Spotlight

Hungary
Progress in Structural Reform

Andrew Burns and Giancarlo Perasso

Recent policy initiatives in Hungary have gone a long way to establishing the necessary conditions for rapid growth and future economic prosperity.[1] A massive programme of privatisation has transferred an unprecedented share of economic activity from the state to the private sector, with the revenues being used to reduce the government's external debt. Substantial foreign investment has helped firms based in Hungary to penetrate western export markets, and the success of these firms has in turn served to attract more foreign investment. After years of being burdened by bad loans, the banking sector has been cleaned up. Increasingly, the economy responds to market rather than bureaucratic signals and competitive pressures are ensuring that efficiency gains are passed on to consumers in the form of lower prices and wider choice.

The accelerated privatisation programme was initiated as part of the stabilisation package put into effect in March 1995 and resulted in the sell-off of about $4 billion (almost 9% of GDP) in state assets in 1995 alone (Table). Two-thirds of GDP is now estimated to originate in the private sector. The privatisation process itself was conducted by the Privatisation and State Holding Company (APV), which was created in May 1995 by merging the agency in charge of privatisation and the one charged with managing state assets in an effort to improve the speed, credibility and transparency of privatisation. Although at times marred by controversy, the APV has gone ahead with its programme rapidly and relatively free of charges of arbitrariness. Unlike other countries in the region, Hungary did not pursue mass-privatisation schemes but rather sold assets to strategic investors, without discriminating between domestic and foreign investors. As a result it now benefits from a clearly defined ownership structure. Foreign participation has resulted in access to western markets for Hungarian-based firms. Domestic partners and the economy in general are benefiting from substantial transfers of technological and marketing expertise.

Andrew Burns and Giancarlo Perasso are economists in the Country Studies Branch of the OECD Economics Department.
E-mail: eco.contact@oecd.org

Privatisation was not restricted to manufacturing firms. The national telecom company was completely privatised, as were gas distribution companies and most banks. The extent of private ownership of utilities is now among the highest in the OECD. Minority stakes in the electrical distribution sector were also sold, and further privatisation is planned. The government nevertheless retains important minority stakes in a wide range of companies as well as golden shares or permanent positions in a number of 'strategic companies' – the strategic purpose of which is not always clear.

Now that the bulk of privatisation is completed, the role of the APV will have to change. Its role as a manager of state assets should be wound up and transformed into a 'treasury' function. But its record as a 'holding' company is mixed. It has frequently shown a laudable willingness to allow small, uneconomic firms in its portfolio be liquidated, but it has tended to treat larger enterprises on a case-by-case basis in an apparent effort to avoid large-scale redundancies. No matter how the government decides to manage its remaining assets, business decisions should be made as free as possible of political considerations.

The most important long-term objective of any privatisation programme is to increase the efficiency of the economy. The competitive market and clear corporate-governance structure that are emerging from the Hungarian privatisation will help to ensure that market forces lower costs, which are then passed on to consumers as lower prices. The role of the state in this new private economy is to protect against anti-competitive behaviour and to regulate natural monopolies. Although an efficient regulatory framework is in place, it has not always been implemented consistently. In the case of telephone tariffs, for example, firms were allowed to increase prices by the full amount of inflation even though the legislation allowed for smaller increases because of efficiency provisions. In contrast, in the energy sector, the government reduced to 18% the original rate increase of 32% by excluding from the calculation a wide range of eligible costs that had been allowed by the regulatory authority. A coherent and consistently applied regulatory framework in these and other sectors is necessary to the long-term development of the economy.

The Financial Sector

As the privatisation process draws to a close, the direct role of the state in the economy will diminish and the importance of market agents, like private debtors and creditors, stockholders and banks will increase. Recent efforts to strengthen the health of the banking sector were therefore a critical component of the programme of structural reforms. In the past, inefficient firms were protected from bankruptcy by soft loans from state-controlled banks (under the old regime, banks allocated funds according to central directives and played no active role). When a two-tier banking system was established in

1. ***OECD Economic Surveys: Hungary***, *OECD Publications, Paris, 1997.*

Table
Privatisation Revenues
million dollars

	1993	1994	1995	1996	Total
Cash:					
Foreign currency	1,203	105	3,274	597	5,179
Forints	250	337	282	260	1,128
Privatisation loans in forints	236	279	32	15	562
Privatisation loans in forex	0	160	0	0	160
Compensation coupons	159	611	240	262	1,272
Total	**1,847**	**1,491**	**3,827**	**1,135**	**8,301**

Source: Privatisation and State Holding Company, Budapest

1987, banks could not afford to write-off loans and were unwilling to deny additional credits to uneconomic firms for fear of forcing them into bankruptcy and possibly facing bankruptcy themselves. Firms were thereby able to avoid necessary restructuring and both their and the banks' underlying positions steadily worsened. These non-performing loans were so much a part of the economy that, despite several attempts to re-capitalise and sanitise the banks' accounts, in 1993 an independent audit determined that three of the five largest banks were technically insolvent.

In 1993, the government recapitalised the banking system by enlarging its equity position in some banks, and by providing subordinated loans to smaller ones. In 1994, the authorities implemented a final programme for coping with banks' bad debts, the so-called 'debt-reconciliation' (or 'debt consolidation') programme. The cleaning-up was impressive. Banks identified and separated bad loans from good, either selling the bad loans at a discount, reaching an agreement with other creditors, or simply writing them off. The programme had more or less been successfully completed by June 1995. Between 1994 and mid-1996, they had disposed of bad debts equivalent to 11% of their total assets, and by the end of 1996, about 90% of bank loans were classified as 'problem free' and all Hungarian banks had capital-asset ratios in excess of 8%.

This clean-up paved the way for privatisation, and about two-thirds of the share capital of the banking system is now privately held. Foreign investors are the majority shareholders in some of the largest banks in the country and they hold almost half of the capital. The Hungarian banking system is now probably the healthiest and the most completely privatised in the region.

In spite of this very substantial improvement, a number of concerns remain. Real bank lending has declined noticeably in the past two years (although there are some recent signs of a pick-up), collateral requirements are very high (as much as three times the value of the loan the enterprise applies for) and the interest-rate spread (the difference between the rates banks charge on loans and pay on deposits) remains disturbingly wide, implying a lack of competition. To some extent, prudence in lending stems from banks' recent experience with bad loans and macro-economic uncertainty – especially about inflation. It may also reflect inexperience on the part of the bank staff in evaluating loan applications and unfamiliarity on the part of management with newly established enterprises. The excessive collateral requirements stem from an underdeveloped mortgage-market and poor maintenance of the property registry – transactions often take as much as three months before being registered and, as a result, multiple sales of the same property are not unknown. To some extent, these problems are likely to be temporary in nature.

Competition within the banking sector is intensifying. Consequently, the interest rate spread is narrowing and banks, which have hitherto restricted loans to 'blue chip' enterprises (mostly firms with foreign participation) and concentrated their funds in less risky investments such as government bonds, are increasingly looking to expanding their lending activities. As their experience with the new environment grows and their staffs acquire the skills necessary to evaluate risk efficiently, credit should become increasingly available to other firms. Lending to individuals will probably remain constrained by problems with the property registry and legal restrictions on banks exercising their collateral rights. Recent legislation on mortgages, which could increase individuals' access to seed capital, may allow this sector to expand as well.

Structural change has been both aided by and reflected in the expansion of foreign trade and foreign direct investment (FDI) over the past several years. Even under Communism, Hungary was a relatively open economy but it opened up even further after transition started. Trade with other OECD countries has doubled since 1990 and now accounts for over 70% of both exports and imports. FDI, in the form both of privatisation and of 'greenfield' investment, made a substantial contribution to this process.

Apart from the temporary surcharge on imports that was abolished as of 1 July 1997, tariff rates have been falling and Hungarian firms are more and more exposed to international competition. There are nonetheless a number of non-tariff barriers still in place, the most important being the 'global quota' on selected consumer goods and restrictions on imports of new and used cars. Although the number of goods covered by the quota has been reduced in recent years, the selectivity of the products still covered suggests that it is being used as an instrument of industrial policy. The government will eventually be obliged to remove import quotas as part of Hungary's accession to the European Union, although more rapid action would be welcome.

The progress made in structural reform over the past two years has placed Hungary in a position where the country should be able to exploit the benefits of a competitive, enterprise-based economy. Provided the remaining 'grey areas' in structural reform (including tax evasion and the underground economy) are tackled effectively, and labour-market reforms (such as the reform of payroll taxes, employment-protection legislation, and labour-supply reduction programmes) are undertaken to prevent unemployment from becoming structural, the economy can look forward to a relatively rapid convergence towards western European standards of development. ■

OECD Bibliography

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