

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

STRATEGY FOR HUNGARY

As approved by the Board of Directors on 2 September 2003

TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
1. THE BANK'S PORTFOLIO	6
1.1 OVERVIEW OF ACTIVITIES TO DATE.....	6
1.2 IMPLEMENTATION OF PREVIOUS STRATEGY	7
1.3 TRANSITION IMPACT OF THE BANK'S PORTFOLIO AND LESSONS LEARNED.....	8
1.3.1 The Enterprise Sector	8
1.3.2 The Financial Sector.....	9
1.3.3 Infrastructure and Environment.....	9
1.4 PORTFOLIO RATIO	10
1.5 MOBILISATION OF CO-FINANCING.....	10
1.6 LESSONS LEARNED.....	10
2. OPERATIONAL ENVIRONMENT.....	11
2.1 GENERAL REFORM ENVIRONMENT	11
2.1.1 Political developments.....	11
2.1.2 EU accession.....	11
2.1.3 Relations with neighbours.....	11
2.1.4 Fighting corruption	12
2.1.5 Labour issues	13
2.1.6 Legal Environment	14
2.1.7 Social issues	15
2.1.8 Environment	16
2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE	17
2.2.1 Macroeconomic conditions for Bank operations	17
2.2.2 Transition success and challenges	19
2.3 ACCESS TO CAPITAL	24
3. STRATEGIC ORIENTATIONS.....	25
3.1 BANK'S PRIORITIES FOR THE STRATEGY PERIOD.....	25
3.2 SECTORAL CHALLENGES AND BANK OBJECTIVES.....	26
3.2.1 The Enterprise Sector	26
3.2.2 The Financial Sector.....	27
3.2.3 Infrastructure and Environment.....	28
3.2.4 Policy Dialogue.....	29
4. CO-OPERATION WITH OTHER IFIs.....	29
4.1 IMF.....	29
4.2 WORLD BANK GROUP	30
4.3 EIB.....	30
4.4 EUROPEAN COMMISSION	30
4.5 OECD.....	31
ANNEX 1A – EBRD OPERATIONS TO DATE.....	32
ANNEX 1B – TC PROJECTS	35
ANNEX 2 – POLITICAL ANNEX.....	38
ANNEX 3 - LEGAL TRANSITION.....	40
ANNEX 4 – SELECTED ECONOMIC INDICATORS	48

EXECUTIVE SUMMARY

Hungary continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. Hungary has made considerable progress in transition with 80% of economic activity in private hands, advanced price liberalisation, an open foreign trade and investment regime and significant advances in the opening of key markets such as telecoms or energy. However, gaps remain in the reform process as well as in the implementation of reforms. The functioning of domestic markets is not yet at the level of well running market economies. Further advances in transition will be needed to strengthen the economy and its institutions.

The investment climate remains attractive. However, recent unfavourable macroeconomic developments such as a large fiscal expansion, a deteriorating external position and wage growth exceeding productivity gains negatively affected Hungarian competitiveness. These developments will limit the room for manoeuvre in the coming years, while Hungary tackles the challenges of EU and EMU accession. Hungary has demonstrated in the past few years the ability to attract significant inflows of green-field FDI, banking on its stable investment climate and highly skilled labour force. Yet, net FDI inflows significantly dropped in 2002 as a result of global slowdown, increased uncertainty linked to the elections and loss of competitiveness in particular in labour intensive sectors. The challenge now will be to reverse the drop in FDI experienced in 2002, within the tight framework of EU competition rules. A number of key challenges must be addressed to build on past successes and further enhance the competitiveness of the country:

- The fiscal situation should prompt reform: while a portion of the 2002 deficit was attributable to one-off items, the underlying budget position, excluding extraordinary items, is unhealthy. Structural reform is required in public administration, health and education to improve efficiency after large public wage increases in 2002. In addition, pension reform must be continued to address unfunded liabilities in the public system, while railway reform must be accelerated to improve competitiveness and reduce the drain on public finances.
- The business climate needs to improve in order to attract larger FDI inflows, which have slowed down considerably, especially the less volatile higher value added projects. In particular, unit labour costs growth must be controlled, with particular attention to nominal wage growth and payroll taxes, to support external competitiveness. Availability of qualified labour must be improved through training and greater mobility, and transparency in awarding state contracts must be increased. Also the welcome recent improvements in the legal and regulatory framework to fight corruption will need to be effectively implemented.
- Privatisation of the remaining state-owned companies such as PostaBank, FHB Bank, MVM, Antenna Hungaria, Malév, Mahart and Dunaferri must be completed as well as the sale of the remaining minority stakes in privatised companies. In addition, regulatory reform in the energy sector must be furthered to allow further privatisation and full liberalisation of the gas and electricity markets in due course.
- The local corporate sector, and particularly SMEs, deserves more attention. The productivity gap between locally and foreign owned companies is significant and

local companies are often at a serious size disadvantage. In addition, many locally owned companies are ill prepared for EU accession and will face considerable investment needs with uncertain financing available. Improvement of the environment in which they operate is also required, in particular through a revision of the tax structure and incentives applied to different enterprises size groups (the current system is heavily tilted in favour of large foreign-owned enterprises).

- Finally, the government, as well as the regional and municipal bodies, will need to consider ways to mobilise private co-financing for infrastructure projects and improve administrative capacity in order to both maximise the use of EU funds and alleviate budget pressures.

As of 31 December 2002, the Bank had made cumulative commitments of €1,326 million to 60 projects and the Bank had helped mobilise a further €4.04 billion from sponsors and co-financiers. The Bank can continue to bring an important contribution to transition over the strategy period by focusing selectively on projects addressing the above challenges and for which it remains additional.

In order to meet the challenge and help ensure that Hungary remains at the leading edge of the transition process, the Bank's activities will be based on the following operational objectives:

- **Financial Sector**

The Bank will primarily seek to work with the local financial sector and new sponsors when required to develop the range of financial products offered to the economy. Particular attention will be brought to equity, mezzanine funding, SME finance, and mortgage finance. The Bank will also support the development of non-banking financial institutions such as leasing companies, mortgage finance institutions, pension funds and asset management companies. Finally, the Bank will seek to support sector consolidation and provide long term capital to support a greater lending activity by the sector.

- **Enterprise Sector**

The Bank will support the privatisation of the last few remaining fully or partially state-owned assets, which often present several challenges. The Bank will also actively support the restructuring, consolidation and regional expansion of the local private sector to improve competitiveness in the Single Market and compliance with EU regulations. In particular, the Bank will focus on the provision of equity, mezzanine and other structured products (including small equity) in order to increase the capital base of the Hungarian economy. The Bank will support foreign direct investment, focusing on (i) projects in underdeveloped regions; (ii) projects developed by medium size foreign investors, who have limited experience in the country; and (iii) projects requiring extensive due diligence and structuring, or involving risks with which the local banking sector would be unfamiliar. Finally, the Bank will continue its efforts to increase financing options available to SMEs.

- **Infrastructure and Environment**

The Bank will promote the introduction of adequately structured schemes that do not rely on a sovereign guarantee, effectively allocate risks among participants and increase the supply of long-term capital to the sector. It will mobilise its existing experience in Hungary and abroad to further the scope for financing projects through public-private partnerships, mainly in the municipal, environment and transport sectors but also potentially in new sectors such as housing, where private sector involvement can improve the Government's capacity to meet its obligations. The Bank will seek to support projects in smaller municipalities through the Municipal Finance Facility. The Bank will bring particular attention to projects promoting the development of less advanced regions as well as cross border regional integration. The Bank will seek to support energy market liberalisation and competition as well as the emergence of regional players in the energy industry. The Bank will be actively seek to add value in the preparation, co-financing and implementation of projects and programmes intended to maximise the use of EU Cohesion and Structural Funds by the national and local authorities. In addition, the Bank will work closely with the national authorities as well as the EIB to identify and address gaps in sovereign-funded projects. Finally, the Bank will support the much-needed railways restructuring and modernisation and will seek to channel finance to small municipalities through local financial institutions with the support of the European Commission.

The Bank will continue to ensure that all EBRD operations in Hungary are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans.

1. THE BANK'S PORTFOLIO

1.1 Overview of activities to date

The Bank has been an active participant in Hungary's transition to a market economy, financing mainly private sector projects across a broad spectrum of economic sectors. At the end of 2002, the Bank's net cumulative Board approved investments in Hungary amounted to € 1,212 million¹. Cumulative signed investments² amounted to € 1,326 million, representing 6.13 per cent of the Bank's net cumulative commitment volume. Hungary is the Bank's fourth largest exposure both in terms of cumulative signed operations and current portfolio commitments. Hungary's private portfolio ratio is 82%, among the highest in the Bank.

Table 1: Net Cumulative Business Volume by Industry

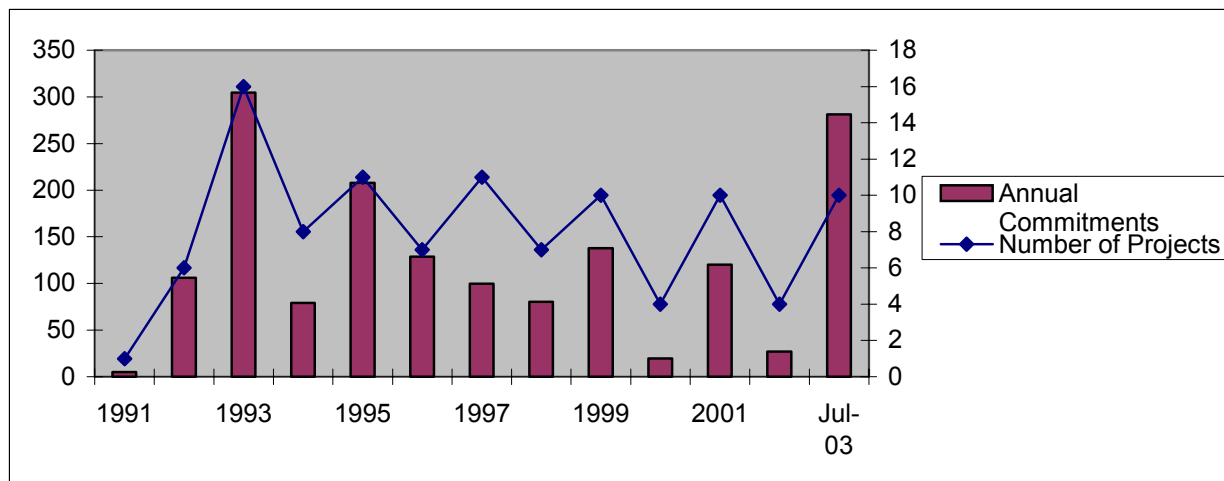
Hungary - including Regional projects							
At 31 December 2002							
Business Group	Sector Team	No. of Projects	Total Cost	EBRD Debt	EBRD Equity	EBRD Finance	Share
			€ Million	€ Million	€ Million	€ Million	%
Energy	Natural Resources	1	81	24		24	2
	Energy Efficiency	2	61	14	12	27	2
<i>Sub-total Energy</i>		3	142	38	12	50	4
Financial Institutions	Bank Equity	6	172	0	114	114	9
	Bank Lending	8	244	199	0	199	15
	Equity Funds	5	419	0	80	80	6
	Non Bank FI	2	86	12	20	32	2
<i>Sub-total FI</i>		21	921	211	214	425	32
Specialised Industries	Agribusiness	2	98	18	8	25	2
	Prop Tour and Ship	5	226	13	34	47	4
	Telecoms Inform & Media	8	2,228	186	60	246	19
<i>Sub-total SI</i>		15	2,552	216	102	318	24
General Industry	General Industry	13	375	65	75	139	11
<i>Sub-total G I.</i>		13	375	65	75	139	11
Infrastructure	Municipal & Env Inf	2	179	77	1	78	6
	Transport	7	1,200	311	4	315	24
<i>Sub-total Infrastructure</i>		9	1,379	388	5	393	30
Country Total		60	5,368	919	407	1,326	100

¹ Annex 1a provides detailed information on all Board Approved EBRD investments in Hungary.

² Net cumulative business volume includes regional projects.

Chart 1 illustrates the activity of the EBRD in Hungary in terms of number of projects and EBRD financed amounts in Hungary since 1991. As can be observed, the time series does not follow a linear trend over time on either dimension.

Chart 1 Hungary - EBRD Operations (including regional)



At end May 2003 the Bank's portfolio stock was € 628.4 million and operating assets were € 466.6 million. Portfolio split is as follows: infrastructure-40%, financial sector-33%, specialised and general industries-24%, and energy-3%.

1.2 Implementation of previous strategy

The last country strategy, approved in September 2001, outlined the following strategic priorities for the Bank in Hungary:

- The development of the local private corporate sector through provision of equity and venture capital;
- The promotion of economic diversification and development of the weakest regions mostly through SME support; and
- Support to Hungary's attractiveness to foreign investors particularly through investments in infrastructure.

During the period covered by the previous country strategy, the Bank signed 14 projects in Hungary representing total commitments of approximately €150 million. Activity however was higher in 2001 as elections in 2002 delayed decision-making in both private (as illustrated by a dramatic decline in net FDI inflows) and public sectors. A number of postponed projects have been or should be signed in 2003. Total 2003 signings are expected to reach or exceed €300 million.

During 2002, operations were affected by 2 elections in the spring and the autumn respectively and an unexpected change of parliamentary majority, which delayed decision-making. All new operations were the private sector, with a large proportion of equity transactions.

The Bank continued to support the provision of equity and quasi-equity with investments in a property fund and in the first provider of Mezzanine debt in the region. The Bank was also able to provide support to the agribusiness sector ahead of EU accession through a €9 million investment in a major dairy. The Bank also increased its commitment to the pension and life insurance industry through two follow-on projects with Winterthur. Finally, the Bank capitalised on a successful environmental revolver credit line by extending both the disbursement period and the final maturity to allow the participating bank to recycle the funds for a further 3 years and support more sub-projects.

1.3 Transition impact of the Bank's portfolio and lessons learned

The Bank has played a major role in promoting and supporting Hungary's transition to a free market economy. This role has evolved in response to the country's changing needs during the transition process and can be summarised as significant to very significant, according to the findings of the Bank's Transition Impact Retrospective (TIR)³.

HUNGARY - Transition Impact Retrospective	
FINANCIAL INSTITUTIONS	
Banking	Very Significant
Non-Banking Financial Institutions	Significant
SME's	Significant
SPECIALISED and GENERAL INDUSTRIES	
General Industry	Very Significant
Telecommunications	Very Significant
Property & Tourism	Significant
Agribusiness	Moderate
INFRASTRUCTURE	
Transport	Significant
Municipal & Environmental Infrastructure	Moderate
ENERGY	
Energy Efficiency	Very Significant
Natural Resources	Moderate
Power	Minimal

1.3.1 The Enterprise Sector

- The Bank has helped to attract initial FDI inflows to Hungary by providing long term limited recourse finance to several large and visible projects sponsored by foreign investors in the early 1990's (GM, PCA, TVK-CC), when such finance was unavailable. Owing to availability of finance from other sources (additionality principle), the Bank has somewhat reduced its involvement in this market in the past few years and limited itself to projects in more difficult sectors (Ozd steel mini mill). It is possible that higher risk opportunities will arise with EU accession as Hungary increasingly becomes an investment target for smaller sponsors from existing EU

³ The purpose of the TIR is to identify the pattern of the Bank's successes and under-achievements in promoting transition using a consistent assessment across all sectors and countries. The TIR looked at the Bank's impact on transition from five different angles: impact on capital flows, project level impact, sector level impact; impact on legal systems; and impact on the environment.

countries or sponsors from countries currently not investing, which seek to benefit from the Bank's experience and may prove difficult for commercial banks to service.

- The Bank has played an active role in opening the international debt and equity markets for many Hungarian corporates, including MOL, Matáv, BorsodChem and Rába. Many of these clients have been able to capitalise on their debut transaction with the Bank and return to the market on their own. The Bank however may keep a role with some of these clients and finance selected projects with appropriate transition impact as they sometimes experience lending limit issues with local banks.
- The Bank has also been active in supporting privatisation and restructuring of Hungarian companies sponsored by both local management and foreign partners. In particular, the Bank has actively made equity commitments to Hungarian corporates with an overall positive experience.
- Through its investments in the telecommunications sector, the Bank has fostered the restructuring and privatisation of the national operator (Matáv, first telecom privatisation in the region) and the progressive emergence of a credible challenger (Vivendi Telecom Hungary) to the incumbent. Together, these investments contributed to creating what is today one of the most decentralised and competitive telecommunications and media industries in the region.

1.3.2 The Financial Sector

- The Bank has been present in the Hungarian banking sector from the beginning of reforms in 1994, supporting privatisation and the involvement of strategic foreign investors. The Bank contributed directly to one of the great sector transition achievements, the re-capitalisation of the banking system in a market setting (with privatised companies, well regulated and in competition with each other). The Bank's engagement in the sector started with a convertible bond issue for Foreign Trade Bank (MKB). Following this, investments were made in four major Hungarian banks. The Bank has focused in its operations on mitigating regulatory risk in order to improve the investment climate for private investors, and – through its extensive presence on banks' boards - on corporate governance. The Bank has pioneered a number of innovative financial instruments in Hungary, such as long term local currency bonds, guarantees and exchangeable bonds.
- The Bank was also successful in reaching the SME segment, first through sectoral credit lines (ARP Projects) and more recently through dedicated credit and leasing lines and equity funds (under the EBRD-EC SME Facility), for which momentum is growing.
- The Bank has pioneered a number of innovative financial instruments in Hungary, such as long term local currency bonds, guarantees, and exchangeable bonds.
- The Bank has played a key role in the reform of Hungary's secured transactions law and the establishment of a centralised registration system. After inadequacies of the take over code and minority shareholder protections were highlighted by a high profile case in 2000-2001, the Bank supported a revision of the Securities Act, as well as an increase in the regulator's effectiveness through TC, leading to a better regulated stock market.

1.3.3 Infrastructure and Environment

- The Bank played a key role in upgrading Hungary's transport infrastructure. In particular, the Bank enabled one of the largest motorway construction programmes in

the region to proceed (M0, M1/M15 and M5), and it pioneered the use (and showed the limits) of commercial finance in the sector. The refinancing of the M5 project moreover could help give impetus to the current Government's PPP drive. Slow reform and restructuring of the railway sector has hampered the Bank's efforts with only two transactions.

- In the Municipal and Environmental sector, the Bank has had some successes in promoting privatisation and outsourcing of waste-water management. Efforts however have been hampered by demographics (only five Hungarian cities have population in excess of 150,000) and the concentration of EU and central budget grants on the larger projects, thus reducing co-financing needs to small amounts. The Small and Medium Municipalities Facility will give the Bank a tool to access a constituency unreachable until now.

1.4 Portfolio ratio

The portfolio is 82% private, a top 5 rating in the Bank's portfolio. The potential for further sovereign operations is limited. There is however some potential for sub-sovereign public projects (with sponsors such as municipalities and regions), which would increase public sector portfolio volumes.

1.5 Mobilisation of co-financing

In addition to its own investments, the Bank helped to mobilise a further € 4.0 billion of co-investment over the 1991-2002 period, representing a multiplier of 4.0x⁴. The total value of projects in which the Bank participated is € 5,368 million.

The Bank remains able to help generate large co-financings, particularly for infrastructure projects or in the framework of large syndicated transactions in credit challenged sectors such as telecoms, etc. The Bank's risk mitigation role was key in mobilising co-financing for M1/M15 and M5 where the Bank remains additional and the current Government's interest in the PPP concept may open new opportunities for the Bank.

1.6 Lessons learned

The Bank's experience in Hungary has provided some general lessons to be taken into consideration for future operations:

- Transition is not a linear process; despite Hungary's significant advances, opportunities remain for the Bank, including in sectors or with clients for which it had previously lost additionality but can experience changed conditions (commercial bank appetite, credit limits, etc).
- To maintain a transition momentum, the Bank must increasingly consider more innovative, labour intensive and ultimately riskier projects with smaller local or foreign corporate or sub-sovereign sponsors requiring flexible structured products.
- The Bank can still contribute added value in preparing, structuring and implementing public projects. Further opportunities could arise in co-operation with EU Funds and EIB in the future.

⁴ Calculated as total project costs/net cumulative business volume (EBRD commitments).

- Capital markets remain underdeveloped, whether for debt or equity finance, despite the advanced transition stage. While this is a prime focus for the Bank, its ability to make decisive changes is limited and the task will require continued long term efforts.

2. OPERATIONAL ENVIRONMENT

2.1 General reform environment

2.1.1 Political developments

Hungary is a stable parliamentary democracy fully conforming to the criteria of Article 1 of the Agreement Establishing the Bank. It has a President and a unicameral parliament elected every four years. The Constitution provides for an independent judiciary, which the government respects in practice. Both civil and human rights are guaranteed effectively. Prime Minister Peter Medgyessy heads a coalition government formed after the elections in April 2002 and led by the Hungarian Socialist Party (MSZP), with the Free Democrats (SZDSZ) as the junior partner. Together with the Czech Republic and Poland, Hungary became a member of NATO in 1999 and, in December 2002, was invited to join the European Union on 1 May 2004.

2.1.2 EU accession

Hungary is set to become a member of the European Union in May 2004. Hungary was the first transition country to formally apply for EU membership in March 1994. As decided at the Luxembourg European Council in December 1997, negotiations with Hungary were launched on 30 March 1998. Since then, Hungary's progress towards accession has been monitored by the Commission's regular reports published every autumn. The latest Regular Report published on 9 October 2002, concluded that Hungary would fulfil the economic and *acquis* criteria and be ready for membership from the beginning of 2004. The European Council in Brussels on 24 and 25 October 2002 endorsed the recommendations of the Commission. The European Council in Copenhagen on 13 December 2002 concluded the negotiations. On 12 April 2003 the accession referendum resulted in a very strong support to accession (84%), despite a very low voter turnout (48%). The EU Accession Treaty was signed on 16 April 2003 in Athens.

2.1.3 Relations with neighbours

Hungary has close neighbourly relations with Austria, Croatia and Slovenia. Its relations with Serbia/Montenegro (former FRY), strained for over a decade, have improved since the democratic changes that followed the overthrow of the regime of Slobodan Milosevic in October 2000. The treatment of the Hungarian minority in the northern province of Vojvodina, where it is concentrated, has improved. However, Romania and Slovakia, both with sizeable Hungarian minorities, have strongly criticised the so-called Status Law, adopted by a large majority in the Hungarian parliament in June 2001. The Law offers ethnic Hungarians living in neighbouring countries the opportunity to apply for a Hungarian identity card entitling them to education, healthcare, travel and cultural discounts, and short-term work opportunities in Hungary. Financial support from Budapest is offered to parents educating their children in Hungarian-language schools in neighbouring countries.

2.1.4 Fighting corruption

On 21 February 2003, Prime Minister Peter Medgyessy accepted the resignation of Elemer Kiss, Minister in charge of the Prime Minister's Office, and a powerful political figure. It had come to public notice that the law firm in which Kiss is a partner had received several state commissions in 2002 worth around 30 million Forint (Euro 121,000). There was no suggestion of law-breaking or impropriety.

On 7 April 2003 the Hungarian Parliament passed unanimously, with support from the opposition parties, the so-called "glass pockets" programme. One essential element of the programme, which is aimed at making the use of public funds more transparent, is the expansion of the role of the State Auditing Office, which is now authorised to follow the path of public funds – even in private companies, which have concluded contracts with state or local government bodies. The new law stipulates that private sector contractors will no longer be allowed to keep secret which state contracts they have been entrusted with, and how they use public funds. The law states that all government contracts involving large sums of money must be made public by state and local authorities.

Members of the opposition Fidesz party, which was in power from 1998 till 2002, have spoken of a 'tip of the iceberg' and demanded a thorough examination of all contracts given by the PM's office since last year. Since the Medgyessy government, took office last year, several investigations into allegations of large-scale corruption during the previous Fidesz-led government of Viktor Orban have been initiated by the police and the public prosecutor's office. Those investigations are in progress.

Corruption continues to be a problem in Hungary, according to the European Commission's 2002 Regular Report on Hungary's Progress towards Accession published in October 2002. The 2002 Report lists some new measures taken in line with the long-term anti-corruption strategy adopted in 2001 (its implementation is the responsibility of the Ministry of the Interior and the Ministry of Justice):

- Declarations of assets have become compulsory for senior civil servants since October 2001. In December 2001 this obligation was extended to the President of the Republic, judges, ombudsmen, chairman, vice-chairmen and controllers of the State Audit Office, chairman, vice-chairmen and employees of the National Bank, public notaries, mayors, members of local government and other persons managing public assets. Reports on asset declarations by MPs are regularly published in the Hungarian Official Gazette.
- The revised Law on Public Procurement, adopted in November 2001, tightened up the monitoring of contract award procedures.
- Within the amended Penal Code, which came into force in April 2002, more severe punishments and sentences for bribery were introduced.
- Practical measures revising the salary structure in the customs services were introduced (salary increases and bonuses).

Hungary is a party to the Council of Europe Convention on Money Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and various other conventions. It has signed bilateral agreements of relevance for the fight against corruption with 45 countries, with 17 more under preparation. Hungary is a member of GRECO, the Council of Europe Group against Corruption. However, the 2002 Report notes, overall public

perception of efforts to fight corruption has not really improved and many areas in the public sphere continue to have a bad reputation in this respect.

In 2002 Hungary was ranked in the 33rd place among 102 countries (behind Slovenia and Estonia from the transition countries group), scoring 4.9 in the Corruption Perceptions Index prepared by Transparency International. In 2001 it was ranked in the 31st place. The Index relates to perceptions of the degree of corruption as seen by business people and risk analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).

Hungarian law prohibits trafficking in persons. However, according to US State Department Country Report on Human Rights practices in Hungary, published in March 2003, trafficking in women and children for the purposes of prostitution and in men for forced labour remained a problem. The country is primarily a transit point but also a source and destination country for trafficked persons. Women and children were trafficked for sexual exploitation primarily from Romania, Ukraine, Moldova, Poland, Serbia and Montenegro (former Yugoslavia) and China to and through the country to Austria, Germany, Spain, the Netherlands, Italy, France, Switzerland and the United States. Trafficking victims from Hungary typically were women from the eastern part of the country, where unemployment is high. Men trafficked for forced labour through the country en route to EU countries and the United States usually come from Iraq, Pakistan, Bangladesh and Afghanistan

2.1.5 Labour issues

The Labour Code recognises the right of trade unions to organise and permits trade union pluralism. There are six trade union federations; each is targeted broadly at different sectors of the economy. The largest trade union is the National Confederation of Hungarian Trade Unions, the successor to the former monolithic Communist union, with approximately 235,000 members. According to the Hungarian Tax Authority, in 2001 654,000 taxpayers declared a deduction for payment of trade union fees. The National Labour Affairs Council (OMT) provides a forum for tripartite consultations involving management, employees and government. In 1998 the work of the former Ministry of Labour was split between the Ministry of the Economy, which is responsible for policy issues, and the Ministry of Social and Family Affairs, which is responsible for employment issues and for drafting labour-related legislation. Law XI, 2002, reunited the competence for these two sets of policies by creating the Ministry for Employment and Labour. Strikes occur only sporadically and often arise out of domestic political issues rather out of labour conflicts.

The labour force includes many skilled workers and employees with a tertiary education. Many people still have more than one job, as was the case under socialism. Unemployment is endemic in eastern regions. Wages are significantly lower than in Western Europe but higher than the average in Central Europe. Despite the growth in productivity recorded in recent years, Hungarian productivity is still far behind EU levels. According to a study published by the Central Statistical Office, per capita GDP in Hungary was 50.7% of the EU average in 2000 and is not thought to have risen above 55% in 2002. The causes of the difference are as follows: 20% is due to the lower employment level and 80% to lower labour productivity. In this respect, Hungary is fifth

among EU accession states – behind Cyprus, Malta, Slovenia and the Czech Republic. However, it leads the group in terms of labour unit costs.

On 31 March 2003, parliament amended the Labour Code. The primary aim of the Code, due to come into effect on 1 July 2003, is to incorporate the provisions of five EU guidelines into the domestic labour acts. The principal amendments are:

- A ban on ‘disadvantageous’ discrimination’ both in full-time employment with defined duration and in part-time employment;
- Work-from home regulations are to be the responsibility of the National Council for Interest Coordination;
- With regard to legal succession, if a commission of employees’ representatives are terminated, the continuation of employee representation must be guaranteed until new representational bodies are established;
- Selection of employment contracts must not be directed at restricting the legitimate interests of employees;
- In line with the ILO Convention 183, it will be forbidden to carry out tests intended to establish whether or not potential employees are pregnant, and/or oblige employees or job applicants to present certificates establishing that they are not pregnant;
- If work performance is 100% and full work time is completed, the compulsory minimum wage must be guaranteed to employees.

2.1.6 Legal Environment

Over the past decade Hungary has introduced notable reforms to its legal environment. The legal system has strongly evolved towards an internationally acceptable level and Hungary is one of the most advanced of the Bank’s countries of operation in terms of legal transition. The country, however, needs to continue to strengthen the institutions upon which the smooth functioning of a market-oriented economy depends.

Hungarian commercial laws are more advanced than many of its Central European neighbours and within the region. Legal reforms have been fruitful in bringing the country’s commercial laws towards internationally accepted standards and towards the EU accession level. As transition to a market economy progressed, however, inadequacies in the development of legal institutions may have arisen. Constant revision of legal rules and development of institutions will be key to the further promotion of investment into the country.

An analysis of key commercial laws that directly contribute to creating a favourable investment climate in Hungary, such as secured transactions and bankruptcy laws, shows that good laws at times suffer from being poorly implemented. Annual surveys, conducted by OGC since 1995, of the perceptions of lawyers who advise on or are otherwise familiar with the law of Hungary confirm this assessment, i.e., that commercial laws suffer as a result of not always being sufficiently accessible or through inadequate administrative and judicial support. This implementation gap undermines the utility of the specific laws in issue. Hungary needs to address this by improving its legal institutions. Hungary’s efforts to join the EU will assist in improving the standard of both its commercial laws its legal institutions.

2.1.7 Social issues

The Central Statistical Office's annual report lists Hungary's population in 2002 at 10.175 million, a decline of 534,000 since 1981. The population has been falling since 1982, when the death rate began to exceed the birth rate. The country's ageing population places an increasing strain on the traditionally generous system of pensions and early retirement. After 1994 the Socialist government significantly reduced maternity and family benefits as part of its economic austerity programme. The 1998-2002 Fidesz administration sought to increase support for families via tax breaks as part of its declared aim to reverse the population decline.

Hungary has a well-developed institutional framework protecting the interests of minorities and promoting their cultural and educational autonomy. There are 13 recognised minorities in Hungary, accounting for 2% of the total population according to the 1990 census. Unofficial estimates suggest that the minority populations' share may be higher. For instance, the 1990 census showed 142,700 Roma, but unofficial estimates speak of a much higher number (the European Roma Rights Centre claims there are more than half a million Roma in Hungary, or 5.7% of the total population). The Roma community is the most seriously affected by social inequalities: around 70% of Roma of working age are at present unemployed. Only 33% of Roma children start secondary education (compared to 90% of non-Roma children) and the percentage of Roma with higher education is small (around 1% of the total). The position of the Roma population – not just in Hungary but in the broader region – was the subject of an international conference in Budapest in May 2003, attended among others by several Prime Ministers from the region. The October 2002 regular report by the European Commission on Hungary's progress towards EU accession noted that 'on the whole, the Hungarian Government has continued to make efforts to address the situation of the Roma minority'. On 1 April 2003, the government announced that it had earmarked over 1 billion Forint for grants designed to help Roma students pursue academic studies. The funds should cover the cost of continued studies for 18,200 Roma students. Housing conditions are also very poor for the large proportion of Roma. Recent health surveys suggest that life expectancy for the Roma is 15 years below the Hungarian average, which was 76 years for women and 67 years for men in 2000.

Life expectancy for all inhabitants in Hungary remains lowest for all OECD countries. On 7 April 2003, parliament adopted a programme called the 'decade of health' aimed at ensuring that over the next decade life expectancy at birth of Hungarians rises by at least three years. However, infant mortality has decreased dramatically (from 23.2 per thousand live births in 1980 to 9.2 per thousand in 2000). The secondary school gross enrolment ratio has gone up from 70% of the 15-18 population in 1980 to 98% in 1998. The gross enrolment ratio for tertiary education has also gone up from 14% of the 19-24 population in 1980 to 34% in 1998. Hungary's share of the population living below the poverty line of \$2 per person per day (in terms of purchasing power parity) was 7.3% in 1998, placing Hungary behind the Czech Republic, Estonia, Poland, the Slovak Republic and Slovenia. Public spending on healthcare has declined in the 1990s and amounted to 6.1% of GDP in 1999.

2.1.8 Environment

Targeting entry in the EU in May 2004, Hungary has been steadily achieving environmental quality improvements as well as environmental harmonisation with EU Environmental Directives. The main objective of Hungary's second National Environmental Programme for the period of 2003– 2008 is to preserve natural assets and improve the environmental quality as well as strike a balance between economic development and environmental protection. The Hungarian public has a high environmental awareness and enjoys better access to environmental information and decision making process in the region.

In many parameters (e.g. green house gas emissions, solid waste recycling) Hungary's environmental indicators are equal to those of EU member countries. The structural environmental indicators in the summary report adopted at the Barcelona meeting of the Council of Europe indicate that the country's environment, in general, is close to the EU average. Important structural changes in environmental quality include significantly declined industrial pollution induced by the closure of outdated and non-competitive industries in the first half of the 1990s. Furthermore, since then increasing manufacturing production has not been accompanied by an increase in pollution.

Nevertheless, there are challenges for full harmonisation with EU Directives as well as further environmental quality improvements as follows: improvement of land fills as well as hazardous waste treatment facilities; exploitation of renewable energy; water quality improvement to meet fully with EU drinking standards as well as to protect public health; strengthening of waste water treatment capacities; and flood controls. Hungary's investment needs to comply with EU Directives are significant in the environmental area, in particular waste water treatment, at an estimated €4 billion over the next 15 years. In order to address the challenges, the share of the environmental investment of the country financed from the central budget already accounts for 1% of GDP. As a ratified member of the Kyoto Protocol, Hungary has solid scope of Joint Implementation (JI) opportunities and some European countries and Japan are actively seeking JI projects in the country.

The Bank's environmental approach for Hungary reflects the country's advanced stage of economic development as well as support for Hungary's investment needs to comply with EU Directives in the Bank's specific project context. The Bank has approved MOL-Duna wastewater treatment plant outsourcing project in which MOL, a Hungarian oil and gas company, will outsource the operation and upgrading of the wastewater and management facilities at its Duna refinery. An international environmental company will undertake the task. The operation will enable MOL to meet EU environmental standards by the end of 2005. In the financial sector, since 1995 the Bank has provided environmental due diligence training for eight financial intermediaries operating in Hungary. The training ensures that the Bank's financial intermediaries (FI) are capable of implementing environmental due diligence procedures, which are incorporated into the FI's credit/investment appraisal process.

Among other organisations, the EU ISPA and PHARE (until December 2003) funds will continue to play an important role in supporting urgent environmental investments in Hungary. The World Bank is envisaging utilising funding of Global Environmental Facilities (GEF) for Hungary and Black Sea countries as part of the program under the

Danube and Black Sea Basin Strategic Partnership in their efforts to adopt policy, legal and institutional reforms and co-finance nutrient reduction investments. In the case of Hungary, it would also help the country adapt EU environmental norms and comply with its international commitments under the Danube Convention. The Bank will continue to co-operate with other organisations to create synergy for effective environmental investment.

2.2 Progress in Transition and the Economy's Response

Since the last strategy, the Hungarian economy has withstood the global slowdown, with reasonable growth rates of 3.7 per cent in 2001 and 3.3 per cent in 2002. Due to the high degree of openness of the economy, growth is vulnerable to developments in the EU, which accounts for under three quarters of Hungary's exports. However, two factors offset the negative impact of the European slow-down on Hungarian exports: public sector investment, boosted by pre EU-accession requirements, and consumer demand, stimulated by expansionary fiscal policies, including large increases in public sector wages and salaries. Despite the loss in competitiveness due to exchange rate appreciation and unit labour cost increases, Hungary remains an attractive environment for foreign investors due to past achievements in structural reform and its highly skilled labour force. This constitutes a sound basis for sustaining growth in the future.

2.2.1 Macroeconomic conditions for Bank operations

Since the last Strategy was presented to the Board in 2001, ***the economy has maintained a reasonable growth rate despite the deterioration in the external environment.*** Growth slowed to about 3.3 per cent in 2002 from 3.7 per cent in 2001 and 2.7 per cent in the first quarter of 2003 on a year-on-year basis. Stimulated by fast rising real incomes and by the EU accession investment requirements, since Q1 2001 growth has increasingly been driven by private consumption and public investment. Public sector investment remained robust, driven by large public investment programmes in infrastructure, while private investment fell. Net exports turned sharply negative as export growth slowed while import growth accelerated. As regards its sectoral composition, output growth in 2002 was mainly driven by construction (stimulated by a generous government supported mortgage loan subsidy) and by services (mainly wholesale/retail and financial services), whereas industry stalled and agriculture contracted.

In October 2001 the crawling peg was abolished and the Forint/Euro rate was allowed to fluctuate within a band around a fixed central parity. The width of the band remained the same as it had been since May 2001 under the crawling peg: +/- 15 per cent. Because of strong capital inflows, the Forint subsequently appreciated in real terms against the Euro by about 8 per cent both in 2001 and in 2002. A strong Forint helped inflation to come down to 3.6 per cent per annum in May 2003. However the fiscal expansion and pressure from rising personal disposable incomes may work against further reductions. The general government budget deficit reached 9.3 per cent of GDP in 2002, driven in part by one-off expenditures (around 3 per cent of GDP) and generous public wage adjustments. Government targets to cut the deficit to 4.5 per cent in 2003 and to 2 per cent of GDP by 2006 seem ambitious. In the medium term the reduction of current non-interest expenditures remains an important political challenge, if a significant increase in the overall tax burden is to be avoided.

During January 2003, large speculative capital inflows driven by an anticipated revaluation of the central parity of the Forint prompted interest rate cuts by 200bps and heavy central bank intervention on the foreign exchange market (€ 3.8 billion⁵) in mid January 2003. These interventions were successful in stabilising the Forint below the 15 percent intervention band and resulted in much lower non-resident purchases of local currency bonds (from HUF 73 billion in January to a monthly average of HUF 23 billion since February), thus easing the appreciation pressures on the currency that characterised 2002 and early 2001. Following the central bank's declaration at the end of May that it had stopped buying back the Forints it had injected in the system in January, the Forint showed increasing volatility. On 4 June, the Ministry of Finance announced a 2.3% devaluation of the central parity to 282.36 per Euro, maintaining the +/-15% band. The market reaction was very strong and the Forint moved from 255 per Euro to 265 per Euro in a matter of minutes after the announcement. Increasing competitiveness and job creation were quoted by the Ministry of Finance as the main reasons for the change.

Simultaneously the Ministry of Finance announced public spending cuts worth HUF 75 billion, including reductions in mortgage subsidies and other current expenditures. The package is a clear indication that the government intends to take steps to correct the loss of fiscal control and the deterioration in competitiveness that occurred during 2002. However, lack of co-ordination between the government and the central bank led the latter to raise interest rates by a cumulative 300bps⁶ a few days later in June, in order to achieve a stronger exchange rate that would facilitate the achievement of the inflation target. In somewhat exaggerated form, this Hungarian experience is an example of the conflicting challenges faced by advanced countries in the run-up to EU and EMU accession. Lack of coordination between the monetary and fiscal authorities exacerbates the difficulty of meeting these challenges. A devaluation followed within a week by an interest rate hike, amounted to an unpredictable and inconsistent policy, which weakens the central bank's credibility and increases the volatility of the exchange rate. Under circumstances like those of June 2003, an increase in interest rates meant to attract investors into Hungarian bonds, and thus to strengthen the exchange rate and support low inflation, may well backfire. It can scare off potential portfolio investors and may even drive them to unwind their positions, leading to an unintended weakening of the currency.

The government is planning to adopt the Euro in 2008. Assuming a the two-year minimum participation in ERMII before Euro adoption, the earliest possible date for full EMU membership is 2007. Should the Hungarian authorities opt for a more gradual pursuit of the Maastricht criteria for EMU membership (including the requirement that the general government financial deficit not exceed three percent of GDP), a later entry date (say, 2009-2010) may eventually be agreed.

Because of buoyant domestic demand and the weakening of Hungary's traditional export markets, the current account deficit widened to 4 per cent of GDP in 2002. This development reversed the downward path of the current account deficit of the past three years. At the same time, net FDI inflows fell to 23 per cent of the current account deficit,

⁵ With its intervention on the foreign exchange market the central bank made profits estimated at HUF 43 billion.

⁶ 100 bps on June 10 (effective on June 11) and 200bps on June 19 (effective on the same day).

from over 200 per cent in 2001. In the first six months of 2003, there was a significant net outflow of FDI reflecting strong investment activity of Hungarian companies abroad.

Sustained growth combined with real appreciation is forecast for the next few years. However, rapid income growth could lead to a further widening of the current account deficit. Also, a recovery in Western Europe is likely to stimulate private investment in Hungary, especially by foreign-owned corporates, which represent a large share of the Hungarian corporate sector. This would further widen the current account deficit. A current account deficit of 4 percent of GDP, or even somewhat larger, need not be a source of concern in a well-managed advanced transition country achieving real convergence with its west-European neighbours. However, a large current account deficit, when coupled with a very large fiscal deficit, is likely to become a constraint on the growth of demand. The necessary fiscal tightening planned by the Hungarian authorities may in the short-term depress economic activity, despite continuing buoyancy of private consumption, driven by continued large real wage increases and the lagged effects of the personal income tax cuts introduced in 2003. Better control of domestic price and cost inflation and the lower interest rates made possible by a more restrictive fiscal change will, however, stimulate both export demand and domestic investment. An early and determined fiscal retrenchment will enhance the medium- and longer-term prospects for growth and real convergence.

2.2.2 Transition success and challenges

Hungary has an excellent track record in structural reforms. In many respects, such as privatisation and respect for property rights, Hungary has set standards of excellence for other countries in transition. Its bold attitude to transition during the early and mid-1990s and its openness to foreign investment have created an environment that remains conducive to private investment. These reforms, coupled with careful macro-economic management, laid the basis for a decade of strong growth and robust export performance and helped attract significant FDI inflows.

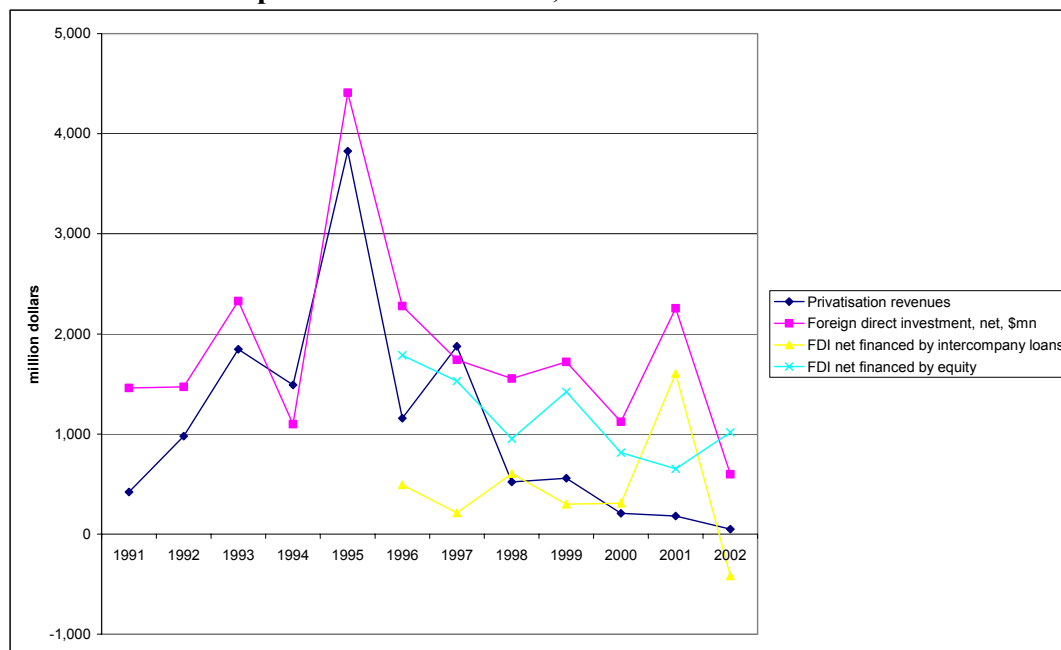
Hungary remains one of the most attractive environments for foreign investors among the transition countries, despite the current exceptions in sectors such as energy and pharmaceuticals. However, the global slowdown (global FDI contracted in 2002, although total net FDI in the EBRD's countries of operations increased), the practice of the previous government to limit procurement of large infrastructure contracts to local enterprises, the loss of competitiveness and uncertainty about the outcome of the parliamentary elections, net FDI inflows dropped in 2002 to less than 1 per cent of GDP, from 4.4 per cent in 2001. A net shift in the financing of FDI also took place in 2002, with a shift towards equity acquisitions and away from intercompany loans (see chart 2.1). Since 1998 Hungary entered the post-privatisation phase of foreign investment, and the vast majority of FDI has been green-field.

The 2002 reduction in competitiveness has provoked a shift in the composition of FDI, with some manufacturers of electronics components (which have low transport costs) shifting their production to lower cost countries, such as China. Investors unable to upgrade the quality of the services they offer or to shift their production to more sophisticated, higher value products, have left Hungary. Most of the current FDI inflows are either reinvested earnings or existing investors recapitalising their companies to meet

new legal requirements. The challenge for existing (and new) investors that wish to remain in Hungary for strategic reasons is to shift their production towards goods and services for which productivity and efficiency gains can offset rising labour costs. Some investors have already shown the willingness and ability to implement such a shift, such as Opel's plant in Szent-Gotthard, which shifted away from assembling cars from imported kits to specialist production of engines and sophisticated transmission equipment. This plant has become an efficiency benchmark for the European car industry.

Hungary has nearly completed the privatisation of state assets. Its labour force now commands significantly higher wages than it did at the time of the last strategy. Because of EU accession, there is reduced scope for fiscal incentives aimed at foreign investors. As a result of these developments, prospects for FDI are now limited almost exclusively to high-value added, capital-intensive and knowledge-intensive green-field type investments, Hungary continues to attract capital intensive productions (Phillips production of flat screen televisions is one recent example) because of the wide availability of skilled workers, the high proportion of knowledge workers in the labour force and the implementation of supportive economic policies. In its effort to support Hungarian competitiveness, the government is planning to set up a € 134 million Fund to support companies' investment in R&D, in particular in areas such as IT, biotechnology, healthcare, social sciences and agriculture. Since 2001 tax incentives to support investment in R&D are also in place.

Chart 2.1 FDI and privatisation revenues, 1991-2002.



Hungary is set to become a member of the European Union in May 2004. This means that it has fulfilled the requirements, spelled out in the *acquis communautaire*, as regards the reform of laws, institutions and practices that will allow it to withstand competition in the common market. However, the *acquis* does not prescribe comprehensive standards and a complete characterisation of all reforms in every area of the economy, required to achieve

an effective market economy. Even following accession, Hungary will still have some way to go before its transition to a market economy is complete.

Since the last strategy, privatisation, which had almost been completed at the time through the sales for cash method, has not progressed further. The current government has decided to complete the privatisation process within three years. State assets up for sale include Dunafer (steelworks), Malev (airline), Mahart (shipping), Babolna (agribusiness), MVM, FHB (Mortgage Bank), Konzumbank and 25 per cent stakes in MOL (Hungarian Oil Company) and Richter. At the end of the three-year period, 37 companies will remain permanently in state ownership. The assets slated for privatisation in 2003 are FHB (to be sold through a public offer on the stock exchange to avoid distorting the budding subsidised mortgage market), Postabank (Erste Bank won the privatisation tender and the transaction is expected to close before the end of the year) and Konzumbank (privatisation tender under process) and part of the stake in MOL, market conditions permitting.

Table 2.1: Indicators of transition in EU future member countries

	<i>Private sector share in GDP¹</i>	<i>Labour productivity in industry, % change²</i>	<i>Share of exports to EU, %, 2002</i>	<i>FDI per capita, 1989-02</i>	<i>Electricity tariff (US c)³</i>	<i>Phone lines per 100 inhabitants, 2001</i>	<i>Asset share of state-owned banks, 2001</i>	<i>Bad loans (% of total), 2001</i>
Hungary	80	128.6	76	2,253	6.8	37.4	9.0	3.1
Bulgaria	70	13.1	56	547	3.7	35.9	19.9	7.9
Czech Republic	80	60.7	68.6 (2000)	3,413	6	37.4	3.8	13.7
Estonia	75	75.5	68	1,864	4.9	35.2	0.0	1.5
Latvia	65	68.3	60.4	1,336	6.5	30.8	3.2	3.1
Lithuania	70	9.2	48.4	1,024	6.3	31.3	12.2	7.4
Poland	65	118.8	70.6	997	7.8	29.5	12.2	20.1
Romania	65	86.3	67.1	405	5.2	18.3	45.4	3.4
Slovak Republic	80	46.1	60.5	1,784	5	28.8	4.9	24.3
Slovenia	65	33.4	59.3	1,722	6.4	40.1	48.4	9.2

¹ EBRD estimate, 2001

² cumulative change from 1992 to 2001

³ per kWh; average retail tariff, converted at current exchange rates, 2001

In January 2003 the electricity market for around 200 large industrial customers, with consumption over 6.5 GWh and accounting for around 30 per cent of total power sales was opened. These customers are now allowed to choose their suppliers for 50 per cent of their power consumption. However, because 95 per cent of import capacity is locked into long-term contracts and generation capacity is tied to long term agreements with MVM, this measure will be raising competition only gradually. The Energy Office estimates that the recent increase in regulated electricity prices should allow MVM to cover its costs and halt its dependency on government subsidies. The government is also proposing to eliminate preferential pricing in the natural gas market, where prices for residential users and small businesses are well below world levels. Full liberalisation of the market is scheduled to be completed in 2010.

Financial sector reform is well advanced. Most financial sector institutions characterising a market economy are present in Hungary, well capitalised and profitable. However, the relative importance and market share of these institutions is below that found in advanced market economies. Domestic credit accounts for 52 per cent of GDP (December 2002) - only one quarter of the Euro area average. Similarly, at 34 per cent of GDP, domestic credit to the private sector is still very low compared to Hungary's western neighbours.

About 42 per cent of banks' assets are credits to non-financial institutions. This low level of bank intermediation is a concern in Hungary, despite the widespread foreign ownership in the corporate sector, which makes access to financing abroad easy for these companies. However, what is true for large companies owned by multi-nationals does not hold for smaller, locally owned companies. Some of these smaller companies have benefited in recent years from heavily subsidised programmes financed by Phare, or by the Hungarian government (Szechenyi plan). Competition in the banking sector is fierce and has driven down margins on prime clients. This had the effect of stimulating entry and fast growth of SME lending albeit from a very low base. Medium sized companies, which have not benefited from FDI are worst affected by lack of finance.

Concentration of bank credit on relatively few large borrowers and the rapid growth of consumer and mortgage lending, supported by overly generous and unsustainable government subsidies, are issues of concern. The ongoing consolidation in the western European banking sector is likely to impact on the Hungarian banks given their ownership composition. Upon Hungary's accession to the EU the implementation of the "Single European Passport" will allow European banks to provide services in Hungary either directly or via branches (the endowment capital requirement will be lifted). As more than three quarters of Hungarian banks are foreign owned it is difficult to assess what effect accession will have on the structure of the financial sector.

Non-bank financial intermediaries are developing fast, but remain small in size by western standards. The scope of their activity is narrow and capital markets are relatively shallow. About three quarters of financial intermediation is implemented by banking institutions.

Capitalisation of the equity section of the Budapest Stock Exchange as a share of GDP has declined in the past three years and stood at 17.4 percent at the end of 2002. Turnover of the equity section of the stock exchange collapsed in 2001 and at end 2002 accounted for just 44% of turnover in 2000. The abolition of the punitive capital gains tax introduced in January 2001 has not helped boost the capitalisation of the stock exchange, which is dominated by government securities. The past two years were characterised by several delistings of locally owned mid-sized companies. Large enterprises tend to be less affected by the weakness of the local capital markets, as several of them are listed on western stock exchanges.

Hungary has a range of non-bank financial institutions, including insurance companies and pension funds. However, their portfolios remain heavily dominated by government securities.

In 2000 FHB, the government-owned Land Credit and Mortgage Bank, reintroduced mortgage bonds, after an absence of 60 years. While the government securities market is developed and liquid and Hungary's international bond issues have been successful, the corporate bond market is lagging far behind.

The second stage of pension reform has not yet been carried out and some elements of the previous stage of pension reform have been weakened. Under the last government, the rule that new entrants into the pension system could not elect to remain in the state-funded pillar was abolished. It is now optional to select participation in the state-funded pillar. In order to strengthen public expenditure control and to improve delivery of quality services, health care reform should be a priority on the authorities' agenda. The most important and politically controversial issues are hospital over-capacity and under-investment.

Sectors in which foreign investors' presence is significant have grown at spectacular rates, but the growth and export performance achieved by the local corporate sector, dominated by SMEs, has lagged well behind. In addition to the lack of finance, other problems are affecting the enterprise sector. Despite the fact that Hungary's corporate tax

rate is, at 18 per cent, one of the lowest among OECD countries, local taxation is a drag on the enterprise sector. Local authorities charge enterprises between 0 and 2 per cent of firms' turnover and only a limited number of costs such as the purchase of capital equipment are allowed to be deducted to calculate the taxable base⁷. Moreover, Hungary's *Mittelstand* is thin, with companies still small by European standards and affected by corporate governance problems. In the absence of targeted action they are likely to experience difficulties coping with competitive pressures following the country's accession to the European Union.

Severe regional imbalances persist, even if they are somewhat lower than two years ago. Very few foreign investors have been lured by government incentives (land and local tax breaks) and by lower wages (up to 25 per cent lower than in western Hungary) to locate in the least prosperous areas of Hungary. Problems, aside from physical distance from the border with the EU, include the very weak transport links and poor municipal infrastructure. Foreign investment is heavily concentrated in the western regions, bordering the European Union, and has absorbed most of the available (and highly skilled) labour force there. Vacancies in the western region of Hungary take very long to be filled and unemployment is very low at 3 per cent of the labour force. In contrast, in certain areas of east Hungary unemployment persists at 20 per cent of the labour force. In purchasing power standards (PPS), Budapest's GDP per capita is 8% above the EU average, and central Hungary (including Budapest) stands at 83.5% of the EU average. In contrast, northern Hungary achieves only 34.6% of the EU average. Of Hungary's seven regions, only central Hungary is above 75% of the EU average (a benchmark for receiving EU aid). Poor labour mobility is also impeding the levelling of regional differences. The recent boom in the construction sector, supported by the heavily subsidised mortgage programme, has not yet had a significant impact on labour mobility.

Financing municipalities, which are in charge of much of the accession related investment in environmental upgrade and infrastructure, is still an untackled issue.

2.3 Access to capital

Hungary maintains easy access to external financing, due to the increasingly favourable credit ratings, close to those assigned to advanced economies (Moody's upgraded Hungary long term hard currency sovereign debt to A1 in November 2002 and Standard & Poor and Fitch Ratings maintained their ratings at A-, all with stable outlook, except Fitch, which switched to a negative outlook in July)⁸. Investment and funding strategies based on so called "convergence plays" (motivated by relatively high Hungarian interest rates and the expectation of Forint appreciation prior to EMU membership), have contributed in further lowering the spreads on sovereign benchmark bonds, which are among the lowest in the region. The January 2003 € 1 billion worth of Hungarian ten-year Eurobond was 50% oversubscribed: it carried a 4.54% coupon, 27bps above Euribor and 45.5bps above German bond yields. Despite the fact that macroeconomic conditions have deteriorated in the last year and that this Eurobond was issued at the time unfavourable data on the 2002 domestic and external deficits were released, the

⁷ An amendment to the local business tax, so that it is calculated on adjusted profits, is being planned.

⁸ Long term local currency sovereign debt ratings are respectively: Moody's A1, Fitch Ratings A+, and Standard & Poor A, all with stable outlook except Fitch, which switched to a negative outlook in July.

conditions for access to capital are significantly improved since 2001 when on a similar bond Hungary had to offer 30bps above Euribor and 70 bps above German bunds. Thus, the large portfolio inflows (2.3 per cent of GDP in 2002) allowed a comfortable financing of the external deficit despite reduced FDI inflows. As outlined by the Agency for Debt Management, the trend will be that of fewer, larger issues and longer maturities in the next few years.

When assessing the sustainability of these conditions, there are two factors to note. First, the relatively high level of external indebtedness (55 per cent of GDP on a gross basis) limits the scope for further borrowing on the international markets. Second, the very high share of foreign investors' holdings of Hungarian government securities (38.8 % of bonds, or approximately 50% of marketable bonds - an increased by 40% in 2002) could be seen as an element of weakness, should a loss of confidence bring about a sudden unwinding of the "convergence plays" that have driven much of these portfolio inflows. A sudden reversal of capital flows and a significant weakening of the external value of local currency could be highly damaging for the economy. It could have a strong negative impact on the corporate sector, through the balance sheet, given that many private borrowers have large FX liabilities. This could more than offset the positive impact on export competitiveness of a weaker Forint. Consistency and credibility of macroeconomic policy will be key to maintain the confidence of investors.

3. STRATEGIC ORIENTATIONS

3.1 Bank's Priorities for the Strategy Period

Based on its analysis of Hungary's current transition challenges, the Bank has identified five key priorities for the forthcoming period. The Bank will thus focus on:

- Completion of privatisation (with particular attention to transactions facilitating the restructuring of troubled enterprises as well as transactions leading to deepening the local capital markets) and market liberalisation (mostly in the energy and telecommunication sectors);
- Support to the local corporate sector to prepare for the post-accession challenges through direct investments, when size is sufficient, but also and equally importantly by developing the local financial sector's level of intermediation towards local SMEs;
- Support for renewed FDI inflows, specifically targeting medium size sponsors and projects located in lesser developed regions;
- Support to the consolidation and development of the financial sector. The Bank in particular will seek to leverage on past successes to increase financial intermediation in the economy, targeting particularly smaller economic agents as well as the introduction of new products and instruments.
- Support to the upgrade of infrastructure, particularly transport and environmental, with specific attention to lesser developed regions, sub-sovereign projects and smaller municipalities.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 The Enterprise Sector

Transition Goals

The Bank recognises that the gap between locally and foreign owned corporate sectors remains significant and it will continue to support projects contributing to narrow this gap, particularly projects targeting SMEs. Recent government sponsored efforts have brought some results but have not proved sustainable. In addition, given the situation of diminishing privatisation opportunities and increases in labour costs, Hungary must attract new sources of FDI to maintain high investment ratios and continue the transition effort in less developed region. This implies creating the conditions to attract higher value added projects and new sponsors. Finally key reforms such as privatisation and market liberalisation must be completed.

Operational Priorities – Enterprise Sector

In order to help the Hungarian economy meet these goals, the Bank will focus on the following operational priorities.

- The Bank will actively support the completion of the privatisation effort, with particular focus on transactions leading to the restructuring of troubled enterprises (Dunaferr, Babolna, Malev, Mahart) or transactions leading to capital market deepening (Antenna Hungaria, MOL, MVM, Richter). In the former case, transactions may involve debt and equity instruments and the support of a strategic investor will be actively sought. In the latter case, transactions are expected to be primarily equity capital market operations.
- The Bank will seek to deepen and broaden the pool of funds and instruments available for SMEs, primarily through the financial sector, and when feasible through co-investment with specialised equity funds. The Bank will support the preparation of the medium and larger local corporates for the challenges of the post accession period (including competitiveness in the Single Market, regional integration, and environmental/safety regulations, etc.), through equity and quasi equity investments, flexible long-tenor debt instruments and support to industry consolidation.
- The Bank will selectively provide debt finance to FDI projects in difficult sectors, in under-developed regions or with mid-size sponsors, or when there is insufficient capacity from the private sector.
- The Bank will support the further liberalisation and opening of the electricity, gas and telecommunications markets. In the energy sector, the Bank will support restructuring and adjustments required for companies to comply with EU requirements as well as efforts to bring energy efficiency in line with Western standards. In the power sector in particular, the Bank can help to provide liquidity through equity investments in generators and to provide assistance with stranded costs. In the telecommunication sector, the Bank can support alternative operators/new service providers, provide innovative solutions and products to all operators, support the on-going ownership rationalisation and address potential funding gaps stemming from the sector's problems.

3.2.2 The Financial Sector

Transition Goals

While Hungary's banking sector is varied, well-capitalised, profitable and predominantly foreign-owned, levels of banking intermediation remain low and the range of services on offer lacks the sophistication reached in more mature markets. The sector thus fails to address the needs of the private sector in a balanced way. Increased competition however is making banks more receptive to new initiatives, with some progress on the SME and consumer finance fronts. The sector is likely to experience further consolidation, possibly triggered by acquisitions at group level in Western Europe while OTP, the biggest Hungarian bank, is actively pursuing a regional expansion strategy into neighbouring countries.

The specialised financial institution sector has seen the emergence of mortgage institutions as well as of consumer finance operations in the past two years, driven by consumer demand and a generous mortgage subsidy scheme. Municipal finance remains underdeveloped, despite growing awareness of the investment burden faced by local authorities to comply with EU transport and environment requirements.

The Hungarian capital markets have been unable to develop with the exception of a well-functioning national and, international market for government bonds as well as a burgeoning market for mortgage bonds. There is no corporate bond market to speak of and the equity market is struggling. Trading volumes are low, liquidity scarce beyond a small group of blue chip stocks and there has been no meaningful IPO for some four years, while several companies have actually left the exchange in the past two years.

Given the current challenges faced by the financial sector, Hungary's key transition goal is to strengthen and diversify the response of the financial sector to the private sector demand for financial products and services.

Operational Priorities – Financial Sector

The Bank has played a major role and made a substantial contribution to the early restructuring of the Hungarian financial sector. It will endeavour to help Hungary achieve the goal described above by fulfilling the following priorities.

- The Bank will support the consolidation, modernisation, and regional expansion of the sector as well as contribute to the completion of privatisation (FHB Bank, PostaBank, Konzumbank). Equity and subordinated debt will be the prime instruments used in the process.
- The Bank will actively seek to increase the availability of finance to SMEs through financial intermediaries. In particular, the expansion of the EU/EBRD SME Finance Facility to new partner banks and leasing companies will be a priority. In addition, the Bank is also seeking ways to strengthen the equity base of SMEs to support their further growth.
- The Bank will support the nascent mortgage market by providing long-term financing to residential mortgage finance providers. The Bank will also seek to provide subordinated debt to specialised mortgage banks to strengthen their capital base, allow them to meet the growing demand for mortgage financing, and facilitate private ownership of housing and housing stock improvement.

- The Bank will introduce the newly developed EU/EBRD SMM Finance Facility on the Hungarian market to encourage partner banks to provide longer term financing to small and medium size municipalities and help them address the investment requirements of the post-accession period.
- The Bank will initiate new product developments, that may include mezzanine and structured products, extension of various risk sharing facilities, securitisation of asset portfolios, provision of credit enhancements, secondary financing of infrastructure projects and possible co-operation with the Global Environment Fund (GEF) to facilitate the implementation of trans-boundary pollution reduction projects.

3.2.3 Infrastructure and Environment

Transition Goals

Upgrading its transport, environmental and municipal infrastructure is one of Hungary's major remaining transition challenges. It is estimated that investments in excess of € 20 billion are required over the next 12 years just to meet the *acquis communautaire* requirements. A key transition goal in the transport sector currently is the upgrading of existing transportation corridors in order to facilitate investment and economic development in the underdeveloped regions of the country and to integrate Hungary into the European transportation network. The continued rationalisation of the railways is critical because of the burden the sector places on the budget and the related macro-economic effects. The restructuring programme, however, needs further impetus, particularly in terms of network rationalisation. Hungary also has substantial investment needs in environmental and municipal infrastructure and needs to upgrade the wastewater and solid waste sector to meet EU environmental standards. These requirements must be set within the tight fiscal framework.

Operational Priorities- Infrastructure and Environment

The Bank can help improve Hungary's competitiveness and bridge regional development gaps during the next stage of transition by supporting infrastructure development. A key challenge in this respect will be to develop new project structures for the government and other public sector entities that draw on private capital and do not increase the public debt burden.

- The Bank will concentrate on the provision of schemes that do not rely on a sovereign guarantee, increase the supply of long-term capital to the sector and adequately allocate risks among participants. In particular, the Bank will actively support the Government's effort to develop the PPP concept in Hungary in the infrastructure, environmental and municipal sectors, through policy dialogue, encouraging dialogue with and involvement of foreign PPP developers, as well as by taking a leading role in adequately structured pilot projects. The Bank will also explore opportunities in new sectors such as housing or healthcare, where private sector involvement can improve the Government's capacity to meet its obligations.
- The Bank will be at the disposal of the national and local authorities to prepare, co-finance and implement projects and programmes intended to maximise the use of Cohesion and Structural Funds. In addition, it will co-operate closely with the national authorities as well as the EIB to identify gaps in sovereign-funded projects, to which it might bring added value.
- In addition to using the EU/EBRD SMM Finance Facility to encourage banks to

provide long term financing to small and medium size municipalities, the Bank will also explore the use of multi-user PPPs and multi-borrower loan facilities for regional groupings of small projects / municipalities.

- The Bank will support policy reform, restructuring, modernisation commercialisation and eventually privatisation in the rail sector through targeted investment projects and technical co-operation.
- The Bank will support energy efficiency efforts in both the private and public sector, through direct instruments when feasible and otherwise through intermediaries. It will also seek to support the development of a market for carbon credits.
- Finally, the Bank will bring particular attention to projects promoting the development of less advanced regions as well as cross border regional integration.

3.2.4 Policy Dialogue

The Bank has had a long-standing and fruitful policy dialogue with the Hungarian authorities, leading to achievements such as the Secured Transaction Law. During the next strategy period, the Bank will continue the policy dialogue with the Government and governmental agencies in relation to SMEs support. In addition, the Bank will seek to assist in the development of a legal framework conducive to private sector involvement and investment in infrastructure projects as well as continue its efforts in support of capital markets deepening and development.

4. CO-OPERATION WITH OTHER IFIs

4.1 IMF

Hungary became a member of the IMF in 1982. Its quota is SDR 1,038.4 million. The country accepted Article VIII of the IMF Articles of Agreement as of 1 January 1996, stipulating that member countries shall not impose restrictions on current payments. Hungary availed itself of financial support on seven occasions during the past twenty years. The most recent Stand-By arrangement expired in February 1998. Hungary has no outstanding obligations to the IMF. Hungary is on a 12-month Article IV consultation cycle. The IMF concluded its Article IV Consultation for Hungary on 2 May 2003⁹. These highlighted the recent broadly positive developments in maintaining respectable growth rates and succeeding in meeting inflation targets in two consecutive years. However, they drew attention to the dangers of fiscal laxity and excessive wage growth. The government plans for early fiscal consolidation are therefore supported and wage moderation is indicated as key to disinflation and supporting external competitiveness. The Article IV mission also praised the recent policy decisions in the areas of privatisation and energy sector liberalisation, while noting more should be done.

⁹ <http://www.imf.org/external/np/sec/pn/2003/pn0358.htm>

4.2 World Bank Group

In agreement with the Hungarian Government the World Bank is set to initiate the process of graduation for Hungary. The 2002 Country Assistance Strategy for Hungary does not envisage further lending to Hungary during the period preceding and following its accession to the EU. However, the World Bank maintains an assistance program, consisting mainly of analytical and advisory services, to support the EU accession process, poverty reduction and social inclusion, the environment, and the development of a knowledge economy and Hungary's role as a donor. A \$ 32 million municipal wastewater project is still active. IFC's overall business strategy for the central and eastern European countries plans to withdraw from those sectors where its role and additionality is not obvious and where the private sector and European financial institutions are actively engaged. Its remaining programme in Hungary focuses on provision of credit to SMEs for energy efficiency investments. MIGA will continue to offer investment guarantees against non-commercial risk to foreign investors in line with demand.

4.3 EIB

Since 1990 when it started operating in the country, the EIB has finalised a number of loans in Hungary, representing total cumulative commitments of EUR 2.8 billion. The proceeds were mainly dedicated to infrastructure projects (30 per cent), to global loans to financial institutions for SME and municipal finance (37 per cent), and to the private sector (33 per cent). In the context of preparation for EU membership and following Accession, the EIB will continue to focus on areas such as infrastructure, environment and industry projects but expand its lending also to newer areas such as health and education and support of innovation and technology. Emphasis will continue to be placed, through global loans, on SME support and municipal infrastructure, but also on projects aimed at improving and safeguarding the environment. For sectors, where more sophisticated financing structures could be applied, the EIB expects to be ready to join such operations in due course. The MÁV modernisation project signed in 1998 was developed jointly by EBRD and EIB. Further co-operation between the two institutions on large infrastructure and environment projects is possible and will substantially depend on cost considerations and government priorities.

In 2002 EIB further strengthened its co-operation with the EU Commission and acted as co-financier and adviser to the Commission on new ISPA supported projects in the country.

4.4 European Commission

Since January 2000, there have been three pre-accession instruments financed by the European Community to assist Hungary, together with the other applicant countries of central Europe in their pre-accession preparations. In addition to the Phare programme, that has been providing support to the countries of Central and Eastern Europe since 1989, SAPARD (Special Accession Programme for Agricultural and Rural Development), which provides aid for agricultural and rural development and ISPA (Instrument for Structural Policies for Pre-Accession), which finances infrastructure projects in the fields of environment and transport, have been made available. These programmes concentrate their support on the Accession Partnership priorities that help the candidate countries to fulfil the criteria for membership. The combined annual set

aside of these three instruments for Pre-accession assistance is (since 2000) about €220 million.

The PHARE programme allocated to Hungary €1,030 million during the period 1992 to 1999, € 119.8 million in 2000, €108.8 million in 2001 and €130.7 million in 2002. In 2003, Hungary will be entitled to €120.7 million, which have already been allocated.

Hungary received €88 million from ISPA in 2000, €90.8 million in 2001, €92.4 million in 2002 and will receive €94.4 million in 2003, roughly divided in equal terms for environment and transport projects. Implementation of the ISPA programme in Hungary has made good progress. During the first two years of its operation all the ISPA funds have been committed.

The Hungarian SAPARD programme foresees the improvement of the competitiveness of the agricultural sector and processing industry focusing on environmental protection and seeks to enhance the adaptation capabilities of rural areas. The average annual public expenditure amounts to €50.5 million during the period 2000-2006, of which €38.7 million is the EU-contribution. In November 2002, the Commission transferred management of these funds to Hungary's SAPARD Agency.

4.5 OECD

Hungary has been a member country of the OECD since 1996. In its latest Economic Survey (June 2002), the OECD highlights the need for fiscal consolidation in order to avoid a confrontation with monetary policy, which aims at rapid disinflation to ensure early EMU entry. It suggests that fiscal consolidation is unlikely without the introduction of credible expenditure ceilings and the introduction of performance budgeting. The OECD also advocates reform of public service provision (education and health) in order to improve human capital and long term growth prospects. The report suggests that privatisation should be completed and liberalisation of the energy sector accelerated. These are necessary pre-requisites for achieving the conditions in terms of productivity that would allow for rapid growth rates necessary for a catch-up to average EU income levels. In this respect, the low participation rate is seen as a big constraint on growth and a cause of economic and social inequality.

ANNEX 1A – EBRD OPERATIONS TO DATE

Op Name	Type	Signing Date	Total Project Value	EBRD Finance	Debt	Equity
Petofi Nyomda Rt.	Direct	06/11/91	5.1	5.1	5.1	0.0
Hungarian Telecommunications Project	Direct	09/03/92	216.4	33.6	33.6	0.0
Westel Radiotelefon KFT	Direct	08/06/92	8.4	8.4	8.4	0.0
Fusion Inv. Co. Fast Food Restaurant Chain	Direct	25/06/92	21.5	3.0	0.0	3.0
General Motors	Direct	09/07/92	82.1	30.7	30.7	0.0
Budapest Orbital Motorway (MO) Project	Direct	15/09/92	108.8	21.0	21.0	0.0
TVK/Columbian Tiszai Koromgyarto KFT	Direct	18/11/92	47.1	7.6	7.6	0.0
Kner Nyomda RT	Direct	03/03/93	5.5	1.5	1.5	0.0
Eurocorp	Direct	11/05/93	2.7	0.1	0.0	0.1
New Europe East Investment Fund	Regional	28/05/93	23.0	4.9	0.0	4.9
PCA-Budafok (Kartongyar) KFT	Direct	01/06/93	13.8	3.4	3.4	0.0
Hungarian Foreign Trade Bank (MKB) - Bond Issue	Direct	02/06/93	33.2	7.7	7.7	0.0
Magyar Hotec (Formulae 1 Hotel), under RZB ag line	Direct	30/06/93	1.7	0.9	0.9	0.0
Dun & Bradstreet	Regional	15/07/93	0.8	0.3	0.0	0.3
ARP - Budapest Bank RT	Direct	26/08/93	6.8	6.8	6.8	0.0
ARP - Kereskedelmi (Credit and Commercial Bank)	Direct	26/08/93	34.2	34.2	34.2	0.0
ARP - OTP (National Savings Bank)	Direct	26/08/93	18.0	18.0	18.0	0.0
Budapest Public Transport Rehabilitation Project	Direct	26/08/93	86.1	46.1	46.1	0.0
Goldsun	Direct	30/08/93	4.1	4.1	4.1	0.0
Hungarian Telecommunications Equity Investment	Direct	18/11/93	275.2	50.9	0.0	50.9
Pannonia	Direct	22/11/93	49.6	6.3	0.0	6.3
EGIS Pharmaceuticals - Partial Privatisation	Direct	20/12/93	38.0	37.8	0.0	37.8
M1-M15 Motorway Project	Direct	23/12/93	256.7	72.2	68.3	4.0
Budapest Wholesale Market	Direct	08/03/94	20.2	4.4	4.4	0.0
Framochem - Borsod Chem/SNPE	Direct	08/04/94	5.1	0.6	0.6	0.0
ARP - Magyar Hitel Bank (Hungarian Credit Bank)	Direct	08/06/94	9.2	9.2	9.2	0.0
Hungarian Foreign Trade Bank (MKB) - Privatisation	Direct	12/07/94	23.1	17.5	0.0	17.5
Advent Private Equity Fund - Central Europe LP	Regional	17/08/94	39.6	5.8	0.0	5.8
OTP Bank	Direct	02/11/94	11.0	11.0	11.0	0.0
Central Business Center	Direct	16/12/94	18.4	5.9	4.9	1.0
MOL Rt: Zsana Gas Container Project	Direct	30/12/94	71.8	21.1	21.1	0.0
Hungarian Capital Fund	Direct	12/01/95	34.3	9.4	0.0	9.4
Cofinec SA (Kner)	Direct	26/01/95	10.1	4.2	0.0	4.2
MBA Loan Project (guarantee)	Regional	06/03/95	2.1	1.3	1.3	0.0
Graboplast Capital Increase	Direct	27/06/95	8.6	2.4	0.0	2.4
East European Food Fund	Regional	18/07/95	38.8	7.8	0.0	7.8
Investel Syndicated Loan Facility	Direct	05/09/95	863.2	13.5	13.5	0.0
ARP - Budapest Bank Rt- Extension	Direct	12/10/95	0.4	0.4	0.4	0.0
M5 Concession Motorway B.O.T.	Direct	11/12/95	350.7	101.2	101.2	0.0
Budapest Bank Privatisation (equity)	Direct	15/12/95	26.1	36.6	0.0	36.6
Prometheus ESCO Financing	Direct	15/12/95	3.8	3.8	3.8	0.0
Deltav Rt. - Hungary Regional Telecommunications	Direct	21/12/95	157.7	23.9	22.0	1.9
ARP - Kereskedelmi (Bank Extension)	Direct	29/01/96	31.6	31.6	31.6	0.0
Borsod Chem Rt Privatization	Direct	14/02/96	15.8	14.8	0.0	14.8
Digitel 2002 Rt	Direct	16/04/96	97.1	15.5	14.1	1.4
Szikra Lapnyomda Rt.	Direct	12/09/96	10.6	6.1	4.1	2.0
New Europe Insurance Ventures	Regional	23/10/96	3.3	0.9	0.0	0.9
OTP Subordinated Loan	Direct	18/12/96	42.2	42.2	42.2	0.0
Budapest Bank Credit Line for Environment and Energy	Direct	31/12/96	26.8	9.3	9.3	0.0

Op Name	Type	Signing Date	Total Project Value	EBRD Finance	Debt	Equity
Winterthur MPF/CS L&P Pentzarszolgaltato (equity)	Direct	27/05/97	8.4	4.5	0.0	4.5
Hungarian Equity Partners	Direct	09/09/97	39.3	8.4	0.0	8.4
Raba Rt.	Direct	30/09/97	82.2	9.6	0.0	9.6
DBG Osteuropa Holding GmbH	Regional	01/10/97	11.5	2.6	0.0	2.6
Prometheus II	Direct	01/10/97	28.9	16.1	9.6	6.5
Hungarian Foreign Trade Bank (MKB) Cap Increase	Direct	05/11/97	63.5	11.5	0.0	11.5
Kereskedelmi es Hitelbank Rt	Direct	05/11/97	25.3	26.2	0.0	26.2
Baring Communications Equity	Regional	05/12/97	12.7	2.4	0.0	2.4
Hungarian Commercial Television	Direct	12/12/97	53.3	12.3	12.3	0.0
SRP - Hungarian SRP - Ganz Gipgyar Holding Kft	Direct	18/12/97	4.0	4.0	0.0	4.0
Environmental Investment Fund	Regional	19/12/97	4.7	0.6	0.0	0.6
Advent Central & Eastern Europe II - Regional Fund	Regional	06/01/98	44.3	5.3	0.0	5.3
Winterthur MPF/CS L&P Biztosito (equity)	Direct	04/02/98	10.2	4.9	0.0	4.9
MAV - Railcar Modernisation and Marketing Project	Direct	23/02/98	220.0	40.0	40.0	0.0
Innova/98 LP	Regional	10/06/98	10.5	1.9	0.0	1.9
MBA Loan Project II (guarantee)	Regional	07/12/98	0.5	0.2	0.2	0.0
Budapest Waste Water Services Privatisation	Direct	29/12/98	40.2	13.7	13.7	0.0
CGE MPF Budapest Wastewater Service Privatisation	Direct	29/12/98	40.2	13.7	13.7	0.0
Info. and Comm. Tech & Industrial Electronic Fund	Regional	02/06/99	11.8	2.9	0.0	2.9
AIG New Europe Fund	Regional	29/06/99	40.2	6.3	0.0	6.3
M1-M15 Motorway Restructured Project	Direct	19/08/99	206.0	67.0	67.0	0.0
L&G ESCO Hungary	Direct	23/09/99	3.6	1.2	1.0	0.3
OTP Equity Investment	Direct	26/10/99	19.4	21.5	0.0	21.5
Ozdi Acelmuevek Kft Minimill Project	Direct	26/11/99	19.9	10.2	10.2	0.0
Honeywell ESCO Hungary	Direct	30/11/99	12.6	2.1	0.0	2.1
Regional/Private Equity Fund Facility - Trigranit	Regional	07/12/99	37.3	6.8	0.0	6.8
Energy Efficiency and Emissions Reduction Fund	Regional	22/12/99	10.7	3.0	0.0	3.0
Emerging Europe Capital Investors LDC	Regional	23/12/99	19.9	4.7	0.0	4.7
Budapest Intermodal Logistics Centre	Direct	29/12/99	23.4	10.0	10.0	0.0
Argus Capital Partners	Regional	26/09/00	45.2	8.1	0.0	8.1
Heitman Central Europe Property Partners Fund	Regional	29/09/00	36.6	8.1	0.0	8.1
Winterthur MPF/CS L&P Biztosito - 1st Cap Increase	Direct	13/12/00	6.0	2.1	0.0	2.1
Winterthur MPF/CS L&P Pentzarszol - Capital Increase	Direct	13/12/00	4.2	1.5	0.0	1.5
Regional/Private Equity Fund Facility - Trigranit II	Regional	07/02/01	2.2	0.7	0.0	0.7
EU/EBRD Phase I - Euroventures Danube BV	Regional	26/02/01	15.0	3.0	0.0	3.0
DVI, Inc. (debt)	Regional	19/03/01	6.0	2.0	2.0	0.0
Innova/3	Regional	23/04/01	37.7	4.5	0.0	4.5
Winterthur MPF/CS L&P Biztosito - 2nd Cap Increase	Direct	17/05/01	9.7	3.3	0.0	3.3
Raiffeisen EU Enlargement Fund	Regional	02/07/01	8.5	4.1	0.0	4.1
Viking River Cruises	Regional	13/08/01	6.3	6.3	6.3	0.0
Vivendi Telecom Hungary (VTH)	Direct	24/08/01	378.4	49.2	49.2	0.0
Tecnicredito Hungary (syn loan)	Direct	03/12/01	25.0	10.0	10.0	0.0
EU/EBRD Phase II - Ext. - VOLKSBANK	Direct	12/12/01	10.1	10.1	10.1	0.0
Accession Mezzanine Capital LP	Regional	08/01/02	16.3	7.5	0.0	7.5
Winterthur MPF/CS L&P Biztosito - 3rd Cap Increase	Direct	26/06/02	7.7	2.5	0.0	2.5
Parmalat MPF - Hungary	Direct	16/09/02	27.8	9.1	9.1	0.0
Heitman Central Europe Property Partners Fund II	Regional	09/12/02	28.4	8.1	0.0	8.1
DBG Osteuropa Holding II	Regional	24/01/03	21.8	6.6	0.0	6.6
ORCO APARTHOTELS	Regional	07/03/03	17.1	1.7	0.0	1.7
MOL - Duna WWTP Outsourcing Project	Direct	14/04/03	39.8	17.4	17.4	0.0
Prometheus III	Direct	12/05/03	3.0	0.6	0.0	0.6
Winterthur MPF/CS L&P Pentzarszol - 2nd Cap. Incr.	Direct	27/05/03	2.3	0.8	0.0	0.8
Winterthur MPF/S L&P Biztosito - 4th Cap Increase	Direct	27/05/03	5.3	1.9	0.0	1.9
			5,125.0	1,287.8	873.7	414.1

ANNEX 1B – TC PROJECTS

Commitment Number	Commitment Name	Euro Committed	Fund Approved Date	Commit. Stage Name	Sector
ECP2000-2002-12-12	General Credit Line for Budapest Bank - Environmental support	70,000	05/12/02	Committed	Community/Social Services
ECP96-97-02-44	Environment project preparation	106,369	13/02/97	Closed	Community/Social Services
ECP96-97-02-45	Environment project preparation	174,704	13/02/97	Closed	Community/Social Services
FIN-1992-12-08	National Labour Centre	46,870	02/12/92	Closed	Community/Social Services
FIN-1993-10-07	National Labour Centre - project start-up	32,528	22/10/93	Closed	Finance, Business
FRA-1993-06-02	Municipal development - Hungarian Communal Bank	28,597	28/05/93	Closed	Transport, Storage
FRA-1993-07-04	Budapest public transport - fares system restructuring study	85,797	09/07/93	Closed	Transport, Storage
GER-1994-03-04	Tiszai Vegyi Kombinat Rt - investment preparation	69,791	16/03/94	Closed	Energy
JAP-1991-08-02	GIRO Bankcard	79,962	01/08/91	Closed	Finance, Business
JAP-1992-01-09	Budapest urban infrastructure	545,261	01/01/92	Closed	Construction
JAP-1992-01-13	M1-M15 motorway concession	462,064	01/01/92	Closed	Transport, Storage
JAP-1992-02-14	Export credit guarantee	21,490	01/02/92	Closed	Finance, Business
JAP-1992-10-28	Agricultural restructuring	209,998	01/10/92	Closed	Agriculture, Forestry, Fishing
JAP-1993-08-36	Budapest public transport rehabilitation project - parking control scheme	125,000	01/08/93	Closed	Transport, Storage
JAP-1993-08-37	Budapest public transport rehabilitation project - commercialisation study	246,987	01/08/93	Closed	Transport, Storage
JAP-1993-10-53	Agricultural restructuring project - advisory assistance to four banks	239,437	17/11/93	Closed	Finance, Business
JAP-1993-10-54	Agricultural restructuring project - training assistance to four banks	207,818	17/11/93	Closed	Finance, Business
SPA-1994-09-03	Foreign trade financing	137,953	12/08/94	Closed	Finance, Business
UKC-1994-05-02	Budapest public transport rehabilitation project - commercialisation study	17,000	01/05/94	Closed	Transport, Storage
UKC-1994-09-06	Transelektro group - environmental audit	3,378	01/09/94	Closed	Energy
UKC-1994-09-07	Transelektro group - technical study	88,693	07/09/94	Closed	Energy
UKE-2001-01-03	Hungarian Financial Supervision (HFSA) - Supervision Assistance	100,000	19/01/01	Closed	Community/Social Services
FRA-1995-08-02	Energy efficiency project development - financing through energy service companies	104,786	17/07/95	Closed	Energy
UKC-1996-09-21	Technical update on the gas distribution sector	18,480	25/09/96	Closed	Energy
ECP-1995-12-44	Special restructuring programme - fund enterprise portfolio - Investment Development and Implementation Team (IDIT)	1,024,683	02/01/96	Closed	Manufacturing
ECP-1995-12-45F	Special Restructuring Programme framework contract - pre-investment enterprise support - Team I	326,941	02/01/96	Closed	Finance, Business
ECP-1995-12-46F	Special Restructuring Programme framework contract - pre-investment enterprise support - Team II	173,727	02/01/96	Closed	Finance, Business
GER-1994-12-12	Hungary Special Restructuring Programme - feasibility study	170,423	03/11/94	Closed	Finance, Business

Commitment Number	Commitment Name	Euro Committed	Fund Approved Date	Commit. Stage Name	Sector
GER-1995-11-06	Hungary Special Restructuring Programme Feasibility study - extension	12,194	24/10/95	Closed	Finance, Business
GERK-1996-05-05	Magyar Hittel Bank - due diligence	307,363	01/05/96	Closed	Finance, Business
JAP-1993-01-01	Clearing and depository centre for Budapest Stock Exchange	176,702	01/01/93	Closed	Transport, Storage
EC-1992-08-34	Danube River Basin Development Programme - environmental management in the chemical industry	237,180	10/08/92	Closed	Finance, Business
EC-1992-09-37	Danube River Basin Development Programme - project financing and investment	155,336	15/09/92	Closed	Finance, Business
ECP-1995-12-38	M1-M15 monitoring study	165,765	15/11/95	Closed	Construction
ECP96-97-02-41	MAV Hungarian Railways - passenger rail services study	345,948	10/02/97	Closed	Transport, Storage
ECP98-2000-02-63	MAV Passenger Railway Services Study, Phase II	150,000	08/02/00	Closed	Transport, Storage
FIN-1993-01-01	Danube river basin development - pulp and paper assessment	50,954	20/01/93	Closed	Finance, Business
GER-1994-11-11	Combined transport feasibility	52,774	24/10/94	Closed	Transport, Storage
SWI-1994-11-03	Combined transport feasibility	131,280	17/10/94	Closed	Transport, Storage
DEN-1997-08-02	TurnAround Management Programme - Transelektro II	4,524	15/08/97	Closed	Manufacturing
GRE-2001-09-03	Secured Transactions: Institution Building in Hungary	5,680	05/09/01	Closed	Community/Social Services
JAP-1993-08-31	Environmental training for bankers	99,000	01/08/93	Closed	Finance, Business
JAP-1993-09-47	TurnAround Management Programme - Ajka	27,822	01/09/93	Closed	Manufacturing
JAP-1993-09-49	TurnAround Management Programme - Caola	4,198	01/09/93	Closed	Manufacturing
JAP-1995-05-14	TurnAround Management Programme - Tanselektro	49,748	01/05/95	Closed	Manufacturing
JAP-1995-05-15	TurnAround Management Programme - Eger East-West Limited	25,624	01/05/95	Closed	Manufacturing
JAP-1997-08-23	TurnAround Management Programme - Transelektro II	10,815	15/08/97	Closed	Manufacturing
LUX-2000-09-04	TAM Programme in central, eastern & southern Europe	58,951	13/09/00	Closed	Manufacturing
TAI-2002-01-02	TAM Programme - Malyi Brick	47,927	15/01/02	Disbursing	Manufacturing
TAI-2002-01-03	TAM Programme - Salgotarjan Konfekcioipari	47,927	15/01/02	Disbursing	Manufacturing
UKC-1995-12-23	Assistance in developing a register for charges over movable assets	49,793	12/12/95	Closed	Community/Social Services
UKC-1997-01-02	Assistance in implementing registration under new law for charges over moveable assets	200,389	29/01/97	Closed	Community/Social Services
UKC-1997-08-08	TurnAround Management Programme - Transelektro II	28,163	15/08/97	Closed	Manufacturing
UKE-1999-11-07	Regional - close-out netting legislation	50,000	08/11/99	Closed	Finance, Business
UKE-2001-03-10	Legal Advisory Services to Hungary in connection with drafting a New Comprehensive Securities Act	49,684	20/03/01	Closed	Community/Social Services
UKE-2001-05-17F	Secured Transactions: Institution Building Project	149,915	03/05/01	Disbursing	Community/Social Services
HOL-1992-11-10	Establishment of national guarantee scheme for SME	9,970	01/11/92	Closed	Finance, Business

Commitment Number	Commitment Name	Euro Committed	Fund Approved Date	Commit. Stage Name	Sector
JAP-1993-07-22	Establishment of National Guarantee Scheme for SME's	4,181	01/07/93	Closed	Finance, Business
AUS-1991-07-01	Prefeasibility study - Telecommunications	25,609	01/07/91	Closed	Telecommunications
AUS-1994-05-01	Culture-based tourism study	34,854	30/05/94	Closed	Commerce, Tourism
EC-1993-12-72	Budapest whoelsale market project expansion - rationalisation of market operations/establishment of Market Information System	323,750	17/12/93	Closed	Manufacturing
FRA-1992-07-05	Budapest wholesale market	20,305	13/07/92	Closed	Manufacturing
FRA-1993-12-07	Meat processing industry restructuring	185,795	10/12/93	Closed	Manufacturing
ITA-1992-12-01	Budapest wholesale market	75,509	01/07/92	Closed	Manufacturing
JAP-1993-12-62	Budapest wholesale market expansion project - project design, tender preparation and supervision	167,908	01/12/93	Closed	Manufacturing
TAI-1992-04-27	Hungary Telecommunications Company	52,281	01/04/92	Closed	Telecommunications
TAI-1993-01-01	Study of Hungarian Telecommunications Company - due diligence	198,772	01/01/93	Closed	Telecommunications
Country Total Euro Amount:		8,713,324			
Report Total Euro Amount:		8,713,324			
No of Commitments:		67			

ANNEX 2 – POLITICAL ANNEX

The political system

Hungary's present Constitution dates back to 1949, but it has been heavily amended. A multiparty committee worked on a new version between 1994 and 1998 but divisions between parties and within the government prevented parliament from adopting a new Constitution. The electoral system combines elements of majority and proportional voting. Of the 386 seats in the National Assembly, 176 are elected from individual electoral constituencies. Election to an individual district in the first round requires an absolute majority. A plurality is sufficient for victory in the second round of voting. The remaining seats are distributed proportionately according to the party-list vote. The threshold for parties to enter parliament was set at 4% in 1990, but was raised to 5% before the 1994 election.

In Hungary political life is more polarised between the left and the right than in any other Central and South-East European country. Government-opposition conflict is often bitter but in parliament parties regularly co-operate on issues of bipartisan character. The left-right divide is not superficial but is rooted both in history and in culture. That polarisation has deepened in the past decade and has led to the gradual emergence of something beginning to approach a two-party system – not a feature of the political scene in the other countries of the region. At the time of the ending of the one-party system in 1989-1990 a number of parties emerged but only four are currently represented in parliament: the Socialists and the Free Democrats, classified as the parties of the left, form the government, while the right-wing Fidesz and its smaller ally, the Democratic Forum, form the opposition. Among the parties currently outside parliament, there is the Hungarian Justice and Life Party formed in 1993 when István Csurka, a radical nationalist writer and his supporters were expelled from the Hungarian Democratic Forum. Csurka is a controversial figure partly because of his support for the revision of Hungary's post-World War I borders and partly because of his directly or indirectly anti-Semitic remarks. The party got 5.5% of the vote in 1998 but failed to make it to parliament in 2002.

The central government enjoys strong powers. Local governments are small and fragmented and are heavily dependent on the centre in Budapest for funds. The nineteen county governments are directly elected but lack policymaking and fund-raising powers. Under the 1993 Minority Rights Law, there are national and, where relevant, local governments for ethnic minorities. The position of the Prime Minister is powerful: he can be replaced only by a so-called 'positive vote of no confidence', which requires the naming of an alternative candidate at the time of the vote. Under the 1998-2002 Fidesz administration of Viktor Orbán, the office of the Prime Minister, under a junior minister, assumed a strong agenda-setting and monitoring role. Ministers have powers to implement policy via orders and decrees but they are not subject to parliamentary votes of confidence – only directly to the Prime Minister. Perhaps inevitably in a small country, close personal networks play an important role in policy formation and administration. The 1998-2002 Fidesz government sought to justify the appointment of its sympathisers to positions in the administrations and the media by claiming that it was hampered in its activities by the presence in various sectors of public life of individuals and groups left

over from the Communist era. The Ombudsman and the State Audit Office enjoy a reputation for independence. The Constitutional Court is modelled on the German court and has strong powers, including that to review and invalidate parliamentary acts.

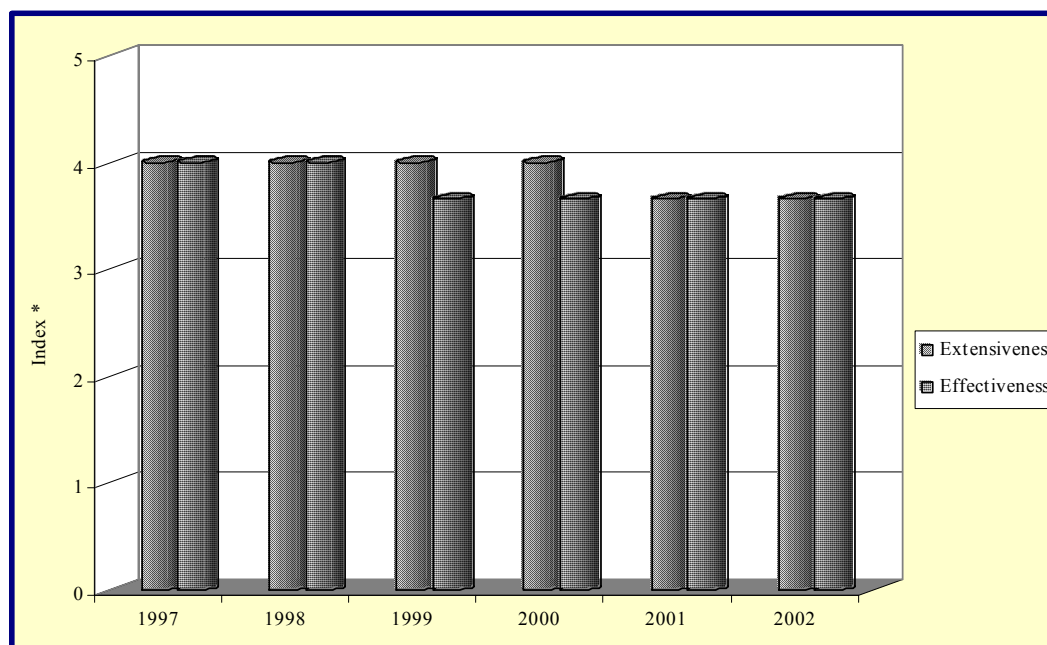
International relations

Ever since the 1920 Treaty of Trianon, which assigned more than two-thirds of Hungary's pre-1918 territory to the neighbouring countries (Romania, Czechoslovakia and Yugoslavia), the presence of large Hungarian minorities in the neighbourhood has been a source of problems for Hungary but also for its neighbours. In the 1980s the plight of the Hungarian minorities – especially in Romania – was an important issue for the emerging opposition parties. Since the end of Communist rule, Hungarian governments have striven to balance the need for constructive relations with neighbours with the desire to support the Hungarian minorities. There are around 1.6million ethnic Hungarians in Romania, around 500,000 in Slovakia and approaching 300,000 in Serbia/Montenegro (most of them in the northern province of Vojvodina which formed part of Hungary until 1918 and between 1941 and 1945). There are also 156,000 ethnic Hungarians (0.3% of the total population) in Ukraine. In 2001 relations with Romania and Slovakia were put under considerable strain by the adoption by the Hungarian parliament of the Status Law in June of that year. The legislation was intended to offer practical support for Hungarian communities coupled with a wish to signal to them that though Hungary, by joining the European Union would adopt the Schengen border at the new frontier of the EU, it would not at the same time abandon the Hungarian minorities in non-EU states. However, both Romania and Slovakia objected to the Law as being both discriminatory and extra-territorial and as unhelpful to bilateral relations developed since the mid-1990s. Various concessions made by the Orbán – and later Medgyessy's - government have succeeded in largely reassuring Romania. An accommodation between the two countries in this matter was incorporated in a treaty signed in September 2003 by the two Prime Ministers, Peter Medgyessy and Adrian Nastase. Slovakia remains resolutely opposed. Recent attempts by the Medgyessy government to persuade Slovakia to alter its attitude have so far remained unsuccessful, but negotiations are continuing.

ANNEX 3 - LEGAL TRANSITION

I Assessment Over Time

Extensiveness and Effectiveness of Hungary's Commercial Law¹⁰



Source: OGC Legal Indicator Surveys; 1997 - 2002

*Note: Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

Hungary's commercial laws have achieved a high standard, generally maintaining this level over the past six years. The commercial legal rules of Hungary that impact on commercial transactions, such as secured lending, debt restructuring and the formation of joint-stock companies, are considered to be comprehensive. According to the perceptions of local lawyers, while there has been a slight decline in both the extensiveness and effectiveness of commercial laws since 1997-98, the effective implementation of these laws has remained constant since 1999 and the extensiveness has remained constant since 2001.

¹⁰ The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extend these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

II Situation in Other Transition Countries

Hungary's normative laws are approaching international standards, supported by institutional mechanisms to implement these laws, and as a result the country overall compares well with other transition countries. Based on the 2002 EBRD Legal Indicator Survey, which measured the perception of lawyers familiar with Hungarian law, the commercial laws of Hungary can be characterised as adequate for supporting investment and other commercial activity.

Compared with other countries in the region, Hungary's commercial law is regarded by lawyers in the field as being among the best. Hungary's commercial law is perceived to be on a par with that of the Czech Republic, Estonia and Lithuania.

LEGAL SECTOR ASSESSMENT

Bankruptcy

Hungary's present bankruptcy legislation is contained in Act IL of 1991 on Bankruptcy Procedures, Liquidation Procedures and Final Settlement. This law entered force on 1 January 1992 and has since been amended a number of times, most substantially in 1993 and 1997. Overall, while the regime has been considered favourable to debtors, recent amendments have made it somewhat more creditor friendly. The substance of some of these amendments is set out below.

Amendments to the Bankruptcy law contained in Act CXXXVII of 2000 (effective September 2001) aim to improve a secured lender's position in liquidation proceedings, by providing that 50% of the proceeds from the sale of secured property during liquidation are to be used to satisfy the secured creditor exclusively (after deduction of the costs of the property's sale). To receive such payment however, the secured creditor must have established the security in question at least one year prior to the date of commencement of the liquidation and, where challenged, it must be shown that the contract establishing the security was entered into in good faith or for sufficient consideration.

Another significant recent change in the framework was the elimination of the so-called 'six month' rule, pursuant to which debts secured by mortgages registered with the Land Registry less than six months prior to the commencement of liquidation proceedings were treated as unsecured in the statutory order of payment. This reform is of particular importance to lenders whose mortgage is secured by property located in the City of Budapest, where administrative backlog can delay the registration of a mortgage in the Budapest Land Registry by up to a year.

Act CXXXVII of 2000 also expanded the rule on "related party" agreements to include not only relatives of a debtor in liquidation, but also shareholders of the debtor, executive officers and their relatives and direct and indirect affiliates. Any contract entered into between the debtor and a related party is presumed to have been entered into in bad faith and may not be effective vis-à-vis creditors.

Four further amendments have been made to the Bankruptcy law since the adoption of Act CXXXVII of 2000, relating mostly to the administration of bankruptcy and liquidation proceedings.

While this legislative package contains significant advances in terms of adopting a modern framework, it still fails to address certain bottlenecks and provides weak legal ground for sophisticated transactions. Although the EU views the legal framework for bankruptcy as good, it still considers implementation with regard to company liquidation and the treatment of creditors' claims to be lengthy and cumbersome.

Remaining challenges to be addressed include: (i) the delays between filing and a legally valid declaration of bankruptcy, which remain quite long; (ii) the lack of control by courts and creditors over administrators (e.g. the court has no discretion when taking the decisions that end the proceedings); (iii) the costs associated with triggering the bankruptcy process, which can be discouraging; and (iv) the information on the financial and business condition of a troubled company which needs to be provided to creditors in time to initiate a restructuring.

Capital Markets

The primary legislation governing the Hungarian securities markets is Act CXX of 2001 on Capital Markets (the "CMA"). The CMA entered into force in January 2002 and replaced the Securities Act of 1996, the Commodities Exchange Act of 1994 and the Investment Funds Act of 1991. The CMA has brought further alignment with the relevant EU directives on investment services, public offering and trading of securities, investment funds, investor protection and supervision of the financial sectors. The CMA also establishes new types of investment funds. The CMA, however, falls short of fully implementing the EU directive on undertakings for collective investment in transferable securities.

The key regulator of the Hungarian capital market is the Hungarian Financial Supervisory Authority ("PSZAF"), which was established in April 2000 pursuant to the Law on the Hungarian Financial Supervisory Authority, adopted in December 1999. PSZAF replaced the three different supervisory authorities previously existing for the securities market, banking and insurance sectors respectively. The Law on the PSZAF was amended in January 2002 to reinforce the independence of PSZAF. However, PSZAF does not have the power to issue its own regulations. Therefore, an area where continuing improvement is needed for Hungary is focus upon reform efforts to strengthen the powers of PSZAF.

The Insurance Law of 1995 was amended in June 2000 with an aim to bring the relevant Hungarian legislation in line with EU standards. The amendments include provisions on an increase in the minimum capital requirements for insurance unions, increased transparency of ownership structures, and strengthened prudential supervision. The Hungarian pension system was reformed in January 1998 and a three-pillar system started to replace the then existing 'pay-as-you-go' (PAYG) system. The second and third pillars, by contrast to PAYG, are fully funded -- participants save up capital for their own pensions, instead of paying for previous cohorts. The second pillar consists of private

pension funds, in which participation is mandatory under a certain age, while the third comprises voluntary pension funds.

Company Law and Corporate Governance

The current Company Act (the "CA") was promulgated in 1997 as Act CXLIV and was amended in 2001. Under the CA, there are three types of corporate entities: the joint enterprise, the limited liability company and the joint stock company. The limited liability company and joint stock company are the two most widely used corporate forms in Hungary. Different capital requirements are prescribed by the CA for different forms of corporations. Pursuant to the Act on Company Registration of 1997, there is a 60-day deadline for a company to be registered by courts. A company is not permitted to engage in activities before registration for which licensing is required and the ownership interest in it is inalienable until registration is completed.

In a joint stock company the shareholders' meeting is the primary organ and has the right in general to elect and remove officers. To convene a shareholders meeting, a 20-day advance notice should be sent to shareholders. The board of directors is the main institution responsible for the daily management of the joint stock company. According to the CA, a person can be a member of the board of directors of no more than three companies. The CA also establishes other rules dealing with conflict of interest issues (e.g., dealing with immediate relatives as defined by the Hungarian Civil Code). Furthermore, the CA requires a joint stock company to establish a supervisory board, whose main function is to supervise the management activities of the company to ensure that they are carried out in the interests of the company and shareholders. The board of directors has the obligation to report to the supervisory board of the company as frequently as stipulated in the articles of association of the company but at least once every three months. In addition to the supervisory board, the CA also makes the election of auditors mandatory for a joint stock company.

Under the CA, a shareholder of a company can request that a court conduct a supervisory review of a resolution if the shareholder has not voted for the resolution and such resolution is deemed in violation of the CA, the constituent documents of the company or any other law. Such request, however, must be filed within 30 days from acknowledgement of the resolution. The court in charge of the supervisory review may, in its discretion, suspend the resolution in question from being implemented. The resolution in question will be declared null and void if the court determines that it violated the law or the company's constituent documents.

When compared with the OECD Principles of Corporate Governance, the existing Hungarian legislation regulating corporate governance issues appears to be among the best in the Bank's countries of operations, according to the results of the Bank's 2002 Corporate Governance Sector Assessment Project. However, it should be noted that this Project is intended to be an assessment of the existing laws and regulations addressing corporate governance issues. The emphasis of the assessment is on the respective legal framework (i.e., the law "on the books" or the "extensiveness" of the law) in the countries rather than the practice of individual companies or the actual implementation of the law (i.e., "effectiveness" of the law promulgated). Therefore, despite the fact that Hungary

may have in place good laws concerning corporate governance issues, continuing efforts still need to be made to ensure that good laws are transformed into good practices in Hungarian companies.

Concessions

Concessions are governed by combination of a general concessions law and sector-specific legislation. The 1991 Concessions Act, as amended, is a general framework law and contains reference to various sector-specific legislation subordinated to the Concessions Act. The Concessions Act provides an apparently exhaustive list of the activities/sectors where concessions arrangements are applicable. Sector specific concessions legislation further defines concessions arrangements applicable to particular sectors and contains cross references to the Concessions Act. For example, Act XLVIII of 1993 on Mining has a number of sections on concession arrangements in the mining sector while also containing references to the Concessions Act. Under the Concessions Act the term of a concession contract may not exceed 35 years.

The Concessions Act regulates the tendering process but also refers to a special tender law and to the relevant provisions of the Civil Code that are also applicable to a concession contract. The Concessions Act contains rules on contracting arrangements, concession granting procedures and provides for the possibility for international arbitration to be the forum for dispute settlement.

The Concessions Act currently appears somewhat superficial and inflexible. For example, assignment of concession rights to a third party is restricted by the need for the consent of the grantor of the concession. Other difficulties include the absence of a stability clause concept and the lack of clarity as to whether a fair and workable compensation mechanism will emerge if an issue arises.

Secured Transactions

The law on secured transactions is contained in the Civil Code, articles 251-269 and in Law Decree No 11 of 1960, articles 47, 47/A and 48. These provisions came into effect from 1 September 2001 pursuant to Act CXXXVII of 2000 on the modification of legal regulations on charges, replacing the provisions amended by Act XXVI of 1996. The Civil Code provisions cover possessory charges on tangible movable property, registered (non-possessory) charges over tangible movable and immovable property, enterprise charges, charges on rights and receivables and independent charges. Priority and enforcement of charges in bankruptcy are governed by Act IL of 1991 on Bankruptcy Procedures, Liquidation Procedures and Final Settlement (as amended by Act CXXXVII). Finally, two decrees regulate the subject in more detail: (1) Decree No. 11/2001 (IX.1.) IM of the Ministry of Justice on the detailed rules of the charge registry; and (2) Decree No. 12/2003 (I. 30.) of the Government on the sale of charged property through non-judicial enforcement.

Hungarian law provides a comprehensive system for charging all kinds of assets. Registered charges over movable (tangible) assets are registered in the centralised electronic Charges Registry, which has been operated since May 1997 by the Hungarian

National Chamber of Public Notaries. Since the 2000 reform, substantial improvements have been brought to the law:

- ❖ The range of collateral that can be taken has increased.
- ❖ Charges over pools of fluctuating assets are now possible.
- ❖ The priority rules of an enterprise charge have been clarified.
- ❖ Ambiguity over charges over claims and receivables has been removed.
- ❖ Foreclosure rules have been substantially simplified and out-of-court enforcement is now possible. The decree mentioned above now provides sufficient details to make a direct sale by the lender a viable option in case of the borrower's default.

The main area where further improvements could be made is in the enforcement of an enterprise charge, which remains quite hazardous. The Ministry of Justice is currently working on detailed new rules, which should bring some clarification. Also, there is no provision for the registration of charges over rights and receivables. Moreover, much uncertainty persists concerning the possibility of charging securities and, accordingly, further reform work in this area is now long overdue. Complete reform of the Civil Code is currently under way in Hungary and whilst this may bring much benefit in many areas, it is essential that reform of the rules that relate to, or have indirect effect on, secured transactions do not undermine the considerable progress made to date.

Telecommunications

The telecommunications sector is currently regulated by the National Communications Authority ("HIF") and is governed in large part by the Communications Law of 2001. HIF reports to and carries out the policies set by the Ministry of Transport, Communications and Water Management (the 'Ministry'). The law became effective on 23rd December 2001 and liberalised telecommunications markets from January 2002. It provides for a new division of responsibility between HIF and the Ministry and for the registration of communications services providers, which includes both telecommunications and postal services. The rules of the negotiation of interconnection agreements and for the rebalancing of tariffs are well defined in the law.

HIF is legally separate from, and independent of, the ministries and other governmental organisations holding stakes in the operators. It has a separate budget line and full jurisdiction and nation-wide competence in licensing telecommunications equipment, networks and non-concession services, including the postal services. It carries out its activities under the supervision of the Government Commissioner. HIF is responsible for identifying operators with significant market position (companies having 25% market share in telephone services, mobile radio telephone services, leased line services, and interconnection services). Operators with significant market position will be imposed with EU-type obligations.

The regulation of the telecommunications sector can be viewed as clear and consistent. Hungary is widely regarded as being one of the most advanced of the transition countries in aligning its telecom legislation with that of the EU. The Telecoms Chapter of Hungary's EU accession negotiations was formally closed in December 2002, although it had been provisionally closed since as long ago as May 2000. The regulatory

environment can be seen as transparent. The flexible approach of the Government was highlighted by the ending of the monopoly of Matav (the former state owned incumbent) a year earlier than had been originally envisaged, thus accelerating competition in the sector.

While liberalisation will certainly boost competition in the sector, the implementation of competition will take time, with fuller competition not being expected until later in 2003/4. While Hungary is significantly advanced, the EU observes that adoption of certain elements of the telecom *acquis* remain outstanding. Of note in this regard, however, is a recently published bill (May 2003) which, when implemented, should finalise outstanding elements in the harmonisation of Hungary's telecoms law with EU norms ahead of Hungary's planned accession. Amongst other things, this bill contains several measures that should facilitate increased competition. In particular, it proposes the introduction of telephone number portability from January 2004 for fixed-line customers and from May 2004 for mobile customers. Broadband providers will be required to enable customers to select different providers for each service they use and access to the local loop will be made easier. The bill also proposes the revision of the financing of universal access services, the elimination of Matav's access deficit surcharge and the reduction of fixed-mobile termination fees. In addition, it is proposed that, in line with EU requirements, from next year telecoms companies will need to calculate their charges based on their long-run incremental costs, allowing a more accurate reflection of their real costs.

Legal Reform Projects

Concessions

In 2003, the Bank started negotiations with the Hungarian Ministry of Economy and Transport regarding possible legal technical assistance aimed at upgrading the concession legal framework sufficiently to meet EU standards and to help develop Public-Private-Partnership supporting institutions.

Secured Transactions

Since 1995 the Bank has, at the request of the Hungarian Ministry of Justice, actively assisted with the development of a modern, efficient credit market. This assistance (originally comprising two projects, one beginning in 1995 and one in 1997) was aimed at enhancing the legal environment for the Bank's private sector transactions and at improving the general conditions for private sector investment in Hungary through the creation of a computerised registry for charges over movable, tangible assets and later its successful operation and maintenance. The registry has been operating since 1997 and statistics show that it is of considerable benefit. The framework was further enhanced at the end of 2000 with the Bank's assistance. These enhancements became effective in September 2001 and the number of registrations has increased since. The Bank also assisted the Ministry of Justice in drafting new implementing decrees on registration and out-of-court enforcement. Further, it is engaged in the promotion of the reforms within the business community, especially with small and medium size enterprises, which could benefit further from the regime. Given the success of the Bank's technical cooperation projects in this area there may be scope for additional assistance to support further legislative drafting work. Because of Hungary's special position in the forefront of

reform and as a model for other countries in the field of secured transactions, it is essential to ensure that the best standards are applied, which can then be disseminated in the region.

ANNEX 4 – SELECTED ECONOMIC INDICATORS

Hungary	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
								Estimate	Projection	Projection	
Output and expenditure	<i>(Percentage change in real terms)</i>										
GDP	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.7	3.3	3.5	5.0
Private consumption	-0.2	-7.1	-3.4	1.7	4.9	4.6	4.1	5.0	8.8	na	na
Public consumption 1/	-12.7	-4.1	-4.2	5.7	-0.3	1.8	1.2	4.4	1.5	na	na
Gross fixed investment	12.5	-4.3	6.7	9.2	13.3	5.9	7.7	3.5	5.8	na	na
Exports of goods and services	13.7	13.4	8.4	26.4	16.7	13.1	21.8	9.1	3.8	na	na
Imports of goods and services	8.8	-0.7	6.6	24.6	10.1	12.3	21.1	6.3	6.1	na	na
Industrial gross output	7.8	4.3	3.6	12.8	13.7	10.7	18.1	3.6	2.6	na	na
Agricultural gross output	3.2	2.6	6.3	-1.8	-0.3	0.9	-7.9	10.4	na	na	na
Employment 2/	<i>(Percentage change)</i>										
Labour force (annual average)	-3.3	-2.6	-1.2	-1.3	0.4	2.1	0.4	-0.5	0.4	na	na
Employment (annual average)	-2.0	-1.9	-0.8	0.0	1.4	3.1	1.0	0.3	-0.1	na	na
	<i>(In per cent of labour force)</i>										
Unemployment (end-year)	10.7	10.2	9.9	8.7	7.8	7.0	6.4	5.7	5.8	na	na
Prices and wages	<i>(Percentage change)</i>										
Consumer prices (annual average)	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.5	4.0
Consumer prices (end-year)	21.2	28.3	19.8	18.4	10.3	11.2	10.1	6.8	5.3	5.1	4.4
Producer prices (annual average)	11.3	28.9	21.8	20.4	11.3	5.1	11.6	5.2	-1.1	na	na
Producer prices (end-year)	14.8	30.2	20.1	19.5	7.1	8.2	12.4	7.3	-1.3	na	na
Gross average monthly earnings in economy (annual average)	22.6	16.8	20.4	22.3	18.3	13.9	13.5	18.2	18.3	7.6	na
Government sector^{3/}	<i>(In per cent of GDP)</i>										
General government balance	-7.5	-6.7	-5.0	-4.8	-4.8	-3.4	-3.4	-4.7	-9.2	-5.5	-4.5
General government expenditure	59.5	52.6	48.8	49.5	50.4	44.8	47.1	60.5	63.6	58.2	na
General government debt	88.2	86.4	72.8	62.9	61.1	60.7	57.6	52.1	54.3	55.7	55.5
Monetary sector	<i>(Percentage change)</i>										
Broad money (M3, end-year)	14.0	20.8	22.7	20.3	16.9	13.2	18.0	17.1	9.5	14.2	12.0
Domestic credit (end-year) 4/	18.1	13.7	7.6	12.0	13.2	-6.4	14.8	6.2	20.5	na	na
	<i>(In per cent of GDP)</i>										
Broad money (M3, end-year)	49.4	46.4	46.4	45.9	45.5	45.6	46.6	48.4	46.2	48.8	50.1
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>										
Refinance rate	25.0	28.0	23.0	20.5	17.0	14.5	11.0	9.8	8.5	na	na
Interbank interest rate (up to 30-day maturity)	31.3	27.8	23.2	19.7	17.3	14.5	11.9	10.0	8.9	na	na
Deposit rate weighted average (fixed for less than one y	22.9	24.4	18.6	16.3	14.4	11.9	9.9	9.4	7.6	na	na
Lending rate weighted average (maturing within one yea	29.7	32.2	24.0	20.8	18.8	19.4	12.8	12.0	10.3	na	na
	<i>(Forints per US dollar)</i>										
Exchange rate (end-year)	110.7	139.5	164.9	203.5	219.0	252.5	284.7	279.0	225.2	na	na
Exchange rate (annual average)	105.1	125.7	152.6	186.8	214.5	237.3	282.3	286.5	258.0	250.0	260.0
External sector	<i>(In millions of US dollars)</i>										
Current account	-3,912	-2,480	-1,678	-981	-2,298	-2,081	-1,325	-1,118	-2,618	-5,276	-3,472
Trade balance 5/	-3,635	-2,442	-2,645	-1,963	-2,353	-2,176	-1,771	-2,029	-2,082	-4,410	-5,095
Merchandise exports 5/	7,613	12,810	14,183	19,637	20,749	21,844	25,861	28,074	34,792	40,587	44,438
Merchandise imports 5/	11,248	15,252	16,828	21,600	23,102	24,020	27,632	30,103	36,874	44,997	49,533
Foreign direct investment, net	1,097	4,410	2,279	1,741	1,555	1,720	1,123	2,255	598	1,354	1,782
Gross reserves (end-year), excluding gold	8,727	11,967	9,681	8,400	9,312	10,948	11,202	10,894	9,437	9,772	9,738
External debt stock	28,521	31,655	27,956	24,395	27,280	29,336	30,528	33,647	36,453	48,203	52,442
	<i>(In months of imports of goods and services)</i>										
Gross reserves (end-year), excluding gold	7.5	7.6	5.7	4.0	4.1	4.6	4.0	3.7	2.6	2.2	1.9
Debt service	na	na	85.3	40.2	31.4	20.8	14.9	13.4	12.3	14.9	13.4
Memorandum items	<i>(Denominations as indicated)</i>										
Population (end-year, millions)	10.2	10.2	10.2	10.2	10.1	10.1	10.0	10.2	10.0	10.0	10.0
GDP (in millions of forints)	4,364,811	5,614,042	6,893,934	8,540,669	10,087,357	11,393,508	13,145,717	14,824,000	16,980,000	18,370,222	20,060,282
GDP per capita (in US dollars)	4,052	4,359	4,425	4,495	4,641	4,757	4,637	5,083	6,581	7,348	7,715
Share of industry in GDP (in per cent)	21.9	23.1	23.5	25.0	25.9	26.7	27.9	27.2	na	na	na
Share of agriculture in GDP (in per cent)	5.9	5.9	6.1	5.8	5.4	5.3	4.6	4.9	na	na	na
Current account/GDP (in per cent)	-9.4	-5.6	-3.7	-2.1	-4.9	-4.3	-2.8	-2.2	-4.0	-7.2	-4.5
External Debt - Reserves, in US\$ millions	19,794	19,688	18,275	15,995	17,968	16,332	19,326	22,753	27,016	38,432	42,704
External Debt/GDP (in per cent)	68.7	70.9	61.9	53.3	58.0	61.1	65.6	65.0	55.4	65.6	68.0
External Debt/Exports of goods and services (in per cent)	267.2	176.3	138.6	96.2	102.3	106.7	94.9	94.0	85.6	96.2	94.6

Note: Data for 1992-99 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD. Data for 2000-2001 reflect EBRD evaluations, partly based on information from these sources.

1/ Data for public expenditure and imports in 1994 include payments for Russian military equipment.

Government consumption excludes social transfers, which are included in household final consumption.

2/ Data are from the Labour Force Survey.

3/ Government sector data are official fiscal balance data until 2000. 2001-2003 fiscal data are calculated by official sources on ESA95 basis.

4/ Changes in domestic credit adjusted to account for bank recapitalisation in 1994-1995.