate provisioning and also to orient the Hungarian financial institutions towards the international integration. The State Banking Supervision Agency (SBSA) was established.

The Act had been amended several times. Major amendments of the Act were necessitated by the following factors: (i) the development of the banking system and the whole Hungarian economy proved to be less favourable than it had been projected in 1991; (ii) liquidity, profitability has been deteriorated, provisioning requirement could not be met, the share of non-performing assets had been increasing which made necessary the credit consolidation in 1992 and the bank consolidation in 1993. (More details in the Appendix on legal condition.)

A quite complex amendment is carried out today as well in order to meet the goals of prudential and profitable operation more perfectly and to redefine the space of activity of commercial banks by allowing them to trade with government securities and to move towards the European Union standards. This means that in the future regulation will focus more on the different types of activities rather than on the different types of institutions.

Table-III.1 Number and subscribed capital of financial institutions

	Number of financial institutions			Subscribed capital (in million HUF)		
	1992	1993	1994	1992	1993	1994
Commercial banks	35	34	35	115	237	270
of which:						
Hungarian-owned	15	17	16	86	204	230
Jointly-owned	13	18	19	29	33	40
Specialized financial institutions	7	6	7	8	7	7
Investment banks	0	1	1	0	10	12
Total	**42**	**41**	**43**	**123**	**254**	**289**
Savings co-operatives	257	255	255	1	2	2

Table-III.1 (part 2): Total assets of financial institutions

(In billions of HUF)

	1990	1992	1993	1994*
Large banks	1381	1826	1982	2156
Small and medium sized banks (Hungarian-owned)	91	185	194	259
Jointly-owned banks	136	230	329	499
Specialized financial institutes	5	22	27	31
Investment bank	0	0	20	27
Savings co-operatives	79	127	138	155
TOTAL	**1692**	**2390**	**2690**	**3127**

* Preliminary data
Source: NBH Annual reports.

The above tables reflect the substantial development following 1991 concerning the number, the capitalisation and the size of activity of the financial institutions[14]. The expanding activity and the improvement in the capital position of jointly owned sub-sector can be clearly observed.

Table-III.2: Distribution of claims according to the risk (at the end of period)

	1992		1993		1994*	
	HUF bn	%	HUF bn	%	HUF bn	%
1 Problem free	1451.0	88.5	1294.7	70.9	1821	77.9
2. a) To be watched	-	-	122.8	6.7	190.5	8.1
b) Below average	38.7	2.4	52.3	2.9	42.6	1.8
c) Doubtful	63.2	3.9	111.1	6.1	81.8	3.5
d) Bad	84.5	5.2	244.9	13.4	202.9	8.7
Total (a+b+c+d)	186.4	11.5	531.2	29.1	517.8	22.1
Grand total (1+2)	**1637.4**	**100.0**	**1825.9**	**100.0**	**2339.1**	**100.0**

* Preliminary data

When the credit and debtor qualification system became more strict (in 1993) the share of non-performing assets jumped up suddenly. The problem of bad, doubtful and sub-standard loans could not be avoided any more by the second half of 1992, and in December 1992 *a complex program aiming at the improvement of banking sector portfolio was launched.*

As a first stage a portfolio clean up was carried out the end of 1992, when banks with capital adequacy ratio less than 7.25% were involved. The state purchased HUF 102.5 billion (face

[14] Three small commercial banks and five savings co-operatives were liquidated and/or transformed and two saving co-operatives united.

value) loan and interest claims by issuing HUF 80 billion state bonds of 20-year maturity. This first stage was called loan consolidation.

Since the deterioration of banks' portfolio continued in 1993 as well, the consolidation process was continued by company oriented loan consolidation. Under this program 12 large industrial companies' debt was partly written down or rescheduled, and then the government purchased the commercial banks' claims against these companies by issuing state bonds of HUF 57 billion.

Finally in 1993-1994 a bank consolidation procedure has been going on in several steps aiming at the increase of the capital adequacy of the 8 banks involved to the level of international standards. After the recapitalization the share of state holding in equities of these banks increased significantly (over 75% but one of them). The consolidation program added more than HUF 350 billion to the public debt.

Requirements included into consolidation contracts may help to accelerate modernization, training, improving information system etc. which helps to reduce the high level of the present operation costs of Hungarian banks. One of the very important development of the recent years is that banks are audited by international auditors and according to the present rules financial institutions' portfolios are properly classified. According to the consolidation contracts (between banks and government) financial institutions have already got rid of a substantial portion of their non performing assets and they are carried out a more and more active bad debt management. As the main result of the consolidation, the still existing bad portfolio is covered by adequate provisions.

Under the bank consolidation program - using different methods - the share of non-performing assets is planned to be reduced below 10 per cent by the end of 1995. To complete the stabilization process started with the credit and bank consolidation, appropriate professional investors are needed in order to substantially improve the banks' situation by capital increase through privatization.

Although the development during the transition may be considered significant there are a lot of tensions in the banking system.

- The first versions of laws enacted in the early nineties did not forced the emerging banking sector sufficiently to take into account prudential aspects on the one hand, but they were quite - maybe too - severe concerning the announcement of the bankruptcy on the other hand. The basic laws were not harmonized in all the details. When prudential requirements were set more severe the problem of non-performing assets had already grown up to a very dangerous level.

- There is an increasing segmentation which is partly due to the inherited weak position of Hungarian banks partly to their slow adjustment to new requirements. The banking sector traditionally can be divided into to main groups: large and small banks. The so called large commercial banks have had a traditionally large market share which is declining, however, due to their quickly deteriorating portfolio and a relatively underdeveloped technological network. The group of small Hungarian banks can not expand significantly because they are neither too rich in development sources nor they could increase their circle of clients by providing better service than others. The quick privatization might help them to develop backed by professional investors. The newly emerging group of jointly owned banks has to be taken into account by now as an increasingly decisive part of the banking sector. Equipped with more advanced technology and having a better portfolio than Hungarian banks they have the most favourable prospects .

- The expansion of market share of banks jointly or totally owned by foreigners has an other important aspect. Because of the general state of Hungarian enterprises they (foreign banks) are threatened also by the low quality of debtors. They have, however, the advantages to win over the best and most profitable clients from the Hungarian banks.

  Hence, the accumulated bad debt problem of Hungarian banks was solved only formally by the different consolidation programs. The adjustment process of the Hungarian banking sector takes a longer time because they had to transform completely their activity. The most important steps have already made during the consolidation process. Most of the Hungarian banks have elaborated their own credit and debtor qualification system according to European standards. Some of the banks are missing completely in some field of the market and the building up the additional fields of activity needs a lot of efforts (network, training etc.) and capital as well. In some other cases the reduction of the fields of activities may be unavoidable. It is a real danger that those who are unable to realize the necessary adjustment to market conditions will be crowded out from the markets.

- There are a lot of types of financial institutions still missing: housing finance institutions, venture capital companies, investment banks etc..

- The importance to solve the above problems is emphasized by the danger of increasing desintermediation (the declining role of commercial banks in intermediating savings to the investors), although until the inflation is relatively high the inexperienced investors are reluctant to buy securities of greater risk and the share of bank deposits to non-bank securities are still high. The trend of addressing to capital market (especially toward government securities) can already be observed.

The main goal of restructuring the banking system is to make the presently state-owned banks competitive with foreign banks. This can be achieved by realizing a program in harmony with the money and capital market (de)regulation and institutional development. In addition the further development of the Hungarian banking system must be in line with the harmonization efforts under the association agreement with the European Union and Hungary's aspiration for the full membership. According to these goals the share of the state ownership must be reduced (below 25% by January 1997).

The privatization of large banks will be based on the results of consolidation programs implementing the main conditions making these banks attractive for domestic and foreign investors[15].

[15] Hungarian Foreign Trade Bank was already a successfully privatised in 1994 when Bayerische Landesbank and the EBRD purchased the state-owned portion of and also made a capital increase.

In the course of bank privatization primarily strategic investors should be encouraged to acquire property, in line with the need for capital increase at most of the banks. Government privatization program would like to attract both foreign and domestic institutional investors able to alleviate the shortage of capital of consolidated banks, but resident investors (among them bank managers and employees) as well will have the opportunity to purchase shares.

2. Capital markets

During the first years of transition the basic institutions of capital markets have been established. A number of laws were to set the regulation and supervisions of the different institutions according to the market economy standards focusing on the prudential aspects, improving the possibilities of risk management and clearing facilities to the emerging markets.

- The Act on Securities Markets and on the Budapest Stock Exchange defined different types of security trading activity, set requirements for public issuing of securities and defines conditions to be met by security (brokerage) houses. State Supervisory Security Agency (SSSA) responsibility is to control the regulation. The Budapest Stock Exchange (BSE) was re-established pursuant to this Act, and has been operating and developing ever since.

- The Act on Commodity Exchange set regulation of the Budapest Commodity Exchange (BCE) and business terms of futures contracts. The Central Depository and Clearing House (KELER) was established to improve settlement and registration of securities businesses.

2.1. Institutions and markets

The principles of regulation have been based on the concept of a 'specialized' financial institution system where *independent securities firms are acting as intermediaries in the capital markets in order to minimize the risk the commercial banks can take*. The commercial banks are not allowed to pursue securities trading activities, they can not be present at the Budapest Stock Exchange. Underwriting (as commercial activities not for their own name) is forbidden for the banks even in the case of government papers. Although a bank can re-guarantee an underwriter, the law limits the amount of the guarantee that can be undertaken by a broker. However, the law permits banks to have 100 per cent of brokerage firms' shares. Hence this kind of regulation is first of all to separate the risk of securities businesses.

The regulation of securities firms aimed at market development by increasing competitions. That is why the entry to the market has been facilitated by setting the capital requirement of foundation unusually low (HUF 50 million for trading activity on their own account, and only HUF 5 million for brokerages[16]). The next amendment of the law on securities foresees an

[16] Capital requirement to found a commercial bank is HUF 1 billion.

increase in the capital requirement for securities traders. As a result of such type of regulation a number of securities firms have entered the market quite soon. Most of the commercial banks have established their own securities house. Not surprisingly, however, according to the turnover figures of the last two years the most active securities firms are backed by the largest commercial banks. The risk taking capability of firms with law capitalization is very weak.

The major amendment of the regulation has just been elaborated by the SSSA focusing on the recent problems in securities businesses, their supervision and on the necessity of more detailed and more precise definition of conditions to be met in security issuing and trading activity, and on the market development. This problem is related with the regulation of the banking sector as well. The whole concept of the financial system operation has to be reconsidered and it seems to be inevitable to push the regulation towards focusing on prudential and risk taking conditions of the different kinds of activities rather then on different kind of institutions.

The problem has a particular importance in the market of the government papers where it is planned to establish a primary dealer system. Market making involves a considerable risk, however, an average undercapitalized brokerage firm cannot take the risk of two way pricing. Therefore the banking and securities laws have to be amended by allowing commercial banks to deal in government securities.

The most important indicators of the Budapest Stock Exchange are included in the Table-III.3, below. While in early nineties it was thought that transactions on company papers would take the largest part of the turnover in the BSE, the data reflects the overwhelming majority of government securities transactions. Just before the opening of the BSE the public offering of shares was expanding (in 1991, 20 shares were publicly offered), but the actual development was much lower than it could be expected. The participation of corporations in the stock exchange has been hindered by the general problems of restructuring in the transition period. The number of enterprises that can meet the requirements of transparency and performance in order to be able to enter to the stock exchange is still very limited. The lack of strong institutional investors as well as the slowing down privatization process have contributed to the less dynamic than expected development.

Table-III.3: Main indicators of the Budapest Stock Exchange (end of year data)

	1990	1991	1992	1993	1994
Number of BSE members:					
- Securities firms	21	31	41	46	49
- Banks	21	17	7	1	1
Total	42	48	48	47	50
Securities in the BSE					
- Shares	6	20	23	28	40
- Government bonds	-	1	4	16	25
- Corporate bonds	-	1	1	1	3
- Treasury bills	-	-	10	10	31
- Investment funds papers	-	-	1	6	20
- Compensation vouchers	-	-	1	1	1
Total	6	22	40	62	120
Nominal value of securities in the BSE (in billion HUF)					
- Shares	6.1	18.2	28.8	38.3	79.8
- Government bonds	-	15.0	80.0	237.0	374.2
- Corporate bonds	-	0.1	0.1	0.3	1.6
- Treasury bills	-	-	59.3	76.9	256.6
- Investment funds papers	-	-	1.7	9.0	23.8
- Compensation voucher	-	-	20.0	80.3	120.3
Total	6.1	33.3	189.9	441.8	856.3
Capitalization in BSE (in billion HUF):					
- Shares	16.4	38.2	47.2	81.7	181.5
- Government bonds	-	15.3	82.3	241.7	392.9
- Corporate bonds	-	0.1	0.1	0.3	1.8
- Treasury bills	-	-	54.4	74.0	239.6
- Investment funds	-	-	1.9	5.5	19.3
- Compensation vouchers	-	-	16.0	53.8	48.7
Total capitalization	**16.4**	**53.6**	**201.9**	**457.0**	**883.8**

* Source: National Bank of Hungary annual reports

The issuance of compensation vouchers can be considered as one of the special features of the transition. Since 1992 the stock of compensation vouchers amounted to HUF 120 billion. These interest bearing securities can be used to acquire property (shares, business quotas, flats etc.). The amount of publicly offered assets has been much lower than the outstanding amount of vouchers and also the concept concerning possibilities of the use of these voucher has been changed several times since the program was launched. (voucher/share swaps, investment funds etc.)

Table-III.4: Turnover in the Budapest Stock exchange

	1990*	1991	1992	1993	1994	Total
a) Turnover (in billion HUF)**						
Shares	6.12	9.81	6.01	18.26	58.67	98.87
Government bonds	-	0.30	12.36	73.38	55.30	141.34
Corporate bonds	-	-	-	-	0.01	0.01
Treasury bonds	-	-	15.06	85.00	90.94	191.00
Investment funds	-	-	0.03	0.10	0.26	0.39
Compensation vouchers	-	-	0.21	8.95	19.39	28.55
Total	6.12	10.11	33.67	185.69	224.57	460.16
b) Number of contracts	4 962	14509	8565	23749	76121	127906
c) Average daily contracts	27	58	34	94	302	108
d) Average daily turnover (in million HUF)	33.8	40.1	133.6	736.9	891.2	387.0
e) Turnover to contract (in million HUF)	1.2	0.7	3.9	7.8	3.0	3.6

* BSE was opened 21 June 1990.
** Double accounting.
Source: Annual reports of NBH.

The dynamism of government securities business may be considered as a favourable development in the period of troublesome emerging private sector. The BSE financial sources stemming from turnover of government securities are significant allowing to cover the necessary technical developments. On the other hand the BSE may play a central role in the creation of a concentrated secondary government securities market which would facilitate both the improvement of domestic debt management and the monetary policy efficiency. These are the main considerations the recent development plan of the BSE is based on. It has just been decided to separate the government paper section from the market of the other securities allowing at the same time the commercial banks to participate in the government securities section. In the third section the market of derivative financial instruments will be operating which will provide to the investors different possibilities to cover the risk.

At the beginning, the clearing of stock exchange securities transactions was performed within the BSE under the clearing system based on the principle of multilateral netting. However, the accounts of security firms were kept at that time in the National Bank of Hungary. The increasing turnover and emerging OTC market made clear that the further development of the market could be promoted by a central depository and clearing house where not only the stock exchange transactions but also OTC trade would be administered on a delivery versus payment basis. In 1993, the NBH, the BSE and the BCE jointly established the Central Clearing House and Depository Co. Ltd. (KELER) which was registered as a clearing house with a limited banking license. KELER keeps all the securities accounts (belonging to bank and securities firms).

2.2. Investors

Due to the regulation set as explained above the *commercial banks* have been excluded as intermediaries from the capital markets. Hence their activity which dominated for long the capital markets - especially the government securities markets - has been carried out on their own name. The forms of banks' participation in the government securities market has been changed recently. Having their long-term liabilities been squeezed and due to the general crisis of the banking system stemming from the accumulated bad loans, the consolidated banks (among them most of the largest Hungarian banks) have retired from the investments in the longer term government securities. Their investment are generally restricted to the discounted treasury bills according to their liquidity situation. This does not mean, however, that the OTC turnover on secondary markets was declining. It has to be taken into account that banks are quite well provisioned with government bonds that they were given in the consolidation program.

One of the main problems of the emerging markets is *the lack of strong institutional investors*. This sector is, however, quite quickly developing. The number (more than 10) and activity of insurance companies have increased significantly due to the transformation of domestic companies and also the multinational companies have appeared and expanded recently.

The acts on *investment funds* was to strengthen the institutional investors in Hungary. The investment funds can collect the small amounts saved and to invest them using a risk sharing portfolio approach to the benefit of small investors. In 1992 4, in 1993, 12 closed-end investment funds were established (HUF 11.7 billion) At the end of 1994 the papers of 21 investment funds were traded (HUF 24.1 billion), among them one open-end fund and four real estate investment funds were established. The new rules of personal income tax benefits (related to the increase in investments to mutual funds paper and shares) have made the public more interested in investments to mutual funds.

The *social security funds* are presently in a special situation in Hungary. Instead of being the largest investors in the capital markets they have permanent liquidity problems and they produced significant deficits during the 1992-1994 period. This problem should be urgently solved but it needs to find a complete solution: including treatment of the loss of incomes, financing and debt management. Even the independence from the budget of the Pension and Health Funds has to be reconsidered when setting up a treasury system.

The investments of foreigners in Hungary was practically liberalized by the law enacted in 1989. Except for a few special sectors such as banking, no special license is required to acquire ownership. The only limitation is that foreign investors can acquire registered shares only. As a result of liberalization, the foreign investors are determinant dominant participants in both the primary and the secondary securities market. Since May 1994 the government securities markets are open as well but still some restrictions are in vigour (only primary issues of more then one year maturity securities are available to foreigners.)

3. Monetary policy

In the developed market economies the conduct of monetary policy needs to be based on a permanent research process in order to get the most profound knowledge about the operation and interdependencies of money and capital markets which is a precondition for monetary targeting and for the development of the tools the monetary policy can use effectively. This is quite a difficult task under any circumstances - due to the lag the monetary policy can perceive the recent structural and behavioural changes in the economy and due to the lag the economic agents react to the central impulses - but in the transition economy there are a number of characteristics making the outcome of the monetary policy even more uncertain.

- Most important among them is that the basic markets (money, capital and forex) are still in an emerging phase, the number and the behaviour of actors as well as the regulation are under permanent changes and 'perfection'. This means that the underlying macro- and micro models have been changing significantly during the pre-transition period (1987-1990) as well as for the first years of the transition (1991-1994).

- While in the pre-transition firms having price and output targets tried to minimize output of profit constraint, in the commercialization phase of the transition price and trade was liberalized but firms' budget became harder and finally after privatization the firms start to behave according to profit maximizing rules like in a market economy[17].

- Not only the lack of the basic markets but also the lack of the basic element of financial discipline (no bankruptcy, prompt incasso in trade with socialist countries, voluntary and un-voluntary lending among the enterprises /the so-called queuing up'/ etc.) bounded seriously the efficiency of monetary policy actions by canceling the most of tightening effects.

- Transformation of the ownership structure and transformation of the public finance have been closely related and resulted basic changes in all the sectors of the economy.

  - Firms have a larger choice to get finance for the production and investment projects but face a much greater risk than in the previous regime.

  - Different kinds of instruments are available for households to put their savings in, minimizing their risk by portfolio management: the emerging capital markets are becoming the main competitors of the banking sector exhibiting very ambiguous development. Households' propensity to save is determined several 'unusual before' effects (such like high and accelerating inflation, increasing availability of imported products etc.).

These difficulties have made monetary policy makers hesitating both in selection of targets and introducing new regulation. There is no doubt that inflation stabilization must have a

[17] S. Estrin- P. Hare: Firms in Transition: Modelling Enterprise Adjustment, Centre for Economic Performance, LSE Discussion Paper No. 89 p.22.

primary importance which corresponds to the ultimate goal of protection domestic currency, but due to the serious external and internal equilibrium problems it has to be careful when selecting the intermediate and operative targets: the main task is to find out a set of measures which contributes to the stabilization on the one hand, but allows to maintain (even improve) the competitiveness of the tradable sector on the other hand. Too much rigidity of the exchange rate in favour of desinflation may be as dangerous as to use the devaluation as a tool of primary importance to improve trade balance.

The state and the development of financial sector has a primary importance for the monetary policy because the efficient allocation and reallocation of resources, the quality of financial intermediation is one of the decisive factors of the economic growth. The stability and the reliable operation of financial markets is a precondition for the transmission of monetary authority impulses. It follows from this that the monetary policy and the development of the financial sector are highly interrelated: monetary measures influence money and capital market developments, on the one, hand and the efficiency of monetary instruments may be increased by watching and evaluating money and capital market events, on the other hand.

In transition economies the main trends are the following:

- The capital markets (including the government securities markets) will have an increasing share as compared with the banking finance. The international experiences show as well the 'retirement' of the traditional banking activities. In transition countries - in Hungary as well - the same tendency can be observed, but this is quite natural due to the simple fact that the capital markets did not existed before the regime change. The development of the domestic securities market - which is reflected by the increasing size of issues as well as by higher volumes of trade and by differentiation and standardization of the instruments - takes a longer period. Therefore the banks are expected to keep their traditionally important role in resource re-allocation for longer run. The developments of the secondary and derivatives markets are very important because they provide possibilities to minimize the risk of investors.

- The financial deregulation resulted an increased international capital turnover in all over the world. The Eastern-Central European region is a new possibility for those investors who want to diversify their portfolios.

3.1. Changes in monetary policy targets and tools

Due to the trade and price liberalization since 1991 the economic policy as well the monetary policy can act according to the policy rules and regulation valid for the small open economy with an adjustable peg exchange rate system. In monetary policy the transition from the direct control to a market oriented system calls for institutional and economic conditions which permit the central bank operations influencing the money market processes, on the one hand, as well as an efficient transmission mechanism through financial institutions and basic markets, on the other hand, which would make the responses of the non-financial sector to the central bank's impulses predictable.

The transmission of monetary policy impulses, however, are far from being clear under the present circumstances in the transition economy of Hungary. However, a lot of significant changes have taken place in the scene of monetary policy. Commercial banks have to face an increasing competition. Since the inter-bank money markets (forint and foreign exchange) were opened and the secondary market of government securities has been emerging, the National Bank of Hungary began to operate in them and in this way the set of tools for implementing its policy targets has become much more flexible as it was at the beginning of the transition period.

Having solved successfully the near to foreign exchange liquidity crisis situation in 1990, in 1991 the main concern of monetary policy shifted to the reduction of inflation rate. Considering the inflation rate as the ultimate goal, the monetary policy has used the pegged but adjustable exchange rate (that time using a basket of 50% USD 50% DEM) and the net domestic credit as intermediate targets. Taking into account that the budget sector financing requirement to GDP ratio showed an upturn trend during 1991-92, the crucial problem of the monetary policy has become how to set and how to meet inflation rate target without serious deterioration of foreign exchange position.

Hence the monetary targeting was hesitating between inflation and foreign equilibrium during 1993-1994. In addition it has been very difficult to define intermediate and operative targets. On the one hand, the changing behaviours of different economic agents makes the money demand predictions very difficult. On the other hand, due to the development of the capital markets and the increasing openness of the country (the liberalization of foreign exchange operations and capital movements) the scope of monetary policy in controlling money supply has been narrowed. In the monetary analysis it seems to be better to deal with the M3 which includes not only the cash and the banking deposits but also the banking sector's securities. The even larger category of M4 including government papers outside the banking sector may be a relevant indicator as well for the monetary programming. Due to all these factors the intermediate targets were changed several times: central bank interest rates and/or control to the net domestic assets of the central bank were used to improve efficiency of monetary impulses.

3.2. Shifting to indirect instruments

The arsenal of monetary policy tools has been basically transformed during the last years and the monetary regulation today is based on indirect methods[18]. The NBH played an active role in developing basic markets.[19] .

[18] The tools of monetary policy are under permanent changes which is necessary under varying economic conditions but not very favourable for the economic agents. The description failes to present the latest changes.

[19] The capital markets developed a lot during 1990-94, but more stability, liquidity and deepness would needed to have a reliable reference yield curve.

The NBH - as the agent of the government - has been operating the market of discounted treasury bills since 1988. It has an active market making activity in the government securities market. In January 1993 the NBH introduced the repurchase agreement facility for the commercial banks (repo collateral by government securities) to cover solve their liquidity problems. Since then the open market operations have been playing an increasing role in refinancing. The repo activity became significant and it has to be introduced some restrictions in order to keep the outstanding amount in line with monetary target. The maturity of repo facilities by now is restricted to the short end of the market (1 day, 1 week and the overnight emergency facility at 42% has just been introduced as well). The central bank influences the marginal costs of borrowing and its decision making is based on interest rates prevailing in the money and capital markets. Both the repo rates (33.5% in June 1995) and central bank base rate (28%) are having an increasingly important role among central bank's signals.

At the same time, in the quite short-term segment of the money market, the NBH finds it necessary to dampen the extreme fluctuations of interest rates. Therefore, the NBH has been quoting 1-week reverse repo interest rates since the beginning of 1994.

The NBH took an active part in the organization of the inter bank money market at the end of eighties playing the role of the clearing house. When the confidence in the market was established the NBH retired from the active participation.

The conditions of swap facility collateralised by foreign exchange have been equivalent to repo conditions. By now the forint issues by the NBH through the different channels of derivatives are constrained globally.

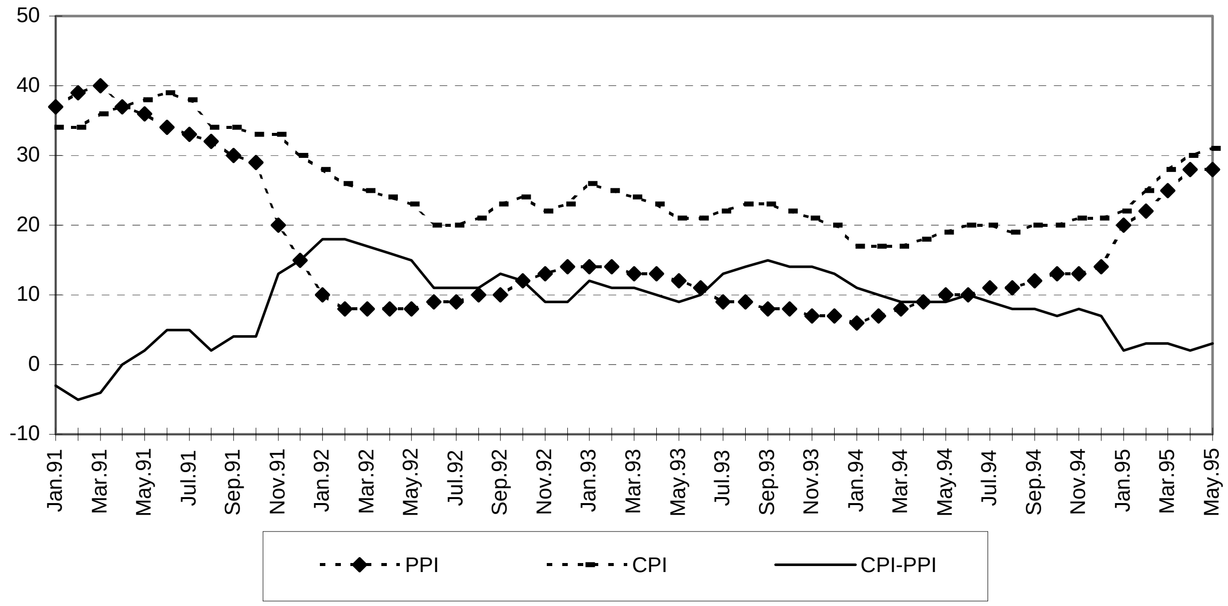
The NBH has been playing an active role in the inter bank foreign exchange market operating since 1992. (before a limited version with the intermediation of the NBH was operating).The intervention band has been gradually widen, today it is +/-2.25%. The NBH is ready to meet the market needs without any limitation on the border.

The NBH support all the projects aiming at the establishment of derivative markets because at the present stage of the development this may contribute to diminish the risk of investors.

In order to reduce the relatively high cost of intermediation it would be necessary to reduce the rate of mandatory reserves. This would improve the international competitiveness of the Hungarian banking system. The nominal reserve rate has already been lowered to 12 per cent, and the consolidation of the reserve and clearing accounts of commercial banks with the NBH reduced the effective reserve rate as well. Due to the unfavourable changes in the internal and external equilibrium, in order to achieve the targets of monetary tightening there was an upturn in the mandatory reserve policy and rates have been increased again. The effect on the profitability of banks, however, have been compensated by paying higher interest on the mandatory reserves.

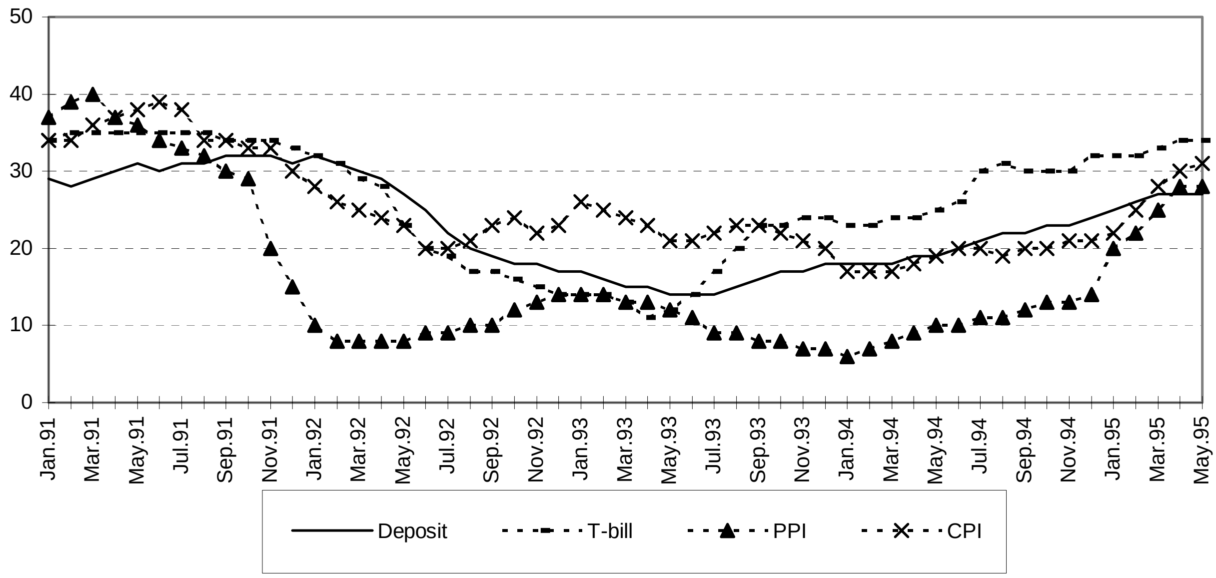
Figure III.1: Producer and consumer price indices and the difference

(same month in the previous year = 0, per cent)



PPI - wholesale industrial price

Figure III.2: Deposit interest rate, T-bill yield and inflation (per cent)



Short term deposit interest rate (Maturity less than one year)
90-day T-bill, CPI, PPI

3.3. Monetary processes, 1990-1994

According to the main direction of the development described above the annual growth rate of broad money (M3), which had exceeded 35 per cent in early nineties began to decelerate gradually from the end of 1992 on. No change in this trend could be observed until the end of 1994 when it was not higher than 13%. Parallel to this trend, the investments in government papers has been increasing and the annual growth rate of M4 was higher than 19% in 1994.

The efficiency of interest rate policy has been improving (it also had a major role in the improvement of the external equilibrium in 1991-92), however, the relative sluggishness of the banking sector reactions to the central bank signals has characterized the whole period of 1990-1994. The last administrative ceilings on deposit rates for households was abolished in 1991, and market deposit and credit rates followed inflation quite rapidly while it was accelerating. At the time when inflation began to decelerate, however, the market interest rates remained nearly unchanged for a longer period, implying a high level of real interest rates on both the deposit and the credit side. The difference between credit and deposit rates was the largest in 1992, when it exceeded 12 percentage points. At the end of 1991 monetary policy had to face the increasing excess liquidity stemming from the improving external position. Considering the permanently threatening danger of the foreign exchange problems the monetary authority should have sterilize the excess liquidity but taking into account the high real interest rates prevailing for long in 1992 it was decided not to do so in order to force the banking system to lower nominal interest rates and to promote recovery by increasing commercial lending.

Finally - at the end of 1992 - the interest rates drop was sudden and 'exaggerated'. The negative real interest rates on the deposit side resulted a significant drop in savings. In spite of that the NBH has raised its interest rates in several steps since the middle of 1993 deposit rates of commercial banks have increased noticeably only since the second quarter of 1994.

The growth of domestic credit was very modest in 1990-1992 and its annual growth rate decreased almost continuously from 10 per cent to 5 per cent. The domestic credit expansion started at the end of 1992 and at the end of 1993 it was close to 20%. Since the foreign equilibrium has deteriorating there has been a continuos policy target to reduce the volume of credit extended by the banking system to enterprises. In 1994 a further acceleration of credit expansion could be observed due to the more favourable business climate, under the circumstances of the starting recovery. Nevertheless, the annual growth rates increased slightly and annual growth of these credits were expanding (were about 20%). When evaluating the figures, however, it has to be taken into account that a significant amount of outstanding non-performing loans was written down in the banking sector consolidation process. Taking into account these loans as well, the credit expansion was more significant (25%).

3.4. Monetary targets in 1995

By the end of 1994 the previous years' monetary policy practice and failures were reconsidered and a new monetary guideline has been elaborated.

- It was emphasized that monetary policy itself is not able to achieve the stabilization targets, the necessary adjustments in fiscal policy cannot be postponed anymore. Monetary tools alone are inefficient to promote the stabilization as it could be observed in 1993-1994. Monetary policy can react to the renewal of equilibrium problems by further raising interest rates, which is inefficient on a certain level and has a negative effect on the PSBR. The more direct instruments (direct constraints) are costly and do not contribute to the solution.

- It was recognized definitively that the practice of double targeting - focusing on the inflation and on the current account at the same time - can not be maintained any more. The inflation stability has been declared to be the sole ultimate goal of the monetary policy in 1995 and the nominal exchange rate is selected as the only intermediate target.

- While in 1992-1994 the main concern was to maintain the real effective exchange rate, in 1995 major changes in exchange rate policy had been carried out. After a significant correction of the exchange rate in March (9% devaluation of the forint) the crawling peg (band) system was introduced with diminishing pre-announced devaluations (1.9 and 1.3% per month in the first and second semester resp.) on a daily basis. The crawling peg system is to restore the credibility of economic policy. The devaluations in this system are not to bridge ex post the differences between the internal and external inflation but they are to reduce this differences ex ante.

- The new system narrows undoubtedly the scope and the independence of the monetary policy. The minimum level of interest rates can be derived from the pre-announced exchange rate. Under this level of interest there is an unbounded possibility for arbitrage gains. The main operative target is to keep the domestic interest rates on a reasonable level (which is high enough to increase domestic savings but does not promote speculative foreign exchange inflow and/or arbitrage of domestic forex funds).

- The structural problems of the banking system makes the monetary transmission ineffective and that is why requirements set in the consolidation program have to be fulfilled as soon as possible, the privatization of the banking system has to make more rapid.

- The co-ordination between monetary and fiscal policy is an essential task. The success of the new monetary policy depends on the fiscal conditions including the reduced borrowing requirement of the government but also the moderate increase in wages and prices in the non tradable sector which can assure the improvement of the profitability in the tradable sector.

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Fiscal Policy in Hungary under Transition
vol. II

by

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IV. BUDGETARY ORGANIZATION AND CLASSIFICATION

1. The structure of the general government

General government in Hungary consists of different sub-systems; these are the central government, the extrabudgetary funds, the social security funds, and the local governments. Its structure is fairly decentralized and complex. The present system is the outcome of last decade's reform processes which permitted decision making on each level of the general government to be strengthened.

The *central government* comprises the state budget, the budgetary chapters and the central budgetary institutions. The state budget is a fictitious unit which finances government tasks and has transfers to other sub-systems of the general government. There are 31 budgetary chapters, containing the ministries, offices of the Parliament, the Constitutional Court, the State Audit Office, the Central Statistical Office and so on.

Attached to these chapters 1,548 *central budgetary institutions* (CBIs) operated at the end of 1993, excluding defense. Out of the one and a half thousand institutions 730 have budgetary autonomy. CBIs are obliged to keep their bank accounts at NBH and must not open bank accounts at commercial banks. CBIs may be engaged in activities with commercial nature in order to utilize their assets and free capacities moreover to have independent sources of income. They must not acquire loans or offer guarantees. Until the end of 1994 it was allowed for them to purchase government securities and treat the interest income as their additional source. This was a circle vicious in the central government: the increasing free sources of CBIs (stemming from their commercial activity and also the central budget financing practice[20]) were invested in the shortest term (30 day) treasury bills of high yield which increased the borrowing requirement thus giving impetus to the further increase in yields etc..

The most important change in 1995 is that CBIs have to keep their temporary funds in the central bank and their accounts are joined to the liquidity fund of the central budget up to 80%. This was a measure of preparation for the Treasury system which will start operation in January 1996, where the central financing will be provided to the CBIs according to the actual costs. The general reform of public administration can not be postponed anymore. Hence the present 'overfinancing' will be eliminated.

As a heritage of the centrally planned economy a number of *extrabudgetary funds* have been operating during the analyzed period because a lot of *governmental tasks were financed indirectly, with the intermediation of these funds*. This type of arrangement has reduced the transparency of budgetary flows. At the end of 1993 there were 30 extrabudgetary funds,

[20] One of the main problem of the present financing system is that the central budget covers the majority of expenditures in advance by equal - monthly - instalments independently from the actual costs.

administered by the budgetary chapters and run by ministries. They were mostly financed by earmarked - partly tax like - revenues, having remarkable independence from the central budget. Some of them could accumulate debt separately from the central budget. (This possibility was, however, exceptional.)

As a part of the government restrictions, from 1st of January 1993, according to the streamlined regulations, only those decentralized funds may be launched and operated by law, in which the purpose, the sources of revenues and scope of expenditures should be specified. The new Act on Public Finances (passed in 1992) declares that the Parliament will review the justification for the operation of the funds in every four year and decide upon their operation. Even in 1995, 29 decentralized funds do still exist, however, a complete revision is just going on. *In the Treasury system the majority of Extrabudgetary funds will be included into the central budget chapters* and only those having special tasks of national importance (e. g. Labour Fund, Road Fund) will continue to operate independently from the central budget.

At the central government level there are two self-governed social insurance funds, the *Health Insurance Fund* and the *Pension Fund*. The formerly unified social security fund was separated from the central budget in 1989, and was split into two separated funds in 1993. Despite their self-administration organizations were set up, the governing bodies authority is restricted by the Parliament. Their financial and policy purposes are ultimately controlled by the Parliament, because their yearly budgets must be enacted by the MPs. (The share of employee and employer representatives are the same in the relevant governing bodies. Employee representatives are nominated by trade unions and elected in every four year, while employer representatives are chosen by employers' association.)

Up to now *the fiscal separation of social security funds has been quite formal*. The main problem has been the steadily increasing deficit of funds fueled by the shrinking tax base, by the significant tax arrears and by the too generous system implemented in the previous regime. From 1993 Social Security funds are allowed to borrow from the market although their bonds have had government guarantee. Due to the above problems social security bonds could not be sold easily and the 1992-1993 deficits are only partly covered by bond issues even in 1995. As a temporary solution they have a direct access to the liquidity fund of the central budget which causes permanently tensions in the liquidity and debt management of the central budget. All this revealed that the problem of social security funds is of crucial importance. The transformation of the social insurance system should be one of the key elements of the public finance reform. It has to be decided whether to strengthen the independent funds or to re-integrate them into the central budget, at least in a budgetary context.

The increased autonomy of *local government* declared first in 1986 and accomplished by the 1990 Act on Local Governments, has led to the proliferation of local authorities. At the same time the increasing autonomy with decreasing sources resulted in growing number of local budgetary institutions engaged in market activities. At local government level there are more than 3,100 governing bodies, which operated 14,913 budgetary institutions, out of which 8,643 have budgetary autonomy. The following table shows the definite increase in the number of government organizations with budgetary autonomy.

Table-IV.1 The growth of number of government institutions with budgetary autonomy (1989 = 100 %)

	1990	1991	1992	1993
Central government	113.4	125.7	126.0	132.0
Local authorities	126.8	145.1	145.3	147.7

Local governments have had their independent borrowing right without any limitations from 1990. After a significant growth in their borrowing in 1994 the regulation was modified in 1995 and today they are not allowed to increase their debt by more then 2% of their own sources. Another way to increase local income is given by taxation right. According to the Act on Local Taxes local authorities can impose taxes within certain restrictions. They are allowed to keep bank accounts at any Hungarian banks as it is specified by local decrees.

So far as a consequence of the above mentioned structure the system of budget preparation and execution has been extremely decentralized which promotes the rigidity of the Hungarian budget and hinders appropriate budget policy formulating. Systematic and significant changes are still to come.

2. Budgetary classifications

The fiscal information system is inadequate in providing sufficiently detailed data in time on government transactions. It must be noted that during the last 10 years every Hungarian government emphasized the importance of having an appropriate information system. Despite of these verbally declared intentions and the severe rules of the 1992 Act on Public Finances different governments have oriented more and more transactions outside the budget and failed to establish a comprehensive information system, so far.

There is a lot of *methodological problems* in the Hungarian budget preparation.

- One of the main problems is that the classification applied in the budget system has changed year by year so long or even medium term time series can be produced by making a lot of correction. From 1991 the classification of budget activities mostly relies on the ISIC (the International Standard Industrial Classification of all Economic Activities) categories.

- Hungarian budget classifications significantly differ from the international standards. Flows and capital movements are mixed: foreign exchange loans (on-lent to the enterprises) are included in revenues, repayments of debt appears on the expenditure size.

- According to government regulations, central and local institutions have the same accounting and reporting obligations. Extrabudgetary and social security funds have less detailed information system which is only partly comparable to the previously mentioned ones.

- Budgetary revenues and expenditures are grouped by institutional framework and by Hungarian functional classification. (The latter does not apply to capital expenses.) The economic classification of government spending is poorly detailed, only.

- For the time being the asset balance and the assessment of indirect expenditures, tax reliefs, tax preferences and other indirect (off the official budget) commitments of the budget[21] are not integrated parts of general government's information system, despite the unambiguous regulations of the 1992 Act on Public Finances. Information on government guarantees undertaken has also been missing, yet.

These methodological problems have serious consequences in the decision making process since the efficiency of fiscal policy is much reduced by missing or false information. The budgetary data do not reflect the right fiscal position of the general government neither of its different sub-systems. Following from this the data may disorientate decision makers. *Our results provide evidences that the present budgeting does overstate significantly the size of the government in the economy and it may lead to false perceptions about the actual state of budget.*

The large amount of intra- and inter-governmental[22] flows have to be netted out in order to see clearly what is the real size of the State in income redistribution. The size of intra-govermental flows can not be given exactly for the lack of reliable data but it is probably more significant then it would be in a less decentralized system. The intergovermental flows can be distinguished more easily from the annual reports. However, due to the inconsistency of reported flows appearing in the balances of different bodies of the general government it is very difficult to execute this consolidation in an appropriate way.

Consequently, dealing with Hungarian government data needs special attention since every researcher has his own calculation. We made a consolidation which - we think - reflects the real scope of government operations. (The explanation concerning our solution will be outlined in the next chapter.)

V. Fiscal developments in 1987-1993

1. The scope of general government

At the end of the eighties Hungary's general government was very large, the role of the state in the economy was excessive. As a result of continuous government efforts there was a significant decline in the ratio of income centralization, until 1991. General government revenues dropped by 3.5 percentage points (in terms of GDP) during the period 1987-1989

[21] When treating the financing problems of large state-owned enterprise - e.g. Hungarian Railway Company (MÁV) - more or less separated from central budget, consolidation process etc.

[22] According to the GFS classification the term intra-govenmental is used to eliminate flows within a single level of government. Intergovernmental relates to flows between different parts of the general government.

and by additional 1.3 percentage points by the end of 1991. After this turning point in the next two years the share increased by almost 4 percentage points.

Since the Hungarian National Accounts introduced the 1993 SNA recommendations in 1993 and recalculated the data from 1991, the share of revenues and expenditures dropped by almost 4 % in the same year. As a result of the new method applied the level of GDP became higher than it was previously. This means that the around 60 % revenues/GDP ratio would have become about 4 % smaller in 1987-1988. Consequently, those high ratios, over 60 or 65%, published so many times, can be attributable to the inappropriate or even missing consolidation as well as to the former Hungarian SNA method.

The roots of these shifts were quite different. In spite of the massive deterioration in GDP, sharp reductions on expenditure side made the decreasing share of revenues possible, in the first part of the period. In 1992 and 1993 expenditures increased in real terms while the decline of GDP continued.

Table-V.1: Revenues and expenditures of the consolidated general government

	1987	1988	1989	1990	1991	1991*	1992	1993
billion HUF								
Revenues	739.1	866.8	978.1	1,168.5	1,280.4	1,280.4	1,533.7	1,945.1
Expenditures				1,150.0	1,346.5	1,346.5	1,719.4	2,204.7
o/w: Non interest expenditures				1,087.8	1,251.4	1,251.4	1,547.0	2,037.1
Balance				18.5	-66.1	-66.1	-185.7	-259.6
o/w: Primarybalance				80.7	29.0	29.0	-13.3	-92.0
per cent of GDP								
Revenues	60,3	60.2	56.8	55.9	55.5	51.7	53.2	55.5
Expenditures				55.0	58.3	54.4	59.6	62.9
o/w: Non-interest expenditures				52.1	54.2	50.5	53.6	58.1
Balance				0.9	-2.8	-2.7	-6.4	-7.4
o/w: Primarybalance				3.8	1.3	1.2	-0.4	-2.6

* Hungarian Statistical Office calculated a new, higher GDP, according to 1993 SNA.

Although in the lack of appropriate figures we do not have consolidated general government balance for the years of 1987- 1989, it is clear that the non interest balance - primary balance - had a surplus until 1991. The 1992 and 1993 figures and the latest developments made it obvious how important changes have been brought about by the new market based deficit financing regime. Interest payments have shown a steeply increasing trend due to the expansion of market financing and due to the high inflation.

Method of consolidation

Based on the previously mentioned institutional context of Hungarian public finances it is very difficult to elaborate a proper consolidation. The separate budgetary sub-systems are intertwined with innumerable financial flows among them.

In principle consolidation means that transactions between all the units within the circle of government should be eliminated. Because of the imperfect government accounts complete elimination cannot be accomplished. Our consolidation involves the elimination of intergovernmental transactions between different subsystems of Hungarian government. (Consolidation within each sub-system is missing, because the lack of information. In addition, we assume that in the case of Hungary intragovernmental transactions are less significant than intergovernmental ones.)

Moreover our consolidation process involves some special adjustments arising from the unusual Hungarian reporting practice. We took out borrowing items, the decrease of cash balances from revenues and put some out of budget expenditures or revenues into the relevant categories. (For example the Hungarian State Property Agency undertake public policy purposes - as expenditures or guarantees - from privatization revenues out of the budget.)

It must be emphasized that the elimination of intergovernmental transaction does not change the budget balance while the latter corrections have some impact on the original budget. Consequently, general government balance in our calculation can differ from the official one.

In 1993 intergovernmental transactions amounted to 16.3 and 15.4 % in terms of official end of year report's on general government revenues and expenditures. In the light of original data, the proportion of general government (as a percentage of GDP) would be 73.8 and 78.2%. Comparing these data to the above mentioned ones it is clear how important it is to use consolidated data to present the real scope of Hungarian government.

The last remark concerning to our data is that when we analyze data of a single sub-system or data within the government sector, those are not consolidated. Consolidation refers only to the level of general government.

2. Basic insight into the public finances

The main factors which influenced the increasing deficit of public sector during the transition have been the subject of a long discussion. Although this question will be investigated later in more details, the most general approaches should be demonstrated by some simplified estimates. The changes of revenues and expenditures of the government at constant prices were compared to the change of GDP. (This is a rough estimation, since the price indices, which are indispensable for constructing volume indices of government expenditures and revenues are not detailed properly enough. So we had to use the GDP implicit price index with the assumption that this is the most relevant deflator.)

Table-V.2: Volume indices of general government revenues, expenditures and GDP (previous year = 100)

	1988	1989	1990	1991	1992	1993
Revenues	102.0	95.1	95.1	87.4	98.3	102.1
Expenditures	..	..	..	93.4	104.9	103.2
Non-interest expenditures	..	..	..	91.7	101.5	106.0
GDP	99.9	100.7	96.5	88.1	97.0	99.2

There was a more rapid decrease in the revenues than in the GDP until 1990. These were the years of constructing a new tax system and it should be taken as a finished one - i. e. similar to the tax systems of the western countries - only by 1990.

There was a turning point in this trend in 1990, as generated income (GDP) decreased quicker than its centralized share (revenues) during the period 1991-1993. (Privatization revenues had a certain impact on this change, which will be discussed in chapter of revenues.) A definite restriction referring to the exceptional cases (tax exemptions and deductions) built into the tax system occurred in 1990 and 1991. So the average tax rates increased, as well. In spite of all these facts the revenues of central government were less than those enacted by the Parliament. (The differences between the original budget's revenues and the executed ones were 7 % in 1991 and 11 % in 1992, in percentage of the original budget.)

Despite the uncertainties of the available data it should be stated that the decrease in revenues centralized to the general government was a bit more stronger than that of the GDP. (see Table-V.3) Due to the numerous tax exemptions (especially in the first years of the tax reform), to the high marginal rates of PIT and VAT and to the emerging and disappearing businesses there was massive evasion and loss in revenues. The government tried to compensate these losses by permanent increase of tax rates year by year.

A more sophisticated picture should be given only for the years 1990-1993, because of the lack of the adequate - consolidated expenditures - figures. The decrease in the volume of expenditures for the years of 1987-1990 could be almost the same with that of revenues (because the definite reduction in transfers to enterprises and in consumer price subsidies). During 1990-93 the decrease of government expenditures is substantially less than the decrease of GDP, independently whether interest payments are taken into account, or not. This fact is a direct consequence of government hesitation. In spite of several initiatives the comprehensive and systematic revision of the general government expenditures was not begun within the referred period. (The 12 March 1995 programme is the first attempt.)

The reform process, started at the end of eighties, came to a deadlock which can be considered one of the main reasons why the balance of general government was deteriorated. The gap between the revenue and expenditure sides has widened since the latter one, especially those attached to households, proved to be too rigid.

Table-V.3: Volume indices of general government revenues, expenditures and GDP

(in per cent)

	1993/1987	1993/1990
Revenues	80.9	87.7
Expenditures	..	101.1
Non-interest expenditures	..	98.7
GDP	82.3	84.8

2.1. Government efforts to reduce the size of state redistribution

By the middle of the eighties it became obvious for Hungarian leaders that the balance between state obligations and sources are totally upset. The increasing deficit was getting even more and more unsustainable, so a reform program was launched in 1987 aimed at redefining and restricting the state role in the economy and the society. The roots of the crisis in the public finances can be attributed to the exhaustion of economic growth. The decreasing GDP, shrinking tax base and almost automatically growing state commitments - stemming from the social welfare system - were the main sources of stabilization procedures. The main target of the three-year economic policy program - completed in 1989 - was to diminish the role of government in income redistribution.

The fiscal changes were launched along the 1988 tax reform and they slowed down in 1990. This weakening was attributable to the political changes and to the fear of social resistance, as well. After the 1990 election the previous government's fiscal reform program had exhausted before coming into practice.

The next attempt can be assigned to the second Minister of Finance of the new government. The 1991 programme of conversion and development promised a new order in state finances and considerable changes in fiscal policy. The reduction in the redistributive role of the state budget and a change in the role of budgetary functions and institutions was planned by shrinking the sources of domestic enterprise subsidies, consumer's price subsidies, budget institutions and extrabudgetary funds. The social welfare system (pension, health care, education and housing) was intended to be overhauled. The proportion of redistribution (in % of GDP) should have had dropped by 7-9 % and the state budget would have been balanced by 1993. The public sector deficit was aimed at 2.5 % of GDP in 1991 and 1.4 %, 0.8 %, finally 0.2 % in the subsequent years.

A new cornerstone of the public finances' conversion was launched in the 1991 Budget Act. Since then new deficit financing and debt policy was introduced - transition to market finance.

Due to the deeper than the anticipated recession and the unfavourable external balance, and because of the continuous postponement of the social welfare system reform this program collapsed by the end of 1992. The government recognized that much of the state's outlays could not fall and rise in line with the performance of the economy, so the entire system had to be overhauled and this would be a long-term process. This reform should be initiated with the new social welfare legislation.

As a consequence of the underestimated losses and expenditures of the transition period it became obvious for the Minister of Finance that the excessive growth in the deficit of public finances cannot be remedied, at least in the short term. At late Autumn of 1992 during the 1993 parliamentary discussion of the budgetary guidelines the Minister of Finance promised a three years consolidation or stabilization programme with the revision of budgetary institutions, with the restructuring of expenditure side in order to stabilize the balance of the general government. Even if the elaboration of such a programme had strong IMF support, the Minister did not have enough time to finalize that work, finally he was dismissed at early 1993.

Despite of the change of the top of Ministry of Finance Hungarian government announced to continue and accelerate the preparatory work of the so-called public finance reform. It was intended to eliminate delays in this area because government experts realized the conditions of balanced growth would be endangered without serious measures. Though the 1993-94 government economic policy contained firm public finance steps - modification of the tax system, in order to halt the decline of tax revenues as proportion of the GDP; transformation of redistribution systems, namely the pension, the health care, the social welfare systems; -, with respect of 1994 general election most of the plans have been failed. And again the revenue side - especially indirect taxes - was modified with significant extent, in order to have substantial funds for the expenditure side. (The Hungarian government increased the preferential rate of VAT and narrowed the range of goods with a zero rate or preferential rate. Consumption taxes /excise taxes/ - tax rates or fixed amounts - were adjusted in line with inflation rate.)

Looking back to the 1987-1993 period an important characteristic can be recognized concerning the government measures. In 1988 for the first time tax system began to be converted - the revenue side -, at the same time curtailments of enterprise and consumers price's subsidies started, then since 1992 a new deficit and debt policy was introduced - transition to market finance. Since 1990 government has made recurrent efforts to raise taxes and to broaden tax bases. Beyond the analyzed years, finally it was March 1995 when welfare system and financial management of government operations - the expenditure side - began to be transformed. It seems to be clear that this sequence has had an adverse effect on the public finances, at least in its fiscal point of view.

2.2. State guarantees

The state guarantee occurred at first in the 1991 state budget proposal. According to the 1992 Act on Public Finances the government may extend a guarantee on behalf of any subsystem of general government or any other institution outside general government for the repayment of their loans or any other repayment to the extent specified in the Act upon a yearly budget. There is no legal restriction in the purpose of guarantees given. The guarantee extended applies to commitments for repayment becoming due in any financial year. The Hungarian budget limits state expenditures for due repayment as a percentage of total state outlays. The relevant data in 1991-1994 were 0.5 %, 2 % and for the last two years 3 %.

There were government guarantee expenditures 0.4 % and 0.8 % of total central budget expenditures in 1992-1993, HUF 4,3 and 10,1 billion. Despite of these negligible shares the stock of extended guarantees amounted to about HUF 180 billion by the end of 1993. (14.5 % of total central budget expenditures and 5 % of GDP.)

It must be noted that the State Property Agency and the State Holding Company (they managing the state owned assets) have their own possibility to provide guarantees which become state liabilities, in fact. These possibilities are not limited in the budget law.

3. General government expenditures

Hungary's consolidated general government outlays could be equivalent to 57-58 percent of GDP in 1987. Until 1990 there was a continuous and significant decrease; the share reduced to 51-52 percent of GDP. (Concerning these years we assumed that GDP ratios would be by 3.5-4 percentage points smaller than in the table below, in accordance with the new SNA method.) Expenditure reduction was mainly due to the curtailment of government spending on transfers and subsidies. From 1991 the ratio were increasing again about up to the same level or even higher from where it started at the beginning of transition period. (It must be noted that 1993 figures are affected by an exceptional item, such as the import of military aircraft from Russia.[23] Without this, the expenditure/GDP ratio would have been 1.1 % smaller, that is 61.8%.)

Although the real value of general government expenditures did not grow between the period 1990-1993, especially if the above mentioned exceptional item had not been included, the sharp drop in GDP resulted in a growing expenditures/GDP ratio. The main changes in the structure of expenditures are as follows:

- interest costs doubled during 1990-92 attributable to the hidden losses of the previous fiscal regime. The relief in 1993 proved to be temporary only, because interest level, after a significant decline, has grown up again;
- by 1991 transfers to enterprises reached the lowest level and then increased slightly;
- households' subsidies surprisingly rose in 1991 and from that time the shares remained almost stable;
- within expenditures of goods and services the ratio of wages and salaries rose by 1-1.3 % in terms of GDP, while other outlays - mainly due to the loose budget regulations concerning to the own revenues of budgetary institutions - grew by a yearly 2 % of GDP.

All of these features show that until the end of 1993 no considerable changes were taken place on the expenditure side, except in the case of transfers and subsidies.

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[23] A certain part of Russian debt (HUF 101.5 billion) arising from CMEA trade were settled by military equipments.

Table-V.4: Consolidated General Government Expenditures

	1990	1991	1991*	1992	1993
Billion HUF					
Total expenditure	1.150.0	1.346.5	1.346.5	1.719.4	2.204.7
Current expenditure	947.8	1.140.2	1.140.2	1.483.3	1.881.9
- on goods and services	401.0	448.3	448.3	606.6	841.0
- interest payment	62.2	95.1	95.1	172.3	167.6
- subsidies and transfers	484.6	596.8	596.8	704.4	873.3
of which: to households	386.4	528.2	528.2	609.7	742.5
to enterprises	98.2	68.6	68.6	94.7	130.8
Capital expenditures	202.2	206.3	206.3	236.1	322.8
As a percentage of total expenditures					
Total expenditure	100.0	100.0		100.0	100.0
Current expenditure	82.4	84.7		86.3	85.4
- on goods and services	34.9	33.3		35.3	38.2
- interest payment	5.4	7.1		10.0	7.6
- subsidies and transfers	42.1	44.3		41.0	39.6
of which: to households	33.6	39.2		35.5	33.7
to enterprises	8.5	5.1		5.5	5.9
Capital expenditures	17.6	15.3		13.7	14.6
As a percentage of GDP					
Total expenditure	55.0	58.3	54.4	59.6	62.9
Current expenditure	45.4	49.4	46.1	51.4	53.7
- on goods and services	19.2	19.4	18.1	21.0	24.0
- interest payment	3.0	4.1	3.9	6.0	4.8
- subsidies and transfers	23.2	25.9	24.1	24.4	24.9
of which: to households	18.5	22.9	21.3	21.1	21.2
to enterprises	4.7	3.0	2.8	3.3	3.7
Capital expenditures	9.6	8.9	8.3	8.2	9.2

* According to the revised Hungarian National Accounts calculations.

3.1 Subsidies on goods and services and to enterprises

A definite cut in transfers was one of the main tools to reorganize the role of the state in the economy. At the very early stage of the transition period subsidies to enterprises and to consumers were planned to be reduced in nominal terms. The target was to reach a definite drop in terms of GDP. During 1987-1993 most of the elements of the inherited subsidization system were removed or at least substantially reduced.

From the beginning to the end of the studied period subsidies were reduced from about 21-23 % of GDP to 6.2 % of GDP. Consumer price subsidies - dairy products, fuel for households, long-distance and urban public transport, water supply and sewage, pharmaceuticals and a lot of food products were the main categories of subsidized products - were gradually reduced year by year and finally almost eliminated. By 1994 only public transport and medicines got central government or social security subsidies. In terms of GDP the actual amount is negligible.

Table-V.5: General government subsidies

	1987	1988	1989	1990	1991	1991*	1992	1993
Billion HUF								
Consumer price subsidies	66.7	44.4	44.1	36.9	42.3	42.3	19.1	21.7
Subsidies to enterprises	150.7	143.8	115.7	98.2	68.6	68.6	94.7	130.7
Subsidies on housing	..	46.4	95.4	96.4	76.9	76.9	79.5	67.9
As a percentage of GDP								
Consumer price subsidies	5.4	3.1	2.6	1.8	1.8	1.7	0.7	0.6
Subsidies to enterprises	12.3	10.0	6.7	4.7	3.0	2.8	3.3	3.7
Subsidies on housing	..	3.2	5.5	4.6	3.3	3.1	2.8	1.9

* According to the revised Hungarian National Accounts calculations.

The most difficult task to estimate the real size of producer subsidies. For the beginning of the period we use the official data, since tax reliefs or other items netted out are very difficult to be estimated. In 1992 and in 1993 producer subsidies are leveled up, because some off budget items - like the reorganization expenditures of State Holding Company - had to be included in general government. In 1993 our data are higher by HUF 44 billion, 1.3 % of GDP, than the official ones are.

By 1991 enterprises' subsidies were a great deal lower than in 1987 and in the next two years mainly due to the out of budget operations their share became fractionally higher. The structure of this item was dominated by different kinds of agricultural and food processing's subsidies. In 1988 government transfers to agriculture and food processing amounted to 70 % of the total sum. The same rate is 75 % in 1991.

Housing subsidies reached a peak in 1989. The system of subsidizing housing purchase was altered at first in 1989 because this very progressive item had to be reduced. (As loans were available for households at fairly preferential interest rates, after 1988, when inflation rate jumped up dramatically, government expenditures grew quickly, too.) To cut any further increase in these types of outlays a new measure was introduced in 1991 to get interest rates paid by households closer to the market ones. Debt holders of preferential loans were required to choose between two possibilities: paying higher monthly payments according to an increase of interest rate on outstanding principal up to 15 %, or having 50 % of their outstanding principal forgiven but paying market rates on the other half. This second solution comprised another possibility: to repay the remaining 50 % of their outstanding debt.

As a consequence of these changes general government expenditures began to fall, and the number of dwellings built slumped by more than a half during 1990-1993. The decline (in terms of GDP) is gradual in accordance with the process of pre-1989 preferential loans' redemption. (The share of pre-1989 housing loans' expenditure was 53 % of the total housing subsidies in 1991 and 37 % in 1993.)

To sum up government programs reducing producer and consumer price subsidies were very substantial and implied a government saving equivalent to 15 % of GDP.

3.2 Expenditures on government services

In this part we review one of the biggest part of government current expenditures, namely expenditures on goods and services. Data in this chapter refer to government services rendered by central and local budgetary institutions only, independently of their sources. (Because the lack of appropriate information data are aggregated.)

It is a very interesting issue what kinds of government policy were in practice during the years of shrinking GDP, what kinds of preferences were applied in order to get additional sources by restructuring of budgetary institutions. One of the findings is that there was no significant change in the number of government employees, while unemployment in general terms has grown up rapidly. Until the end of 1993 there was no definite state effort to reduce the size of the government sector in this context.

The decline in the number of full time employees was 16 percent compared to the 43 percent in the financial and non-financial sector during 1988-1993. Moreover the 1992 Civil Service Act made it very difficult and very expensive to cut down the employment in this area. As a consequence of the big difference between the above mentioned two figures the ratio of government employees in the total employment increased from 24 % to 32 % during 1988-1993.

Only the 1995 government spring package began the reduction by removing most of the obstacles. According to the supplementary budget Central government organizations have to lay off 15 % of their employees in one step and the same step is suggested to local governments. According to the 1990 Act on Local Governments these bodies are legally independent from the central government, but their activities are mostly financed by central government sources. An additional allocation is provided for redundancy costs, while the Parliament has modified the Civil Service Act in order to ease the budget burdens of further cuts.

The method of planning the allocations for budgetary organizations has changed very significantly since the beginning of the transition period. The process shows well the government effort to cut back expenditures in general terms. Every year from the beginning of the period the Ministry of Finance defined nominal expenditure increases for salaries and material expenses, financed by the central budget. The so-called autonomous[24] allocations were lower than the projected inflation rate in every year. In 1989 the planned nominal increase of wages was lower than that of material costs. After 1989 there was a change, as in all successive years the allocations paid on wages had higher increase than material costs. It was a general tendency to plan and to apply the identical nominal increase for central and for local institutions, as well. By 1993 the so-called automatic nominal increase of allocations was canceled for budgetary institutions including the local ones. A nominal freeze of expenditures for salaries and material costs has become usual, except those areas where specific measures were intended.

Table-V.6: The nominal increase of allocations in a few selected years

(in %)

	1989	1991	1992	1993
For wages	6.0	20.0	10.0	0
For material expenses	8.0	10.0	5.0	0
CPI	17.0	35.0	23.0	22.5

One of the possibilities to reduce expenditures was to give allocations year by year increasing less than the adequate inflation rate did. This means the decrease of expenditures in real term while out of this general tendency there was another possibility to reduce or to increase expenditures, i. e. to establish a selective scale of the allocations. For example in 1989 the increase of allocations for wages in the case of higher education was 12 % just like for material expenses in the case of municipalities of villages. In the subsequent years the almost general equality disappeared; not every concerned body got the nominal increase, or the rate was reduced.

The above mentioned drop in the central government allocations resulted a two sided effect; i. e. the objectives of the state budget were heavily supported and the concerned institutions were deeply interested to participate more and more in profit oriented activities. As a result of this secondly mentioned effect since 1991 the share of revenues from market activities within total central government expenditures has exceeded the 10 %. It is quite evident that the chance of proper planning had to be weakened because of this new situation.

Current expenditures by kind of activities show a gradual rearrangement within the government. Partly due to the above mentioned allocation practices health services had a relative advantage while defense suffered from a comparative disadvantage. (The tables - V.7 and V.8. - need special attention because data for public administration and economic services are not comparable between 1991 and 1992 due to the changes in budget functional classification.)

[24] Autonomous means that additional sources - in percent of previous year's state allocation - were provided for government institutions almost every year without scrutinising their obligations.

Table V.7: Current expenditures of budgetary institutions [1)]

	1988			1989		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services	10 183	30 849	41 032	13 128	43 138	56 266
Welfare services	1 996	6 647	8 643	2 231	9 278	11 509
Education services	10 817	50 061	60 878	14 139	69 358	83 497
Cultural services	8 610	6 711	15 321	11 548	9 641	21 189
Sport services	1 163	911	2 074	1 442	1 142	2 584
Public administration	23 206	13 452	36 658	29 003	18 850	47 853
of which: Basic research	8 166		8 166	10 335		10 335
Economic services and other	28 692	12 471	41 163	31 027	15 059	46 086
Defense [2)]	59 051		59 051	61 986		61 986
TOTAL	**143 718**	**121 102**	**264 820**	**164 504**	**166 466**	**330 970**
	1990			1991		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services	17 390	58 242	75 632	25 597	74 649	100 246
Welfare services	2 622	12 406	15 028	3 732	15 442	19 174
Educational services	19 086	92 628	111 714	24 600	119 686	144 286
Cultural services	13 906	11 348	25 254	17 791	13 572	31 363
Sport services	955	1 311	2 266	1 265	1 498	2 763
Public administration	36 124	25 396	61 520	47 832	26 854	74 686
of which: Basic research	11 497		11 497	12 267		12 267
Economic services and other	30 525	13 668	44 193	35 445	20 828	56 273
Defense [2)]	72 232		72 232	85 905		85 905
TOTAL	**192 840**	**214 999**	**407 839**	**242 167**	**272 529**	**514 696**
	1992			1993		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services [3)]	36 032	113 901	149 933	41 695	133 311	175 006
Welfare services			0		34 570	34 570
Educational services	29 731	122 934	[5)] 152 665	36 053	149 303	185 356
Cultural and sport services	23 737	17 495	41 232	32 768	21 250	54 018
Public administration	90 051	44 566	134 617	106 501	67 271	173 772
of which: Basic research	12 492		12 492	14 092		14 092
Economic services and other	24 905	24 120	49 025	25 819	29 763	55 582
Defense [2) 4)]	107 848		107 848	127 436		127 436
TOTAL	**312 304**	**323 016**	**635 320**	**370 272**	**400 898**	**771 170**

[1)] Without transfer in cash
[2)] Defense with public order and safety
[3)] Welfare services are included
[4)] In 1993 the imports of military aircrafts from Russia are excluded (HUF 101.5 bn)
[5)] According to the ISIC some subsidiary services were classified into Hotels and restaurants (HUF 1.5 bn)

Table V.8: Current expenditures of budgetary institutions [1)]

	1988			1989		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services	24.8%	75.2%	15.5%	23.3%	76.7%	17.0%
Welfare services	23.1%	76.9%	3.3%	19.4%	80.6%	3.5%
Education services	17.8%	82.2%	23.0%	16.9%	83.1%	25.2%
Cultural services	56.2%	43.8%	5.8%	54.4%	45.5%	6.4%
Sport services	56.1%	43.9%	0.8%	55.8%	44.2%	0.8%
Public administration	63.3%	36.7%	13.8%	60.6%	39.4%	14.5%
of which: Basic research	100.0%		3.1%	100.0%		3.1%
Economic services and other	69.7%	30.3%	15.5%	67.3%	32.7%	13.9%
Defense	100.0%		22.3%	100.0%		18.7%
TOTAL			**100.0%**			**100.0%**

	1990			1991		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services	23.0%	77.0%	18.5%	25.5%	74.5%	19.5%
Welfare services	17.4%	82.6%	3.7%	19.5%	80.5%	3.7%
Educational services	17.1%	82.9%	27.4%	17.0%	83.0%	28.0%
Cultural services	55.1%	44.9%	6.2%	56.7%	43.3%	6.1%
Sport services	42.1%	57.9%	0.6%	45.8%	54.2%	0.5%
Public administration	58.7%	41.3%	15.1%	64.0%	36.0%	14.5%
of which: Basic research	100.0%		2.8%	100.0%		2.4%
Economic services and other	69.1%	30.9%	10.8%	63.0%	37.0%	10.9%
Defense	100.0%		17.7%	100.0%		16.7%
TOTAL			**100.0%**			**100.0%**

	1992			1993		
	Central gov.	Local gov.	Total	Central gov.	Local gov.	Total
Health services [2)]	24.0%	76.0%	23.6%	23.8%	76.2%	22.7%
Welfare services					100.0%	4.5%
Educational services	19.5%	80.5%	[4)] 24.0%	19.5%	80.5%	24.0%
Cultural and sport services	57.6%	42.4%	6.5%	60.7%	39.3%	7.0%
Public administration	66.9%	33.1%	21.2%	61.3%	38.7%	22.5%
of which: Basic research	100.0%		2.0%	100.0%		1.8%
Economic services and other	50.8%	49.2%	7.7%	46.5%	53.5%	7.2%
Defense [3)]	100.0%		17.0%	100.0%		16.5%
TOTAL			**100.0%**			**100.0%**

[1)] Without transfers in cash [2)] In 1992 welfare services are included.
[3)] Defense with public order and safety. In 1993 the imports of military aircrafts from Russia are excluded.
[4)] It would have been 26.5% if subsidiary services had been included.

The share of expenditures for health care was 15.5 % in 1988 compared to the total current expenditures, and following the gradual and permanent increase after five year the share was 22.7 %. There is no doubt that defense, public order and safety are the mostly definite losers of this transitory process, since their share within the total expenditure dropped from 22.3 % to 16.5 %. As it is indicated by the following tables reduction was carried out between 1988 and 1990 after this time the share remained nearly stable.

Independently from the fact that data are not comparable in their ordinary sense, (because of the introduction of the new functional classification), the very unambiguous conclusion can be drawn that substantial sources have been released for financing other budgetary activities as the effect that some economic services had been out of the scope of the central government. While activities with commercial nature were quite common in every budgetary institutions, there was a special type of central budgetary institutions, which were formed to be engaged in quasi commercial activities. The so-called "interested in the result (profit)" organizations were attached mainly to the ministries of Agriculture, Transport, Telecommunications and Water. A remarkable part of these activities and some of budgetary institutions (e. g. dealing with water and road management) had been transferred to the non-financial enterprise sector.

3.2.1 Current expenditures of government services in some selected activities

First of all some methodological notes have to be taken into account concerning the next figures. Our estimations are to show the tendencies in government services, only. We use aggregated activities because these groups are more reliable than separated ones. When analyzing figures the 1991 change in GDP must be taken into consideration, again.

One of the highest priority spending areas are health and welfare services throughout the whole period. Until 1991 expenses on these services had grown both in terms of GDP and at constant prices, too. The share in GDP increased quicker than in real terms due to the sharp fall in real GDP. After this turning point ratios did not change significantly. (The expenditure/GDP ratio was almost 1.6 points higher in 1993 than in 1988.)

Despite the importance of this sector the expenditures were almost the same in 1993 as they were in 1989. Taking into consideration the gradually but ever worsening health condition of the Hungarian population and their increasing age, despite the fact that expenditures remained almost the same, there was continuous pressure to grow health care expenditures in a short run.

Operating costs on health care in Hungary are financed by the Health Care Fund, three quarters of the institutions work as local budgetary institutions, the rest as central institutions.

Table-V.9: Health and welfare services

	1988	1989	1990	1991	1991*	1992	1993
HUF billion	49.7	67.7	90.7	119.4	119.4	149.9	175.0
HUF billion, at 1988 prices	49.7	57.8	60.1	58.6	58.6	59.8	57.0
As % of GDP	3.5	3.9	4.3	5.2	4.8	5.1	4.9

* According to the revised Hungarian National Accounts calculations.

Education has an emphasized role especially concerning the case how to handle unemployment. The privileged position of this branch is explicit, since expenditures of educational institutions in real terms had a definite increase between 1989-1991 and this amount had not fallen below the 1988 level. The share of this sector in terms of GDP has increased, just like in the case of health services.

While the budgets of elementary and secondary schools financed by local governments compared to those of high schools financed by central government remained almost stable until 1991, in the years of 1992-93 the share of higher education increased.

Table-V.10: Educational services

	1988	1989	1990	1991	1991*	1992*	1993
HUF billion	60.9	83.5	111.7	144.3	144.3	152.7	185.4
HUF billion at 1988 prices	60.9	71.4	74.1	70.9	70.9	61.0	60.4
As % of GDP	4.2	4.8	5.3	6.3	5.8	5.3	5.3

* According to the revised Hungarian National Accounts calculations.
** Using the 1991 classification - subsidiary educational activities i. e. food and lodging are included - the actual amount is HUF 168.4 billion and the share of GDP is the same as in 1991, 5.8 %.

It is a quite surprising fact that expenditures on culture and sports facilities - in real terms - remained nearly constant during the whole surveyed period, in spite of the delicate fluctuations. It could happen so just because the lost state sources were compensated by revenues from own (profit oriented) production. In general, culture and sport have not been taken as a privileged territory of the government budget policy.

Table-V.11: Cultural and sport services

	1988	1989	1990	1991	1991*	1992	1993
HUF billion	17.4	23.8	27.5	34.1	34.1	41.2	54.0
HUF billion at 1988 prices	17.4	20.3	18.3	16.7	16.7	16.5	17.6
As % of GDP	1.2	1.4	1.3	1.5	1.4	1.4	1.5

* According to the revised Hungarian National Accounts calculations.

There are some characteristic features that are typical for all the above mentioned three categories:

- their expenditures have not been decreased in real terms;
- after a temporary increase in 1989-91 their expenses have remained stable or decreased;
- the increase in wages had a significant role in the increase of expenditures and resulted a definite loss concerning material expenditures;
- neither of these areas have been influenced by any item of an overall reform.

Even in 1993 50 % of budgetary institutions (in terms of their expenditures) were involved in public services which are for households needs. (24 % of central, 85 % of local budgetary institutions) 19-20 percent of total actual household consumption is originated from budgetary institutions; the major part of this (17 percentage points) is provided as social transfer in kind.

As it was mentioned earlier the "big looser" of the transition period is the branch of defense, public order and safety. Their expenditure had a 30 % drop at constant prices between 1988 and 1993. This reduction was a tool for the central government to be able to create some resources for financing other projects. Mostly material type expenses were influenced by this reduction. The general reform to be undertaken has remained after 1994.

Table-V.12: Defense, public order and safety

	1988	1989	1990	1991	1991*	1992	1993
HUF billion	59.1	62.0	72.2	85.9	85.9	107.8	127.4
HUF billion at 1988 prices	59.1	53.0	47.9	42.2	42.2	43.0	41.5
As % of GDP	4.1	3.6	3.5	3.7	3.5	3.7	3.6

* According to the revised Hungarian National Accounts calculations.

Because of the introduced modifications of the functional classification in 1991 comparable and separated figures are not available for the whole surveyed period concerning general public administration and economic services. Independently from this disturbing error, it can be stated without any doubt that reduction of economic services' costs is a characteristic feature of this period, together with sometimes stable, sometimes increasing financing of public administration. It is an absolutely specific case that - arising from the change of the regime - several new public organizations were established by the new democratic government. Following the elections of 1990 there was a relatively high number of newly created local authorities, and most of them needed their own administration personnel. The high level of expenditures is supported strongly by the very decentralized structure of the central government and by the case that budgetary organizations were allowed to have their own revenues. Because of the latter mentioned facts, the restrictions that were introduced by the central government, could have come into practice only with difficulties. The general overview of the government sector was postponed after 1994.

Table-V.13: Public administration, economic services

	1988	1989	1990	1991	1991*	1992	1993
HUF billion	77.8	93.9	105.7	131.0	131.0	183.6	229.3
HUF billion at 1988 prices	77.8	80.2	70.1	64.3	64.3	73.3	75.1
As % of GDP	5.4	5.5	5.1	5.7	5.3	6.4	6.5

* According to the revised Hungarian National Accounts calculations.

3.3 Social transfers (in cash)

One of main features of the centrally planned economy is the inherited widespread social transfers, which imposes a heavy burden on general government expenditures. Even in 1993 general government social transfers in cash financed one fifth of households actual consumption. From a fiscal point of view during the transitory years these transfers hinder to a significant extent to conduct a sufficiently restrained fiscal policy.

The two most important items of social transfers are pension and family allowance payments. Their share in the whole general government transfer was 72 % in 1993.

The pension system has been heavily weighted by two significant adverse phenomena. The number of pensioners grew up by 16.6 % between 1987-1993. As a consequence of unfavourable demographic characteristics, i. e. the average age of population is increasing year by year, the increase of the number of own right old age pensioners was about 10 %. During the same period the number of disability pensioners jumped up by 60 %.

In an international context the present legal retirement age is fairly low. (The retirement pension is payable from the age 60 for men and 55 for women.) A gradually introduced increase of the retirement age was enacted in 1993, with implementing it in 1994. At first the introduction was postponed to the beginning of 1995 then it was suspended.

Due to the above mentioned fast increase more than a quarter of pensioners received disability pension out of which almost a half are in working age in 1993. The low eligibility criteria of normal old age pension, the legal possibility and abuses of disability pension led to an effective retirement age of about 53-54 years by 1993.

The average pension compared to the average earnings decreased from the 1988 50% to 42 % by 1993. The ratio concerning disability pension also diminished from 49% to 37 % during the same period. (Average wages refer to after taxation earnings.)

Despite the extremely high, and during the reviewed period even growing, employee and employer contributions due to all of the previously mentioned facts the Pension Fund is having a permanent deficit. (Obviously the revenue side has another strong impact on the balance of the fund which will be reviewed in the next pages.) Pension expenditures decreased by 8 % in real terms in 1988-1993, compared to the 18 % decline in GDP.

In spite of the fact that a parliamentary resolution passed in 1991 established the main priorities of streamlining the pension system, an overall reform programme is still missing in 1995. There is another recent development that the Parliament linked the average pension changes to the net average wage, independently from the present economic conditions. Since 1992, when Parliament introduced formal indexing, pensions are increased twice a year.

Table-V.14: Pensions and family allowance

	1988	1989	1990	1991	1991*	1992	1993
Pensions							
HUF billion	130.0	156.5	202.0	260.7	260.7	305.5	367.1
HUF billion 1988	130.0	133.7	134.1	128.0	128.0	122.0	119.7
As % of GDP	9.0	9.1	9.7	11.3	10.5	10.6	10.5
Family allowance							
HUF billion	36.0	52.8	64.2	81.5	81.5	91.8	107.5
HUF billion 1988	36.0	45.1	42.6	40.0	40.0	36.6	35.0
As % of GDP	2.5	3.1	3.1	3.5	3.3	3.2	3.1

* According to the revised Hungarian National Accounts calculations.

The second type of the biggest social transfers to households is the family allowance. The universal and non-taxable income is out of proportion the Hungarian economic performance. Up to 1991 the number of recipients was growing, while the per capita allowance in real terms has been significantly declining since 1990.

The 1995 Spring austerity package tried to convert this system to a means-tested cash benefit, though the Constitutional Court suspended this proposal for a certain time.

In general, all social transfers showed similar development, that is the decline in their real values did not follow the drop of GDP or moreover of government revenues. Consequently social transfers' share in GDP was almost permanently growing or stagnating in some cases.

4. General Government revenues

The revenue side of the Hungarian budget system has undergone considerable modernization during the analyzed period. The basic elements of the present tax system were established during the period 1988-1990. Modernization began by introducing western formed personal income tax and value added tax and was concluded by enacting different types of local taxes in December 1990. Even if it was quite comprehensive reform too frequent changes followed its introduction. Almost most of the adjustments were exclusively driven by budget pressures.

The crucial problem of the current fiscal policy is the unreasonable financing need necessitated by the expenditure side. It appears in the high income centralization requirement as well as in the fact that money- and capital market conditions are also determined by the financing need of the general government.

As it was shown in table V.2 and V.3 between 1987-93 general government revenues dropped by almost 20 %, in real terms. This reduction have gone with significant rearrangement in the structure of those. The main tendencies and developments are:

- By the end of 1993 privatization revenues became more and more important.[25] In 1993, in accordance with government efforts to get additional, even temporary funds these sources were almost 9 % of total revenues.

- During 1987-93 corporate income tax, which was one of the biggest source of the socialist budgets, became almost negligible, at least comparing to its previous importance.

- The newly introduced personal income tax became a basic source of the budget and mostly replaced the loss of corporate income tax.

- Other current revenues went up by almost 9 percentage points of total revenues. This change was due to the growing importance of market activities of budgetary institutions as well as to some newly introduced tax like revenues.(e. g. employee contributions to solidarity fund are included in this category.)

The amounts and proportions of main sources of revenues in the consolidated general government revenues were the following:

[25] Although official budget reports do not contain a remarkable part of privatisation revenues those are involved in our consolidated general government data. Only those amounts are included in the official budget data, which are automatically defined by the Annual Asset Policy Guidelines (in principle the Parliament passes it connected to the yearly Budget Act) as revenues of the central budget or extrabudgetary funds. Revenues either are handled outside the official budget or inside it have the same importance from an economic viewpoint, privatisation decisions form a part of the state decision making mechanism. In Hungarian privatisation process a decision very often causes more considerable redistribution of government sources than for example modification of a tax rate.

Table-V.15: Consolidated General Government Revenues

	1987	1988	1989	1990	1991	1991*	1992	1993
Billion HUF								
Total revenues	739.1	866.8	978.1	1,168.5	1,280.4		1,533.7	1,945.1
Current revenues	720.2	864.9	975.9	1,138.1	1,229.6		1,427.2	1,734.3
Taxes	440.9	513.9	520.5	601.9	585.8		614.5	753.1
- Corporate inc. tax	145.7	121.4	129.2	144.8	121.8		65.7	64.1
- Individual inc. tax	10.0	65.2	101.8	134.4	183.9		205.7	259.7
- Indirect taxes	231.9	306.7	283.1	319.7	299.7		334.2	418.2
Custom duties, imp. charg.	34.7	36.3	48.9	52.4	62.8		100.2	128.2
Other current revenues	95.0	120.2	160.6	198.9	230.2		333.9	418.8
Social security contrib.	149.6	194.5	245.9	284.9	318.5		358.7	409.5
Capital revenues	18.9	1.9	2.2	30.4	50.8		106.5	210.8
- Privatization revenues	0.0	0.0	0.0	0.7	30.4		66.8	166.6
As a percentage of total revenues								
Total revenues	100.0	100.0	100.0	100.0	100.0		100.0	100.0
Current revenues	97.4	99.8	99.8	97.4	96.0		93.1	89.2
Taxes	59.7	59.3	53.3	51.5	45.8		40.1	38.7
- Corporate inc. tax	19.7	14.0	13.2	12.4	9.5		4.3	3.3
- Individual inc. tax	1.4	7.5	10.4	11.5	14.3		13.4	13.4
- Indirect taxes	31.4	35.4	28.9	27.4	23.4		21.8	21.5
Custom duties, imp. charg.	4.7	4.2	5.0	4.5	4.9		6.5	6.6
Other current revenues	12.8	13.9	16.4	17.0	18.0		21.8	21.5
Social security contrib.	20.2	22.4	25.1	24.4	24.8		23.4	21.1
Capital revenues	2.6	0.2	0.2	2.6	4.0		6.9	10.8
- Privatization revenues	0.0	0.0	0.0	0.0	2.4		4.4	8.6
As a percentage of GDP								
Total revenues	60.3	60.2	56.8	55.9	55.5	51.7	53.2	55.5
Current revenues	58.7	60.1	56.7	54.4	53.3	49.6	49.5	49.5
Taxes	36.0	35.8	30.2	28.8	25.4	23.6	21.3	21.5
- Corporate inc. tax	11.9	8.4	7.5	6.9	5.3	4.9	2.3	1.8
- Individual inc. tax	0.8	4.5	5.9	6.4	8.0	7.4	7.1	7.4
- Indirect taxes	18.9	21.3	16.4	15.3	13.0	12.1	11.6	11.9
Custom duties, imp. charg.	2.8	2.5	2.8	2.5	2.7	2.5	3.5	3.7
Other current revenues	7.7	8.3	9.4	9.5	10.0	9.3	11.6	11.9
Social security contrib.	12.2	13.5	14.3	13.6	13.8	12.9	12.4	11.7
Capital revenues	1.5	0.1	0.1	1.5	2.2	2.1	3.7	6.0
- Privatization revenues	0.0	0.0	0.0	0.0	1.3	1.2	2.3	4.8

* According to the revised Hungarian National Accounts calculations.

From the introduction of the new tax system in 1987 to 1991 revenue decline was more significant than decrease of GDP, so centralized revenues in terms of GDP dropped by some 5 percentage points. There was a sharp decline in 1989. This tendency was due to the shift of the tax system which was heavily weighted by a numerous tax exemptions and loose tax execution. After recognizing the serious imbalance in the budget owing to the government effort the ratio went up by almost 4 percentage points by 1993. Purely aritmethically it is obvious, that the growth in the proportions after 1991 is a result of accounting privatization revenues as revenues of the general government. The general government did not increase its influence on the redistribution of current- and capital incomes, it remained at the same level. Since privatization revenues can be considered as temporary sources this fact calls for a new government approach to public finances.

The fast transformation of the economy into a market one has brought about the quick rise in the number of taxpayer economic organizations (both institutions with legal status and corporations without legal status, entrepreneurs), from the 360 thousand in 1989 it increased to 872 thousand until 1993. Thanks to the, by this time modified, tax system new enterprises could apply an already introduced system. However tax avoidance became a more and more fundamental problem, especially in the cases of enterprises without legal status and entrepreneurs. The Tax and Financial Auditing Office could hardly keep pace with the rapid growth in the number of taxpayers. The tax payment system was based on self-assessment. Even due to the - in international comparison - high level of taxation, the proportion of tax avoidance and non paid taxes simultaneously increased. Therefore the 1995 government package began to create such an instrument- and organizational system starting in 1995, that can reduce this problem.

4.1 Direct taxes

In 1987 individual taxes on income had a marginal role in public finances. Since the introduction of *personal income tax* (PIT) in 1988 its proportion in terms of total revenues has almost doubled. In 1993 PIT accounted for 13.4 % of general government revenues.

PIT has a comprehensive nature, Hungarian individuals are being taxed on their world-wide income. In fact the system is far from being really comprehensive owing to the officially given tax exemptions and the considerable tax avoidance.

Some forms of income that were taxed separately, enjoyed special tax treatment:

- social benefits in cash (e. g. family allowance, scholarship) were not taxed at all;

- income from securities, dividends and interests had a tax rate of 10 or 20 percent;

- small agricultural businesses had a remarkable tax free receipt;

- "intellectual" activities had a special deduction or smaller tax rate;

- pensions were not subject to taxation.

Graduated taxes were introduced with 11 tax brackets from 0% to 60% in 1988. By 1990 the level of the top bracket dropped to 50% then by 1992-1993 to 40%. In 1994 it had to be increased again up to 44% because of the urgent need of the expenditure side. The steep progressivity of the system had strong incentive effects to tax evasion and tax avoidance. In most of the reviewed years tax rates (or brackets) were not fully adjusted (or not at all in 1993 and in 1995) for inflation, so bracket creep led to an increase in effective tax rates.

Despite the recurrent government efforts to broaden the tax base, to decrease tax exemptions due to the above mentioned facts the average rate[26] of taxation went up only 4 percentage points, from 14.5 % in 1988 to 18.5 in 1992. (The actual rate of taxable income was definitely higher, 23.8 per cent in 1988 and 30.2 per cent in 1992.)

Since 1991 personal income tax revenues have been divided between the central and the local governments. During the period 1988-1990 local governments received the total amount of PIT paid in the relevant region two years before. In 1991-1992 the central government possessed one half of the above mentioned PIT, since 1993 the central government share grew to 70 per cent. The rationale of this kind of distribution is that the local community should get its fare share from the results of the economic activity of the region. This system, however, has a drawback that it intensifies the regional differences appeared in the economy. Connected to these two arguments the measure of distribution changed several times in the examined period - by the decision of the Parliament. For the time being the central budget remits to the local governments monthly 1/12 of the 35% of the amount of personal income tax paid in the given region two years before.

The *profit/corporate income tax* (CIT) had a considerable role in the previous regime. CIT revenues amounted to 20 % of general government sources in the last year of the old system (1987) and diminished to 3.3 % of total revenues by 1993. This source is a direct central government revenue.

Profit taxes are to be paid by incorporated businesses. Individuals have the possibility to choose paying profit tax or PIT. The lowering importance is attributable to so many reasons. (The CIT revenues/GDP ratio decreased by 10 percentage points during 1987-1993.)

The tax rate decreased continuously: in 1989 50 %, in 1990-1993 40 % and in 1994 36 % basic rate were applied with numerous tax reliefs. The reduction of the statutory tax rate intended to inspire an increase in economic activity and the propensity to invest. (The new system, introduced in 1995, only 18% CIT and additional 23% if the owner takes out the after-tax profit is a step further in this direction.)

Different tax reliefs were provided from the introduction of the new system in the form of reduced tax rates, accelerated depreciation (given mostly to small entrepreneurs), tax deductions and tax credits. Reliefs were tied to special preconditions e. g. certain foreign

[26] This proportion refers to the notion of total income, while the latter one to taxable income. The difference between these were considerable, however shrinking.

participation in newly established companies, reinvested dividends, some priority activities (public telecommunications services, packaging technology, electronics, etc.). Assets acquired after 1st January 1992 could be accounted with higher depreciation rate than those acquired before. (Despite the favourable changes in depreciation rules the corporate tax law does not allow to apply the perpetual inventory method - continuous revaluation - when determining the cost of depreciation. This lead to an overestimation of profit.)

The fall in payment of CIT also reflects the serious problems of the economy. After the system change the export possibilities to the post-communist countries decreased significantly. The still existing problems of the former large enterprises came to the surface. Due to the dramatically decreasing profitability domestic and foreign entities - subject to corporation tax - accounted for twice higher loss than profit in 1992. The number of bankruptcy and liquidation procedures multiplied due to the recession as well as the new regulation. (The regulation - a new act - concerning these procedures was passed in 1991.) At the end of 1993 the number of corporations with legal entity which declared bankruptcy was 3,074, while the number of completed bankruptcy procedures was 2,793. These processes, for obvious reasons, considerably reduced the tax payment ability, however contributed in a great deal to the formation of a viable economic structure.

The rapidly growing number of economic units (some of them short-lived) made tax collection more difficult, consequently contributed to a certain extent to the evasion of CIT, too.

The taxable income of the financial institutions was directly reduced by the bad- and doubtful debts of the enterprises. Their taxpaying capacity was further eroded with making statutory provisioning for bad or doubtful loans. The new law, that meets international norms and was passed in 1991 prescribes a much bigger provisioning obligation, which temporally minimized taxable income. The bank and credit consolidation was the result of the problems of the commercial bank system. All this will continuously affect the taxpaying ability.

Owing to the relatively favourable possibility to carry forward the accounting losses the tax paying capacity was further deteriorated .

While continuous changes (by 1994 most of the general tax reliefs were withdrawn) broadened the tax base of CIT, these measures had a significant drawback. The too frequent changes made tax policy (and economic environment) unstable and unforeseenable for investors.

4.2 Indirect taxes

Hungary was the first Eastern European country to implement value added taxation in 1988. VAT is levied on domestic sale an imported goods and services. The standard rate has been 25 per cent since its introduction. Preferential rate was fixed at 15 % to most of services while zero rate was in force to most food products, fuels, pharmaceuticals, housing heating services, etc. Medical care, sports, culture, education, financial services, public administration had a tax exempt status. Up to present the original system has changed radically. In 1993 the government launched a major revision: the zero rate remained only for household energy and medicines, the preferential rate diminished to 6 % (from August of the year it was raised to

10 %) and covered a shrinking group of products and services (e.g. food, public transport, telecommunication, household energy). From January 1995 the preferential rate was increased to 12 % and some products and services previously classified into this category were reclassified to be levied on standard rate (e.g. telecommunication services, household energy). Pharmaceuticals are the only products to be levied on zero rate. Exports and investments were entitled to a refund. The latter was gradually increased by 20 % in each year, from 20 % in 1988.

Table-V.16: Indirect taxes in the consolidated general government revenues

	1987	1988	1989	1990	1991	1991*	1992	1993
Billion HUF								
Indirect taxes	231.9	306.7	283.1	319.7	299.8	299.8	334.2	418.2
- Turnover tax[27]	122.9	98.7	66.0	79.0	32.4	32.4	20.0	24.7
- VAT[28]		107.8	119.3	130.4	130.1	130.1	147.5	245.3
- Excises	65.6	85.9	97.8	110.3	137.3	137.3	166.7	148.2
- Wage tax	43.4	14.3						
As a percentage of GDP								
Indirect taxes	18.9	21.3	16.4	15.3	13.0	12.1	11.6	11.9
- Turnover tax	10.0	6.8	3.8	3.8	1.4	1.3	0.7	0.7
- VAT		7.5	6.9	6.2	5.6	5.3	5.1	7.0
- Excises	5.4	6.0	5.7	5.3	6.0	5.5	5.8	4.2
- Wage tax	3.5	1.0						

* According to the revised Hungarian National Accounts calculations.

From the introduction to 1992 the growth of VAT revenues was very moderate. In real terms or in terms of GDP the VAT decreased until 1992. The proportion of zero rate goods and services within the purchased household increased year by year and reached 44% by 1991. Consumers decisions were definitely distorted by the strongly differentiated tax rates. Rebate on investment became full in 1992. The application and the extension of the high standard rate led to a considerable extent of tax evasion. It is very difficult to make an exact estimation but according to some researchers VAT avoidance seems to be more the rule than the exception in some part of the Hungarian economy.

As a consequence of the above mentioned major revision of the system and a more severe tax collection the VAT rate in GDP reached the 1989 level again by the end of 1993.

[27] Until 1989 the bigger part (the so-called differential production turnover tax), then from 1990 the whole amount was derived from rents levied on raw materials, like crude oil.

[28] It must be noted that VAT data are consolidated in this table. VAT paid by budgetary institutions to the central budget are taken out: the relevant figures in turn HUF billion 15.2, 15.7, 16.4, 19.4, 28.1, 41.4 in 1988-1993.

Excise taxes has a relatively important role in Hungarian public finances. As it is reflected in table V.16 these revenues partly replaced the losses of VAT. In 1991-1992 excise taxes even exceeded the whole amount of collected VAT.

Excise taxes are imposed on cars, jewelry, fuels, spirits, coffee, tobacco etc. The tax is applied either as a percentage of the price or as an amount per unit sold. The amounts defined as a lump sum are revalorized time to time to keep track of inflation.

The spreading tax avoidance: street-selling, abuses with oil products, tobacco and alcoholic drinks considerably contributed to the decrease of the revenues of these taxes, by 1993. A new act came into force in 1994 to stop these unfavourable tendencies.

4.3 Other revenues

Custom duties are transferred to the central budget as well. Their proportion in the consolidated general government grew from 4.7% in 1987 to 6.6% by 1993. This increase is the result of the growth of the HUF value of the import. In a long run according to the EC Association Agreement these revenues will not rise parallel with the growth of imports, but the 1995 spring package imposed an import surcharge of 8 percent until mid-1997 on almost all imports.

The revenue coming from the *local taxes* constitutes a relatively small weight in the consolidated general government and in the local governments revenues. Local taxes amounted to 1.5 % of consolidated general government revenues, 0.8% of GDP and 5.1% of non-consolidated local government revenues in 1993. (The relevant figures are 0.6%, 0.4% and 2.8% in 1988.)

The new Act on Local Government enacted in 1990 conferred upon local governments the right to impose different taxes. These taxes, the subject of a tax were outlined in the act. Only the tax rates (with an upper limit) and some possibilities to provide exemptions were in local authorities discretion. The government intention was to transfer some of its responsibilities to the local level, with specific own sources, so the importance of this tool in the tax system is much bigger than its actual weight.

Three broad types of local taxes are available to local authorities i.e. property tax, communal tax and tax on local business. Up to now the most widespread local tax is the local business tax (based on accounting revenues). For the time being local governments are reluctant to impose taxes despite the permanent lack of their funds and they are especially cautious with taxes on households.

One of the main reason because the current Hungarian tax system is said to be not sustainable is the high payroll taxation. *Social security contributions* - with small fluctuations - were about 20-25% in the consolidated general government revenues and amounted to 12-14 % of

GDP. These contributions are earmarked to the Social Insurance Fund.[29] (As it was mentioned earlier the unified fund was split up two self-governed funds in 1993.)

This seemingly more or less stable source of revenue hides serious tensions. Since the middle of the analyzed period revenues do not cover the expenditure (pension, health- and other social cares) needs. Since then the central budget has granted credit to the social security funds and it even has issued government securities to finance their deficit.

There was no major reform on this taxation, except for one, employer contribution grew slightly. (Employee contribution were 10 %, while employer contribution went up from 43% -1989- to 44% in 1992.) These high rates made employment expensive and led to a massive tax evasion. Owing to the arrears of large state owned firms (like Hungarian Railway Company) the assessed but unpaid contributions reached 200 billion HUF by the end of 1994.

The management of the two funds were separated, the collection of the revenues is done by the Health Insurance Trustees, and it is distributed later on. The Pension Fund gets 30.5% of the current 54% and the rest 23.5% belongs to the Health Insurance Fund.

VI. DEFICIT FINANCING AND PUBLIC DEBT

The early nineties had brought about in Hungary a new age in public indebtedness process. The shift to a market based deficit financing regime may be considered as a fundamental change, however, this itself does not provide a sufficient explanation to understand why and how the increase in public debt and debt services have created a crucial problem from the point of view of recovery and sustainable growth for the present. The Hungarian debt problem is determined by several other factors: large external debt and debt services inherited from the previous regime, fiscal crises stemming from the shocks of the early nineties, lack of transparency of the system of public finance.

1. Changes in budget deficit financing

1.1. Financing through the central bank

In the centrally planned economy the central budget was financed by the direct credit line with the National Bank of Hungary (NBH). The central bank accommodated the budget borrowing requirement without any limit at preferential interest rates. In the centralized banking system

[29] Other obligatory wage related burden is the contribution to Solidarity Fund which pays unemployment benefits. We put it into other revenues. From 1992 employers and employees pay into the fund, earlier it was financed directly from central budget. Employer and employee contributions during 1992-1994 in turn 5 and 1%, 7 and 2%, 5 and 1.5% in terms of wages.

the 'monobank' (NBH) had carried out several kinds of commercial banking and quasi-fiscal activities. Large part of central bank assets belonged to the state owned Hungarian enterprises and also after having established the first large commercial banks[30] the refinancing activity of NBH was maintained on a quite high (however declining) level. On the other hand, exercising the rights of the foreign exchange authority the NBH borrowed abroad on its own name to cover the foreign exchange needs of the public sector in large sense (including not only the budget but the state owned sector as well). The foreign debt of NBH was nearly equivalent to the foreign debt of Hungary.

Hence, the system was operating as follows: the central bank financed the budget by issuing base money (cash and reserves) and by borrowing abroad. The budget paid preferential interest on its long term loans at the NBH (40% of the central bank base rate until 1993, equivalent to the average rate on external debt since then) which covered only a part of debt service obligations on external debt. In the CPE the state- owned sector received significant sources of development through the budget. So implicitly the whole economy was provided cheap finance (below market interest) by the NBH which contributed to preserve non profitable activities.

Table-VI.1: Distribution of convertible debt of Hungary by sectors (end of year stocks - in per cent)

Debtor	1990	1991	1992	1993	1994
I. Gross debt					
1. National Bank of Hungary	83.4	79.1	75.2	74.7	70.9
2. Commercial banks	8.6	8.8	8.4	7.2	8.3
3. Government	2.2	6.7	7.7	8.2	7.9
4. Enterprises	5.8	5.4	8.7	9.9	12.9
I. Total(1+2+3+4)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
II. Net debt					
1. National Bank of Hungary	102.4	94.5	87.8	77.4	69.4
2. Commercial banks	4.3	4.1	2.4	3.0	7.1
3. Government	1.5	8.9	11.0	12.3	11.0
4. Enterprises	-8.2	-7.5	-1.2	7.3	12.5
II. Total (1+2+3+4)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Annual reports of the National Bank of Hungary

[30] The two tier banking system was established in Hungary in 1987 when three large commercial banks were created from the divisions of the NBH dealing with enterprises loans and corporate the loan portfolio of the NBH was „distributed" among the new banks.

At the end of eighties the balance sheet of NBH reflected[31] these main characteristics (Table-VI.2) On the assets side the share of refinancing loans was near to 50% and the debt due to HUF depreciation (non interest bearing liabilities stemming from a special arrangement concerning of the exchange rate losses on net foreign liabilities at the NBH) was already approaching 15% within total assets. On the liability side - quite unusual in central banking - the share of foreign debt exceeded a share of 75% (more than 60% of GDP) and the forex deposits of domestic financial institutions at the NBH have been increasing as well.

Table-VI. 2: Balance sheet of the National Bank of Hungary (in per cent)

I. Assets	1987	1988	1989	1990	1991	1992	1993	1994
1.1. Domestic assets	80.0	81.2	87.4	90.1	83.0	82.2	76.6	77.1
1.1.1 Financial sector	48.6	46.4	15.2	19.4	17.1	11.2	11.2	10.6
1.1.1.1. Short term	11.8	9.6	5.7	8.1	7.9	2.6	3.8	1.2
1.1.1.1. Long term	36.8	36.7	9.5	11.2	9.2	8.6	7.4	9.4
1.1.2. Budgetary sector	31.4	34.9	72.2	70.8	66.0	71.0	65.4	66.4
1.1.2.1. Central budget	17.8	17.7	44.5	42.5	34.3	36.7	29.7	29.1
o/w: Short term (securities)			0.7	0.2	0.3	5.3	6.2	10.0
o/w: Long term loans			43.8	42.3	34.0	31.5	23.5	19.0
1.1.2.2. Debt due to HUF depreciation*	13.6	17.1	27.7	28.3	31.6	34.3	35.7	37.4
1.2. Foreign assets	20.0	18.8	12.6	9.9	17.0	17.8	23.4	22.9
I. Total assets	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
II. Liabilities								
2. Domestic liabilities	34.0	31.5	23.5	33.9	40.9	43.1	40.5	38.6
2.1. Financial sector	13.8	11.0	9.6	16.1	20.8	20.7	18.7	19.9
2.1.1. HUF reserves	..	..	..	5.6	8.9	9.8	6.7	5.5
free	..	..	..	2.9	2.1	1.9	1.3	1.9
mandatory	..	..	..	2.8	6.8	7.9	5.4	4.5
2.1.2. FOREX reserves	..	..	..	10.5	11.9	10.9	12.0	14.4
2.2. Budgetary sector	3.3	3.1	1.8	5.3	9.2	9.8	10.3	8.0
2.2.1. Central Budget HUF	..	..	..	3.1	4.7	5.4	5.9	3.6
2.2.2. Government deposits in FOREX	..	..	..	2.2	4.4	4.5	4.4	4.5
2.3. Bank notes and cash (net)	17.0	17.4	12.0	12.5	10.9	12.6	11.4	10.6
3. Foreign liabilities	77.4	79.9	69.6	62.5	57.7	55.1	58.3	60.7
4. Net other liabilities	-11.6	-11.5	6.8	3.1	1.3	1.6	1.1	0.1
5. Retained profit	0.2	0.1	0.2	0.5	0.1	0.1	0.1	0.6
II. Total liabilities	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

* Non interest bearing assets stemming from the special accounting rules of losses on foreign exchanges. See in more details in part 2.

[31] Unfortunately the data for 1986 were not available to demonstrate the effect of introduction commercial banking on the NBH's balance sheet and also the reliability of data for 1988-89 is low.

1.2. Transition to market finance

Over the last two decades, by the end of the eighties Hungary had accumulated a large public debt and the debt to GDP ratio approached 60% of GDP at the end of 1989. It has to be emphasized that in case of Hungary several indicators of public indebtedness have to be taken into account because of the special system of finance prevailing in the previous regime. The NBH financed the public sector (at preferential interest rates) which was covered by monetary expansion and by borrowing abroad. Since 1990, due to privatization the state owned sector has been shrinking but the public debt accumulated in the previous regime belonged invariably to the central budget and to the NBH. In order to see clearly the different channels of public finance, the central budget debt, the debt of general government (derived by consolidating the different sub-systems) and the consolidated public debt (computed by consolidation the central budget and the central bank balance sheet) should be distinguished. (Tables VI.3-4)

In the transition period (after 1990) the public indebtedness has been further increased. As explained above, up to 1991 the NBH's long term credits at preferential rates were the main sources of financing the government. That is why Hungary's public debt to the non-government (outside the central bank) domestic sector was not yet significant. Due to the deeper than anticipated recession in 1990-92 which led to a budget revenue shortfall, the central budget deficit has gone up over 6 per cent of GDP by 1992. As a part of the financial reform, in 1991 a new financing and public debt policy was introduced in Hungary. While in the previous regime the budget deficits had been automatically financed by the central bank lending to the government, the new public debt policy has aimed at shifting to a system in which:

- deficit financing by the central bank is limited, direct finance will have been ceased as the market conditions will be created;
- budget deficits are financed by issuing marketable government securities;
- and economic agents hold voluntarily the public debt.

The crucial point of this policy has been to determine the fiscal stance for macroeconomic consistency and to determine a target for financeable budget deficit. As a consequence of the new deficit financing regime, the domestic public debt to non governmental sector started to increase rapidly due to deficit financing from capital market. In the new system debt management decisions concerning the size and terms of forint denominated issues have been taken by the Ministry of Finance in close co-operation with the NBH being the agent of the government and having advisory role in this field. There was no change, however, in the decision making and management of external public debt: the NBH has been responsible for and dealing with the external debt management, it is completely independent in decision making, however the most important strategic issues (e.g. the level of the forex reserves) needs to be approved by the government.

Table VI.3: Gross debt of general government (End of year stock, in billion HUF)

	1988	1989	1990	1991	1992	1993	1994*
NBH credit to central budget	386.8	426.9	442.6	492.3	489.4	472.7	434.9
State bonds	15.3	14.7	13.0	26.3	149.5	319.4	465.2
Treasury Bills	3.7	8.6	10.2	60.0	157.2	220.6	315.1
Total debt financing budget deficit	**405.8**	**450.2**	**465.8**	**578.6**	**796.1**	**1012.7**	**1215.2**
Per cent of GDP	28.3	26.3	22.3	23.2	27.1	28.6	28.1
Non deficit related credits	62.9	302.0	333.8	344.9	326.2	307.1	306.3
o/w: NBH	62.9	302.0	333.8	344.9	326.2	307.1	298.5
other							7.8
Recapitalization, of which:	9.0	9.0	28.1	30.0	159.8	442.6	552.9
Treasury Bonds to replace housing loans					83.2	79.4	75.8
Housing Fund finance			19.1	19.1	19.1	19.1	18.0
Bonds for NBH rouble claims					48.3	48.3	48.3
Bank Credit Consolidation						285.6	332.7
Other capitalisations**	9.0	9.0	9.0	10.9	9.2	10.2	19.0
Transformation of devaluation debt							59.1
Total domestic debt of central budget (net of non interest bearing item)	**477.7**	**761.2**	**827.7**	**953.5**	**1282.1**	**1762.4**	**2074.4**
Per cent of GDP	33.3	44.5	39.6	38.3	43.7	49.8	47.9
Fiscal liability due to HUF depreciation (non interest bearing debt)	249.5	460.7	519.2	777.9	888.9	1182.0	1440.1
Per cent of GDP	50.7	71.4	64.5	69.5	74.0	83.2	81.2
Credits to Extrabudgetary Funds and local governments			27.6	28.6	26.3	29.1	54.4
Social Security deficit bonds						16.0	16.5
Total domestic debt of general government (net of non interest bearing item)	**477.7**	**761.2**	**855.3**	**982.1**	**1308.4**	**1807.5**	**2145.3**
Per cent of GDP	33.3	44.5	40.9	39.4	44.6	51.1	49.5
Total domestic debt of general government (including the non interest bearing item)	**727.2**	**1221.9**	**1374.5**	**1760.0**	**2197.3**	**2989.5**	**3585.4**
Per cent of GDP	50.7	71.4	65.8	70.6	74.9	84.5	82.8
Total foreign debt of general government	0.0	0.0	37.4	118.8	133.9	202.7	236.5
Per cent of GDP			1.8	4.8	4.6	5.7	5.5
Gross debt of general government	**727.2**	**1221.9**	**1411.9**	**1878.8**	**2331.2**	**3192.2**	**3821.9**
Per cent of GDP	**50.7**	**71.4**	**67.6**	**75.4**	**79.4**	**90.2**	**88.3**

* Preliminary data

** Bonds for prime capital of financial institutions + Restructuring Bonds + EXPO bond issued in 1993.

Table VI.4: Consolidated* public debt (at year end, billion HUF)

	1988	1989	1990	1991	1992	1993	1994*
Gross consolidated public debt	978.2	1190.9	1260.2	1675.6	1919.5	2959.5	3600.7
per cent of GDP	68.2	69.6	60.3	67.2	65.4	83.7	83.2
of which							
- domestic	28.0	32.3	74.4	137.9	355.4	822.7	1046.3
per cent of GDP	2.0	1.9	3.6	5.5	12.1	23.3	24.2
- external	950.2	1158.6	1185.8	1537.7	1564.1	2136.8	2554.4
per cent of GDP	66.2	67.7	56.8	61.7	53.3	60.4	59.0
Monetary base (cash and reserves at NBH**)	303.4	359.0	459.6	639.5	827.8	1000.1	1178.7
per cent of GDP	21.1	21.0	22.0	25.7	28.2	28.3	27.2
Memorandum items							
Gross debt of general government	727.2	1221.9	1411.9	1878.8	2331.2	3192.2	3821.9
per cent of GDP	50.7	71.4	67.6	75.4	79.4	90.2	88.3
NBH's holding of government debt	699.2	1189.6	1300.1	1622.1	1841.9	2166.8	2560.6
per cent of GDP	48.7	69.5	62.2	65.1	62.8	61.2	59.1
Gross external debt at NBH	950.2	1158.6	1148.4	1418.9	1430.2	1934.1	2339.4
per cent of GDP	66.2	67.7	55.0	56.9	48.7	54.7	54.0

* Netting out NBH financing of government.
** Including all the reserves (required and free, forint and foreign exchange) that financial institutions hold in the form of deposits at the NBH.
Source: Ministry of Finance, Hungary

Taking into account that the budget deficit to GDP ratio has fallen in a dangerous range during 1991-93 and especially by 1994, the main problem of the monetary policy has been how to set and how to meet inflation rate target without further deterioration of foreign equilibrium. From this point of view one of the most important decisions of the monetary authority concerns the NBH's share in government debt, the amount of government securities to be held in its portfolio.

1.2.1. Central Bank lending to the government

The Act on Central Bank (enacted in 1991) codifies the autonomy for the National Bank of Hungary and declares that the main task of the central bank is the protection of Hungarian currency and only after this it has to support the government economic policy. It follows from this that the NBH is not obliged any more to accommodate budgetary needs, on the contrary, the NBH's absorption of government securities per year (that is the increase in the stock of „deficit financing" government securities in the portfolio of the NBH) is limited by the Act on Central Bank to 3 per cent of target budget revenues[32]. According to the statue, this 3 per cent target had to be reached gradually (5 and 4 per cent in 1993 and 1994, resp.). The NBH can decide freely up to the limit whether it accommodates budgetary needs or not. The NBH makes decision considering both longer term monetary policy targets (inflation rate and external equilibrium) and short run money and capital market situation. The limitation is quite strict, it has to be met on a daily basis, however, in 1993 a limited (2% of targeted budget revenues) overdraft facility was introduced as well in order to bridge the temporary liquidity problems.

- When setting these limits the following considerations were examined:

- Increased participation of the Central Bank in deficit financing (direct or indirect[33]) may reduce the increase in real interest rates. The Central Bank may also influence conditions of deficit financing in other 'indirect' ways: financing may be made cheaper by looser monetary policy which creates a relative abundance of funds in the economy. However, in a small and gradually liberalized economy a high budget deficit coupled with an accommodating monetary policy (monetization) involves the danger of accelerating inflation and/or may contribute to the further deterioration of foreign equilibrium.

- Until the inflation is higher and capital market is relatively underdeveloped the central bank limited participation in deficit financing can not be avoided. The size of fiscal and monetary adjustments should be reconciled. On the one side, the maximum of adjustment in the primary balance is constrained by social tensions, while on the other side a too strict or too loose monetary policy may be dangerous as well. Too loose monetary policy may threaten stabilization process, too strict monetary policy might result high real rates of interest threatening by too high borrowing requirement (and disequilibrium problems) in the following years. The co-ordination between the two independent bodies - the Ministry of Finance and the NBH - having their own field of responsibility should be based on market signals.

Since 1991 the NBH finances the budget by purchasing marketable government securities. The terms of securities sold to the central bank have been changed several times. First long-term (more than 10 year maturity) bonds at central bank's basic rate had to be issued for this purpose. Today NBH is allowed to buy securities without any special condition. It took a

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[32] The limit concerns the net increase in govenment 'deficit financing' liabilities to the NBH.

[33] Direct means purchased at the primary issues, indirect refers to secondary market transactions.

longer time while principles of market based financing system became clearer. By now the basic principle - that marketability of securities is essential - is more or less accepted but there are some problems in practice[34].

There are, however, some lessons that can be drawn from financing practice during the recent years. The regulation in vigour is too loose and too strict the same time.

- Too loose because NBH is allowed to act as residual buyer at the government securities primary issues. (The net lending of NBH, however, is constrained as given above.) This arrangement may be disputed arguing that it does not seem to be a good solution to let the central bank buy what market does not accept. But in Hungary the creation of capital market started in the early nineties and in a stabilization phase of the economic development when inflation rate has been still high, although decreasing. Thus, Hungarian capital market is still relatively underdeveloped. Both debtors and creditors are inexperienced. Very often securities bought by the NBH at auctions may be sold a few days later to market participants. On the other hand, this allowed the NBH to build up its stock of marketable instruments it needs not only for being able to manage the market of government securities but also for conducting a new type of monetary policy.

- At the same time the regulation is more rigorous than in the EU countries because the present rules constrain the activity of the central bank in the secondary markets by setting the limit on the increase in the so-called net deficit financing debt. It follows from this: (i) even in cases when it seems to be reasonable, the central bank are not permitted to enlarge finance to the government over the limit (ii) under changing circumstances it is difficult to set a limit in advance[35] (iii) there is a so-called non-deficit financing portfolio (consisting from consolidation and other special government bonds) that can be used to avoid the law.

Taking all this together, there is no doubt that the Act on Central Bank must be amended as soon as a primary dealer system can take over the market making from the NBH in the government securities market. Then the activity of the central bank in the primary market can be gradually reduced (until prohibited according to EU standards). Distinction between the deficit financing and non deficit financing portfolio will be invalidated.

Experiences of the first phase of transition concluded to the following.

- without a significant fiscal adjustment the problem of finance cannot be solved (a significant public sector primary surplus is included in 1996 budget);

[34] For instance the special bonds (such like consolidation bond of 20 year maturity or the bonds 10 and 30 year bonds issued for the transformation of non interest bearingt debt) can be sold with significant capital loss, so in order not to create further problem in the banking sector these bonds should be probably replaced by marketable ones sooner or later.

[35] During 1991 - 1994, in cases of unanticipated difficulties in financing the Act on Central Bank was amended by budgets. The amendments either changed the possibility of central bank financing to obligation or increased the limit over 3% of target revenues of the budget.

- and the limit for central bank financing has just been reconsidered. (Direct purchase of the government securities is constrained to the amount of the maturing stock held by the NBH and the size of finance provided to the budget will be freely decided by the NBH).

As the real costs of borrowing had been appearing in the budget due to the change in the system of financing, it turned out quite soon that borrowing requirement should be reduced in order to diminish the pressure to the capital markets. However, the budget perceived the market costs of borrowing with a lag for specific - debt management[36] - reasons which made the problem of financing temporarily hidden.

Table- VI.5: Interest payments of the central budget

(in per cent of GDP)

	1990	1991	1992	1993	1994
1. Deficit financing debt	1.7	2.2	3.0	3.0	3.9
1.1. Credits	1.5	1.9	1.8	1.3	1.1
1.2. Treasury bills	0.1	0.2	0.9	0.9	1.3
1.3. Treasury bonds	0.1	0.1	0.4	0.8	1.5
2. Other obligations	1.5	1.4	2.1	1.4	2.7
2.1. Credits	0.9	1.3	1.0	0.7	0.6
2.2. Treasury bonds	0.0	0.0	1.1	0.6	2.0
Total Interest payments of the central budget	2.7	3.6	5.2	4.4	6.6

Source: Ministry of Finance

This is why the basic budget reforms could be postponed until 1994 which had led to a difficult financing situation by the end of 1994. The primary surplus may counteract the increasing debt service obligations due to transition to the finance by marketable instruments and this can keep the PSBR within a sustainable range. Otherwise the high borrowing requirement of the public sector makes inevitable to increase real interest rates (yields on government papers) which has a direct feedback to the future PSBR (lag and size depending on the structure of the outstanding debt and the average maturity of finance). The adjustment in primary balance must be based, however, on a general budget revision. In 1996 a primary surplus of 4% in GDP is target.

1.2.2. Financing the central budget by marketable debt instruments

Financing the central budget had a central role in public debt increase in the previous regime and it has been still the decisive part element of indebtedness process. This was not, however, the only source of increase in domestic indebtedness.

[36] The shift to bond finance with annual interest payment which was done in the first quater of 1993, and the relatively low real interests on government securities.

In Hungary the issuing zero coupon 30 and 90 day treasury bills (discounted TBs) started in 1989. However, the TBs have a decisive role in deficit financing only since 1992 when the system of regular issues was developed. Marketable government bonds (i.e. securities of maturity longer than 1 year) issues for budget deficit financing started at the end of 1991. The first stock was at floating rate linked to the average yield of 90 day TBs. Inflation slow down in 1992 allowed lengthening the average maturity of public debt by regular issues of 180 and 360 day discount TBs and by issuing 2, 3, 4 and 5 year bonds with fixed coupon. These longer-term instruments were admitted to Budapest Stock Exchange.

The stock of government bonds has been increasing only since the last two months of 1992 for two reasons. On the one hand, the cost of debt determining future budget balances became reasonable only by the end of 1992, because deposit rates followed with a lag the inflation rate deceleration and before this started the so called Liquidity Treasury bills (on tap and redeemable any time) provided a cheaper finance for the budget. On the other hand, it turned out definitively that budget deficit could not be cut suddenly during the transition period, and under these conditions the most important task the debt management faced was to increase the security of finance by increasing maturity. Thus it was decided to shift towards a longer-run financing.

Table-VI.6: Increase in the debt of the central budget

	1991	1992	1993	1994*	1991-1994
1. Budget balance Hungarian presentation*	-114.2	-197.1	-199.7	-321.7	-832.7
in per cent of GDP	-4.6	-6.7	-5.6	-7.4	
2. Budget balance **	-117.5	-193.0	-195.2	-238.7	-744.4
in per cent of GDP	-4.7	-6.6	-5.5	-5.5	
3.1. Increase in total debt financing central budget deficit	112.7	217.7	216.6	202.4	749.4
3.1.1. NBH credit to central budget	49.7	-2.9	-16.7	-37.8	-7.7
3.1.2. Treasury bills	49.8	97.3	63.4	94.4	304.9
3.1.2.1. NBH	0.0	16.0	1.2	27.6	44.8
3.1.2.2. Market	49.8	81.3	62.2	66.8	260.1
3.1.3. State bonds	13.2	123.3	169.9	145.8	452.2
3.1.3.1. NBH	2.5	66.1	53.6	84.8	207.0
3.1.3.2. Market	10.7	57.2	116.3	61.0	245.2
3.2. Increase in other liabilities	13.0	111.0	263.7	109.6	497.3
3.2.1. NBH credit to SDI***	11.1	-18.7	-19.1	-0.8	-27.5
3.2.2. Recapitalization Bonds	1.9	129.7	282.8	110.4	542.8
3.2.2.1 NBH	0.0	48.3	12.8	69.7	130.8
3.2.2.2. Market	1.9	81.4	270.0	40.7	394.0
3.3. Liability from HUF depreciation	258.7	111.0	293.1	258.1	920.9
3. Increase in the total domestic debt of central government (3.1.+3.2.+3.3.)	384.4	439.7	773.4	570.1	2,167.6

* Official Hungarian budget includes borrowing items in revenues and debt repayments as expenditures, 1994 preliminary data.
** Hungarian budget corrected by debt repayments. Used when designing financing and issuing plans.
***SDI: State Development Institute and other credit.

Today there are the following instruments in the market.

Short term instrument:

- *Special treasury notes* (1 year maturity) for households:

  - Interest Bearing Treasury Note (no interest if redeemed before maturity)
  - Household Treasury Note (stepwise daily interest payment, lower interest than Interest Bearing Notes.
  - Treasury Saving Note (quarterly stepwise interest, available in post offices).

- *Discount treasury bills* (TB)of 1,3,6 and 12 month maturity.

Long term instruments:

- *Government deficit financing bonds* of 2-5 year maturity, at fixed and floating rate. There stocks of coupon linked to the inflation rate.

At present there are a large variety of bonds in the market which has not contributed to the liquidity of stocks. It would be better to simplify the issuing strategy in order to establish a benchmark outstanding stock structure and to increase the deepness of the secondary market. For the budget it would be preferable to increase the average maturity of outstanding stocks as well as to sell bonds at fixed coupon which would make interest costs predictable. At present selling the fixed rate stocks would need some interest sacrifice because of high inflation and devaluation expectations. Therefore it is not a cost effective strategy to increase too much the average maturity until the expectations deviate from the officially targeted indicators. (The recently introduced pre-announced crawling peg exchange rate system is to diminish expectations first of all.)

- *Government Bonds issued for recapitalization* .

  - Loan, bank and debtor consolidation bonds of 20 year maturity with coupon linked to the short term discount TBs' yields.
  - Bonds for the conversion of NBH's devaluation debt (10-30 year maturity, at floating rate).
  - Social Security's deficit financing Bonds (1-10 year maturity).

2. „Non deficit" related debt

Hidden losses of the socialist system became evident in the transition period. In the transition it takes a longer period until the tasks of government are re-specified[37]. When the property structure, the economic as well as the budget system are under permanent transformation, the budget deficit may be very different from the true fiscal deficit of the whole public sector. This was illustrated by our results (in previous chapters) concerning the consolidated public sector balances.

In order to promote the development of market conditions the government committed itself in different recapitalization operations.

- When the two-tier banking system was established in 1987, the State paid its *equity contribution* into the newly established commercial banks with newly issued (HUF 9 billion, 15 year maturity, fixed interest rate) government bonds. The so called *Restructuring bonds* were issued in 1987, the issue of which was managed by four commercial banks (HUF 2.7 billion, rolled over in 1993).

- The issue of the *Housing Fund bonds* in 1989 (HUF 294 billion) was related to the transformation of the subsidy system of the housing management. With these bonds the budget purchased from National Savings Bank (OTP) the household loans at preferential interest. In order to finance the deficit of the established Housing Fund a new type of security, the *Housing Fund Finance Bonds* were issued (HUF 19.1 billion) which were purchased by the Social Security Funds and the commercial banks. The Housing Fund was liquidated at the end of 1991, therefore, in order to ensure comparability, it is not included among the budgetary liabilities in 1990-1991) but the Housing Fund Finance Bonds remained together with the *Treasury bonds* (HUF 83.2 billion) issued to OTP and Savings Co-operatives in 1992 to cover losses when preferential housing loans were partly written down.

- In the *RBL settlement system* which prevailed in CMEA non-performing debt of Rbl 1.4 billion developed until 1991 in the balance sheet of the NBH. Taking into consideration that this was the inheritance of the former financial regulations (prompt incasso), in order to ensure settlement on a long-term basis, the central budget purchased this debt owed to the NBH by issuing government bonds of HUF 48.3 Billion face value (10, 15 and 20-year maturity, fixed interest rate).

  Consolidation program.

  Due to the restructuring process in the economy coupled with the implementation of bankruptcy procedure and the more rigorous qualification requirement of commercial bank's portfolio, the amount of the non-performing assets in the banking system was increasing during the first years of the nineties. The different consolidation programs were

[37] In the previous regime the budget assumed some responsibilities which should belong to (private or state owned) enterprises.

carried out to solve the bad debt problem. Government bonds issued under the consolidation programs amounted to HUF 350 billion which contributed about 10 percentage points to the increase of debt to GDP ratio.

Hungary's large external debt can be found in the balance sheet of the National Bank of Hungary. That is why there is a huge *non interest bearing debt (debt due to HUF depreciation) of the government at the NBH,* stemming from the regular below market rate NBH's government crediting during the past decades. The preferential interest rates on the government liabilities to the NBH (loans raised before 1991) did not cover excess interest and revaluation of principal due to the devaluation of Hungarian currency. Instead of accounting these revaluation losses in the profit and loss account of the NBH, the NBH provided a credit to the budget (the so called devaluation debt, without maturity and at zero interest rate). This debt reflects the accumulated exchange rate losses (stemming from official devaluations and cross exchange rate changes) on the net foreign exchange liabilities of the NBH. This part of budget debt has been growing rapidly and it will be increasing in the future as well depending on the exchange rate policy and on the macroeconomic development (until the inflation rate is lowered to the average rate of main trading partners).

The net foreign exchange liabilities of the NBH are expected to decline as the foreign indebtedness of the enterprises and commercial banks will be increasing. This process has already started due to the liberalization of capital movements and also because of the interest rate differences[38] currently prevailing which makes forint investment very attractive. When the foreign exchange debt of the NBH is repaid or when the international reserves of the NBH increases the accumulated losses on foreign exchange debt are realized. From monetary policy point of view this is a sterilization problem of excess liquidity stemming from the conversion of foreign exchange at the central bank[39]. In order to avoid inflation and/or deteriorating foreign position the non interest bearing debt of the budget at the NBH should be transformed into interest bearing, marketable government securities and selling these bonds the NBH can neutralize the effect of excess liquidity.

If the large external debt could be found in the balance sheet of the budget (that is the case when the central bank acts as an agent of the government in the international capital markets) that would be the budget who would sell some more government securities in order to get forint funds and to buy foreign exchange for external debt repayment. The final situation would be the same in both cases (ceteris paribus): the domestic debt of the budget would be increased while the share of external debt is reduced.

According to the present regulation each year 5 per cent of the outstanding debt due to HUF depreciation is converted to marketable bonds. This amounted to HUF 59.1 billion in 1994 and in 1995 a further HUF 72 billion bond will be issued. In the case when the transformation of the non interest bearing debt is slower than the decrease in the net forex liabilities of the

[38] Domestic interest rates are higher than foreign exchange interest rates + devaluation.

[39] Since the introduction of the pre-announced crawling peg system, the market exchange rate is equivalent to the bottom of band.

NBH, the profit and loss account of the NBH would show a (quasi-fiscal) deficit (it is partly related to the NBH's quasi-fiscal activity of foreign exchange debt management).

It has to be emphasized that the issue of non deficit related debt has the same effect in the longer run as if the primary deficit would have been larger in the given period because this type of debt generates significant part of debt service obligations in futures.

3. Structure and dynamics of public debt

Two main characteristics have to be emphasized.

The first one is that the difference between the central government and general government indebtedness is expected to increase if the present system - in which not only the local governments but Social Security Funds are operating as well in a self-governing form and there are a large number of Extrabudgetary Funds authorized to issue debt independently from the central budget - is maintained. In the CPE financial flows producing the public sector deficit appeared directly in the central budget, thus the out off the central budget indebtedness was negligible[40]. In the transition period the indebtedness of Extrabudgetary Funds, Social Security Funds and local governments has been increasing as well due to their growing independence in financing their excess expenditures. It is true that debt of other parts of the general government has been increasing, but it turned out as well that their creditworthiness is very low and they can not afford the debt service obligation. Interest on Social Security Bonds are paid by central budget. Debt of Extrabudgetary Funds is guaranteed by the government therefore commercial banks have been willing to organize syndicated loans for these funds[41]. Local government indebtedness had reached a dangerous level by 1994, so it was decided to set a limit on this borrowing possibility.

- The Budapest Innovation High Level Education Bonds (HUF 6 billion) were issued by the State Development Institute to finance the expenditure related to the 1996 World Expo which finally will not be organized thus these funds are to finance the central budget.
- In 1993-1994 the government approved a more than HUF 20 billion loan to the Road Fund. The objective of the extra funding was to develop the national road network.
- The Social Security Funds have been more and more independent since 1990 and this independence increased further as a result of the social security elections. In order to finance the 1992-1993 deficit of the Social Security Funds bonds will be issued in the value of HUF 40 billion, based on an authorization of Parliament. These bonds partly are transformed to government securities (financing the 1992 deficit), but the other part (financing the deficit of 1993 and later on) will not be considered as government securities

[40] How to take into account the loans of State Development Institute for investment in the CPE may be discussed, however.

[41] The system of Extrabudgetary Funds will be transformed in 1996. All funds but 5 will be included in the Chapters of the central budget.

in accordance with the effective legislation, but the budget shall pay their interest and guarantee their repayment.

- From the point of view of indebtedness it seems to be dangerous that the amount of the state guarantees (more than HUF 200 billion in 1990-1994) on the different development financing loans has been increased significantly. In order to prevent the further deterioration of commercial banks' portfolio it is necessary to reconsider the projects guaranteed by the government in the future.

Taking into account the inefficiency of the system of public finance it was decided to reconsider the interrelationships of different sub-systems of the general government when setting up a Treasury which is a project ahead of great importance. (Treasury system starts to operate in 1996.)

The other characteristics of transition is that budget deficits have not been the only source of expansion of public debt for 1990-94. Great importance attributed to the distinction between deficit and non deficit financing debt has shaded that both are related to the general fiscal situation of the economy and the public sector. Both deficit financing and non deficit related debt have the similar consequences. Hence according to the present Hungarian classification we use this distinction but it has to be emphasized that the actual fiscal deficit is incomplete if we neglect deficits not appearing in the official budget. Further problem results from the special arrangement concerning the foreign exchange debt. The debt of the central budget must be distinguished from the consolidated debt of general government and from the consolidated public debt including the government securities and loans outside the NBH as well as the forex debt in the portfolio of the National bank of Hungary and of the central budget.

While the central budget deficit financing gross debt to GDP has been only slightly increased during the recent years (from 22.3% in 1990 to 28.1% by the end of 1994) the central budget total (interest bearing) debt to GDP had amounted to 47.9% by 1994 from the 40% in 1990. The increase due to the recapitalization was more significant.

There are two factors reducing the growth of public debt.

- The so called Existence and other privatization type loans are refinanced by the NBH. At the same time the same amount of central budget debt at the NBH is converted into the debt of a non-governmental actor.

- The other channel includes that part of privatization revenues which is used directly to reduce borrowing requirement of the budget (HUF 150 billion in 1995 budget).

Long term credits of the central budget in the NBH according to their maturity structure are being gradually transformed to marketable government securities. The share of marketable stocks within deficit financing debt has increased from the 5% in 1990 to 64.2% by the end of 1994 which reflects the speed of making the budget more sensitive to market prices.

The second part of the central budget debt was created in relation to the activities of the State Development Institute (ÁFI), which operated separately until 1991 and the debt was built up from the loans taken to finance the investments of the State and state-owned companies. The debt of the ÁFI represented 10% of the gross debt of the budget at the end of 1992 when it reached the peak.

The third and increasing subgroup of central budget debt is related to the transition into the market economy and the past losses coming to the surface, as detailed above. The share of this 'excess-budgetary' debt had amounted to nearly one forth the total central budget obligations by the end of 1994. According to the recent decision the government will not commit itself in such type of consolidation programs in the future.

A special element of the debts owed by the central budget is the debt generated to the NBH due to the changes in the HUF exchange rates and cross exchange rates, which has no maturity or interest (see in part 2). The devaluation debt - as mentioned before - results from the fact that the high net external foreign exchange debt of the country originated from the loans taken by the NBH and bonds issued by the NBH. This debt represents more than 30% of GDP.

The direct foreign debt of the central budget amounted to nearly 8% of the total debt at the end of 1994 which mainly consisted of loans taken from the European Community and loans taken from the World Bank for the purpose of re-lending.

Taking into consideration the above components, the total domestic debt of the central budget amounted to HUF 2,074.4 billion (47.9 of GDP) at the end of 1994 net of the debt resulting from the depreciation of the Hungarian forint. Adding the debt due to HUF depreciation, the gross domestic debt of the central budget amounted to HUF 3,514.5 billion (81.2% of the GDP).

The "inherited" debts (the main elements of which include the NBH loans taken before 1992 and those items that are determined by the distorted financing system of the previous regime /recapitalization/) represented more than 80% of the total domestic debt of the budget at the end of 1992, when the consolidation programs started. In 1990-1994 the non interest bearing debt increased by nearly than HUF 1000 billion and the increase in the portfolio of bonds related to the transition into the market economy was also significant, totaled more than HUF 500 billion, which means that these tow items represented more than 50% of the increase in the gross domestic debt of the budget during this period.

Adding the gross debts of the Extrabudgetary Funds, the Social Security and the local governments[42] to the gross domestic debt of the budget, the total gross domestic debt of general government was HUF 3,821.9 billion at the end of 1994. (84% of GDP) This represents a rather high level of indebtedness in international comparison (89% considering the foreign debt as well).

However, for the assessment of the high rate of indebtedness it must be taken into consideration that at the end of 1992 - when the new public finance system was introduced officially - within the total budgetary debt the central bank loans and the government securities in the NBH portfolio represented almost 80% and the proportion of domestic debt to the economic sector slightly exceeded 14%.

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[42] Only debt with the Hungarian banking system is taken into account officially, according to our results the off central budget debt has been higher.

Table VI.7: Central Budget

(End of year stock, in billion HUF)

	Assets and liabilities					Balance of interest payments					
	1990	1991	1992	1993	1994*	1990	1991	1992	1993	1994*	
I. Total assets	**326.9**	**405.7**	**471.6**	**700.0**	**671.6**	**1.6**	**14.1**	**19.9**	**17.6**	**15.3**	**Total interest income**
1. NBH HUF	57.6	116.5	139.0	195.7	137.9	0.0	3.1	5.5	3.5	1.7	1. NBH HUF
2. Other HUF	204.6	153.6	135.5	279.1	269.2	-	2.7	3.0	1.4	2.0	2. Other HUF
3. NBH FOREX	39.7	109.4	116.2	145.2	171.8	1.6	8.3	11.4	12.4	11.3	3. NBH FOREX
4. External FOREX	25.0	26.2	80.9	80.0	92.7	0.0	0.0	0.0	0.3	0.3	4. External FOREX
II Total liabilities	**1384.3**	**1850.0**	**2304.9**	**3147.2**	**3751.0**	**81.1**	**97.6**	**166.4**	**170.0**	**173.9**	**Total interest expenditure**
1. NBH debt	780.9	844.1	953.0	984.8	1120.5	72.5	80.1	87.4	102.0	146.2	1. NBH debt
2. Marketable debt	46.8	109.2	329.1	777.7	946.1	-	8.3	64.8	53.3	12.4	2. Marketable debt
3. Other credit					7.8						3. Other credit
4. External FOREX	37.4	118.8	133.9	202.7	236.5	8.6	9.2	14.2	14.7	15.3	4. External FOREX
5. Debt due to HUF depreciation	519.2	777.9	888.9	1182.0	1440.1	0.0	0.0	0.0	0.0	0.0	5. Debt due to HUF depreciation
Net debt of Central Budget	**1057.4**	**1444.3**	**1833.3**	**2447.2**	**3079.4**	**79.5**	**83.5**	**146.5**	**152.4**	**158.6**	**Net interest expenditure**

* Preliminary data
Source: National Bank of Hungary

Table VI.8: National Bank of Hungary

(End of year stock, in billion HUF)

	Assets and liabilities					Profits and loss account					
	1990	1991	1992	1993	1994*	1990	1991	1992	1993	1994*	
I. Total assets	**1837.2**	**2458.9**	**2593.3**	**3315.1**	**3854.8**	**137.2**	**178.9**	**181.3**	**182.4**	**269.2**	**Interest Incomes**
1. Central Budget	780.9	844.1	953.0	984.8	1120.5	72.5	80.1	87.4	102.0	146.3	1. Central Budget
2. Debt due to HUF depretiation	519.2	777.9	888.9	1182.0	1440.1	0.0	0.0	0.0	0.0	0.0	2. Debt due to HUF depretiation
3. Financial Institutions	311.1	362.2	240.8	315.0	350.6	51.3	77.8	60.8	41.3	68.9	3. Financial Institutions
4. External FOREX	181.4	417.4	461.6	775.5	884.6	11.0	16.9	29.5	35.1	49.7	4. External FOREX
5. Domestic FOREX	44.6	57.3	49.0	57.8	59.0	2.4	4.1	3.6	4.0	4.3	5. Domestic FOREX
II Total liabilities	**1837.3**	**2458.9**	**2593.3**	**3315.1**	**3854.8**	**119.9**	**168.9**	**172.5**	**169.6**	**269.2**	**Interest expenditure**
1. Budget HUF	57.6	116.5	139.0	19.7	137.9	0.0	3.1	5.5	3.4	1.7	1. Budget HUF
2. Budget FOREX	39.7	109.4	116.2	145.2	171.8	1.6	8.3	11.4	12.4	11.3	2. Budget FOREX
3. Financial Institutions	52.6	52.5	50.0	42.6	38.2	4.7	8.4	4.4	3.9	11.7	3. Financial Institutions
4. External FOREX	1148.4	1418.9	1430.2	1934.1	2339.4	95.3	112.3	110.4	136.0	177.6	4. External FOREX
5. Domestic FOREX	192.2	293.7	282.3	399.0	555.9	12.2	21.6	21.6	19.7	24.5	5. Domestic FOREX
6. Mandatory reserves	50.8	166.3	204.1	179.5	174.8	0.0	23.1	18.9	4.9	10.5	6. Mandatory reserves
7. Bank notes and cash (net)	230.5	267.7	327.2	379.0	409.8	-9.1	-8.8	-7.7	-6.8	-6.1	7. Bank notes and cash cost
8. Net other liabilities	57.1	31.9	42.7	37.4	5.0	15.2	0.9	8.0	-3.9	-4.2	8. Other expenditure (net)
9. Retained profit	8.4	2.0	1.6	2.6	22.0	17.4	10.1	8.8	12.8	42.2	9 Profit before tax

* Preliminary data

Source: National Bank of Hungary

Table VI.9: Consolidated Public Debt**

	Assets and liabilities					Interest balance					
	1990	1991	1992	1993	1994*	1990	1991	1992	1993	1994*	
I. Total assets	**766.7**	**1016.7**	**967.8**	**1507.4**	**1656.1**	**64.7**	**178.9**	**96.9**	**82.4**	**125.2**	**Total interest income**
A. Budget	229.6	179.8	216.4	359.1	361.9	0.0	2.7	3.0	1.7	2.3	*A. Budget*
1. Other HUF	204.6	153.6	135.5	279.1	269.2	0.0	2.7	3.0	1.4	2.0	1. Other HUF
2. External FOREX	25.0	26.2	80.9	80.0	92.7	0.0	0.0	0.0	0.3	0.3	2. External FOREX
B. NBH	537.1	836.9	751.4	1148.3	1294.2	64.7	98.8	93.9	80.4	122.9	*B. NBH*
3. Financial Institutions	311.1	362.2	240.8	315.0	350.6	51.3	77.8	60.8	41.3	68.9	3. Financial Institutions
4. External FOREX	181.4	417.4	461.6	775.5	884.6	11.0	16.9	29.5	35.1	49.7	4. External FOREX
5. Domestic FOREX	44.6	57.3	49.0	57.8	59.0	2.4	4.1	3.6	4.0	4.3	5. Domestic FOREX
II Total liabilities	**1824.1**	**2435.0**	**2801.1**	**3954.6**	**4735.5**	**144.2**	**185.0**	**243.4**	**234.5**	**394.9**	**Total interest expenditure**
A. Budget	84.2	228.0	463.0	980.4	1190.4	8.6	17.5	79.0	68.0	138.7	*A. Budget*
1. Marketable debt + other credit	46.8	109.2	329.1	777.7	953.9	0.0	8.3	64.8	53.3	123.4	1. Marketable debt + other credit
2. External FOREX	37.4	118.8	133.9	202.7	236.5	8.6	9.2	14.2	14.7	15.3	2. External FOREX
B. NBH	1739.9	2207.0	2338.1	2974.2	3545.1	135.7	167.6	164.4	166.6	256.2	*B. NBH*
3. Financial Institutions	52.6	52.5	50.0	42.6	38.2	4.7	8.4	4.4	3.9	11.7	3. Financial Institutions
4. External FOREX	1148.4	1418.9	1430.2	1934.1	2339.4	95.3	112.3	110.4	136.0	177.6	4. External FOREX
5. Domestic FOREX	192.2	267.7	282.3	399.0	555.9	12.2	21.6	21.6	19.7	24.5	5. Domestic FOREX
6. Mandatory reserves	50.8	166.3	204.1	179.5	174.8	0.0	23.1	18.9	4.9	10.5	6. Mandatory reserves
7. Net cash	230.5	267.7	327.2	379.0	409.8	-9.1	-8.8	-7.7	-6.8	-6.1	7. Net cash
8. Other	65.4	33.9	44.3	40.0	27.0	32.6	11.0	16.8	8.9	38.0	8. Other
Net debt (II-I)**	**1057.4**	**1418.3**	**1833.3**	**2447.2**	**3079.4**	**79.5**	**83.5**	**146.5**	**152.5**	**269.7**	**Net interest expenditure**

* Preliminary data
** Computed for the central budget by netting out NBH financing. Excluding the debt of the local government and Social Security Funds.
Source: National Bank of Hungary

4. Consolidated public debt

In case of Hungary it has to be emphasized that the debt of the central government does not give a realistic picture about the sources from which the excess expenditure of the government was financed. The large amount of Hungarian convertible debt would not appear in this way. However, the gross public debt may not be defined by simply adding to the gross debt of the budget the foreign debt at NBH because the latter one is not independent of the central bank loans provided to finance the budget. The clarification of this issue may take place by defining the composition of the consolidated public debt, by adding the budget and central bank balances and netting out the inverse flows.

Therefore, on the basis of the above relationships, for the definition of the consolidated national debt two factors must be taken into account. On the one hand the debt of the budget to the central bank is netted out when the assets and liabilities of the budget and the central bank are consolidated, since the liability of the budget is an asset for the central bank. When consolidating the budget balance with the balance sheet of the NBH financing loans taken from the NBH are replaced by the foreign and domestic debt at NBH. On the other hand, it must also be taken into consideration that part of the national debt resulting from the consolidation which is very different from other part of the general government debt concerning its costs: that is the central bank's monetary base reflecting the size of monetization.[43]

Interest payments of the budget on the central bank loans are considered as settlement items in the consolidation process: the budget pays the interest on external debt through the NBH and the central bank pays its profit (over the retained part for the operating costs) into the budget. The amount of these interests is important from the point of view of the central bank's refinancing policy.

Table-VI.10: Net interest incomes of the National Bank of Hungary

	1990	1991	1992	1993	1994*
1. Government (net)	72.5	77.0	81.9	97.9	144.6
Foreign FOREX	-84.2	-95.4	-80.9	-100.9	-127.9
Domestic FOREX	-11.3	-25.8	-29.4	-28.1	-31.5
2. Total FOREX (net)	-95.5	-121.2	-110.3	-129.0	-159.4
3. Government+FOREX(1+2)	-23.0	-44.2	-28.4	-31.1	-14.8
4. Financial institutions (net)	46.6	46.3	37.5	32.5	46.7
5. Net interest incomes	23.6	2.1	9.1	1.4	31.8

* Preliminary data

[43] All the details can be found in Tables-VI.7-9.

During the next few years - ceteris paribus - from the point of the interest income of the NBH, the structure of budgetary debts will probably both worsen and improve. The reason for the worsening is the increase of the weight of non interest bearing debt. However, non interest bearing debt should be converted into marketable bonds according to the decrease in net foreign liabilities of the NBH. The improvement will be the result of the increased share marketable debt (bearing market interest) within the budget portfolio . That is a result of new system in central bank financing of the budget deficit and also is due to that the repayment of old loans takes place through the purchase of government bonds. *It can be said that the budget has been paying an increasing part of costs on external public debt during the first phase of the transition.*

5. Government debt management

The public debt management has been burdened by two major characteristics of the Hungarian transition. The first one is that a *relatively high risk premium* has to be included into the coupons and yields on medium term instruments stemming from the difficulties of maintaining and improving the credibility of the government's economic programs. The recent 'swings' in development have seriously destroyed *investors' confidence and public's expectations deviated significantly from the official forecasts*. This hindered the development of the very weak secondary market.

The second characteristic having a decisive impact on debt management was the difference between CPI and PPI[44] development as well as *the large spread between lending and borrowing rates* (10-6 percentage points in the period investigated) which contributed to the market segmentation making more difficult to develop a deep secondary market. While the institutional investor sector is not yet strong enough to collect longer term small savings the government is 'competing' with commercial banks on the deposit side and competing with private sector on the asset side. The higher the yields are on government securities the higher is the risk of crowding out the private sector which would be unfavourable from the point of view of the growth path.

If there is de facto market segmentation, *the government might entertain the idea of exploring it through price discrimination*. Taking into account the above mentioned price structure there is no doubt that one possibility to diminish government cost of borrowing is *to increase the direct selling of the government securities to retail investors*. Actually it has been done partly by targeting the household sector through savings bond types instruments, and by some private placements. Increasing part of 1994 financing (about 15%) was provided by the investments to these special instruments. Of course private placements are doubtful methods because of the requirement of transparency and both private placements and special household instruments might contribute to the perpetuation of segmentation without enhancing the scope of the secondary markets.

[44] The difference between price indices has disappeared in 1995.

Before 1994 two major techniques had been used for issuing government securities: auctions and syndication method. The government bonds covering the recapitalization obligations and other off-budget operations were issued by private placement.

Majority of government securities - discount TBs and large part of government bonds - have been issued *on auctions*. The auctions have a multiple price character, bids are always based on price and bidder pays the price they bid for. According to the characteristics of different types of debt instruments different regulations existed for 30/90 day and 180/360 discount TBs and auction rules of bonds issues have been changed several times. Direct participation at the auctions was different for 30/90 day TBs' auctions from other securities' auctions, where the direct participation have been limited to commercial banks, security houses and investment funds. That is why the primary market of government bonds had a wholesale character, while retail investors could by these securities in the secondary market trading which started just after the auctions through the NBH's network.

Due to the financing difficulties the issuing technique of government bonds has been changed again in 1995 and today government *bonds are issued again through syndications* with a two weak subscription period. This can be considered quite a doubtful change because it does not enhance the transparency which would be necessary to develop a deeper secondary market.

The debt to GDP ratio has been increased by more than 20 percentage points during 1990-1994 and to prevent it from further increase has become the main priority of the present economic policy.

The transition period can be divided into sub-periods from the point of view of public financing. While in the early nineties the budget deficit increased mainly due to the shortfall of revenues since 1993 the structure of PSBR has been restructured and these *are the growing interest charges* (see in previous section) *that requires an urgent adjustment in the primary balance of the budget*. In 1994 following the first quarter of relatively abundant liquidity (stemming from some privatization revenue) the government demand for funds could be met only by further increasing the yields of government securities. Today yields on short term papers are above 30 per cent (compounded yield are above 35%). The high short term yields are dangerous in the present situation when the bonds at floating rate have a significant share (60%) in the outstanding stock.

Adjustments in different fields are as follows.

- The most important is *to restore the credibility* of government programs and to convince investors by creation a favourable climate.

- Due to the high level of public debt and its composition (the increasing share of short term TBs and floating rate bonds) and also because of the increase in the yields, at present the PSBR depends mostly on the interest expenditures. To cope with the problem of the interrelationship between interest rates and budget borrowing requirement (to avoid the 'snowball' effect) the government has decided to achieve a sufficiently huge primary surplus by implementing a package of measures in May 1995.

- It is essential *to improve the availability of government securities* for the investors. *The auction terms and issuing calendar of discount TBs were changed* at the end of June, 1994. Latest changes concern the followings: the same auction rules were introduced for all types of discount TBs; the method of payment, the custodian system have been developed and the more perfect fit of maturity allows of easy reinvestment. All discount TBs but 1 month maturity are admitted to the Budapest Stock Exchange. At the same time efforts are concentrated on enlarging the network where government papers are sold and to improve the publicity.

The range of investors has been expanded by making available the 1 and 3 month TBs for individual investors as well. Direct bidding is, however, restricted to security firms and commercial banks. This may be one of the points the regulation of Hungarian financial institutions and security markets has to be reconsidered.

- *Development of the secondary market* is an other essential task for debt management. In 1990 the regulation of the financial institutions was set according to a specialized banking system. Large number of security firms were established because the funding capital requirement was set low. Many of banks as well have their own brokerage firm in order to be able to do security businesses. The undercapitalized, not adequately supervised security firms are not able to provide a stable support for the budget in government security distribution (at primary and secondary market). Some of them failed and this highlighted that the present regulation should be changed soon.

In order to cover the primary issues and to increase the liquidity in the secondary market it is planned to establish a *primary dealer system*. However, an average undercapitalized brokerage firm cannot take the risk of two way pricing. Therefore the regulation has to be amended by allowing commercial banks to deal in government securities. Market making involves considerable risk any time, especially under circumstances when interest rates are very volatile. That is why a major precondition for the establishment of a primary dealer system supporting the stable and cheaper financing is to reduce volatility of interest rate movements which should be based on improving external and internal equilibrium position of the country.

At present there are a large variety of stocks in the market, because issuer tried to survey market preferences by offering products of different terms, 2-5 years and floating and fixed rate as well. This has not contributed to the liquidity of stocks. It would be desirable to simplify the issuing strategy in order *to establish a benchmark* outstanding stock structure.