DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR HUNGARY

As approved by the Board of Directors on 15 November 2005

TABLE OF CONTENTS

ABBREVIATIONS

AAK	State Motorway Management Company
EIB	European Investment Bank
EIF	European Investment Fund
ESCO	Energy Savings Company
ETS	Emissions Trading System
EU	European Union
EUR	Euro
FIDESZ	Alliance of Young Democrats
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GM	General Motors
HUF	Hungarian Forint
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
IFI	International Financial Institutions
IMF	International Monetary Fund
IOSCO	International organisation of Securities Commissions
IPO	Initial Public Offering
MAV	Hungarian State Railways
MAVIR	Hungarian Electricity System Operator
MDF	Hungarian Democratic Forum
MKB	Hungarian Foreign Trade Bank
MOL	Hungarian Oil and Gas Company
MSME	Micro, small and medium-size enterprises
MSZP	Hungarian Socialist Party
MT	Hungarian Telecom
MVM	Hungarian Power Companies Ltd
NATO	North Atlantic Treaty Organisation
NHH	National Telecommunications Authority
OECD	Organisation for Economic Co-operation and Development
OTP	National Savings Bank
PAYG	Pay As You Go
PCA	PCA-Budafok Cardboard Factory
PPP	Public Private Partnership
PSZAF	Hungarian Financial Supervisory Authority
SME	Small and medium size enterprises
SZDSZ	Alliance of Free Democrats
TSO	Transmission System Operator
TVK	Tisza Chemical Works
WWTP	Waste Water Treatment Plant

EXECUTIVE SUMMARY

Hungary continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. Over the last 15 years Hungary has made remarkable progress in transition and it is one of the most advanced countries among the new EU member-states with about 80 per cent of economic activity in private hands, a large degree of price liberalisation, an open foreign trade regime and liberal foreign investment conditions.

The accession of Hungary to the EU in May 2004 has positively influenced output growth and trade, agricultural incomes and infrastructure investment. Economic growth reached 4.2 per cent in 2004, up from 2.9 per cent in 2003, due to an increase in private investment, increased exports, and strong growth in agricultural production. However, macroeconomic imbalances remain significant. The fiscal deficit declined to 5.4 per cent of GDP in 2004. This was lower than the 6.5 per cent deficit in 2003 but higher than the original target, highlighting the need for significant further fiscal measures in order to avoid a destabilisation of the economy and enable Hungary's accession to the Euro zone as planned in the medium-term. Public debt reached around 57 per cent of GDP, with significant infrastructure investments undertaken off-budget. The current account deficit stabilised at around 8.8 per cent of GDP in 2004. The external deficit was financed by significant portfolio investments and foreign borrowing. Net foreign direct investments (FDI) recovered in 2004, after a temporary fall in 2003, and were equivalent to about 40 per cent of the current account deficit. The attractiveness of the country as a destination for FDI is enhanced by a 16 per cent corporate tax rate and tax exemptions for foreign strategic investors, but high real wages relative to other countries in the region pose a challenge to future competitiveness.

Regarding structural and institutional reforms, there has been some progress. Privatisation has almost been completed with two large transactions, Antenna Hungaria and Budapest Airport scheduled to be finalised in 2005. To improve the business environment, a simplified entrepreneurial tax was introduced for small and medium-sized enterprises in February 2003 that allows businesses to be taxed at a flat rate of 15 per cent of income, provided they forego all other tax incentives and deductions. Hungary's approach to road financing was consolidated with the adoption of a vignette system and the remuneration of private operators based on the availability of roads, rather than toll revenues. These principles were applied in 2004 to the restructuring of the M5 motorway, the M5 extension, and the tender for the M6 motorway. In 2003, the electricity market was partially liberalised, and regular biannual auctions for electricity were launched for trading companies and commercial users.

Looking forward, a number of key challenges still require attention:

- Structural measures need to be implemented to reduce fiscal deficits and public expenditures, including in the healthcare, education and pension sectors, to avoid a destabilisation of the economy and to enable Hungary's accession to the Euro zone in the medium term.
- The business climate requires further improvement, particularly with respect to the insolvency regime, the company registration process and the availability of credit information.

- New financial instruments need to be developed to address the needs of small and medium size enterprises and businesses operating in the agricultural sector, particularly in the less developed regions of the country.
- Investments in energy efficiency and renewable energy need to be promoted to reduce energy intensity and meet environmental targets.
- Transport and environmental infrastructure needs to be improved with the assistance of EU structural and cohesion funds, private sector involvement and local commercial co-financiers. The development of municipal projects requires the strengthening of municipal administrative capacity and cooperation, particularly among smaller municipalities, as well as improvements in procurement and project management standards.
- Non-banking financial institutions require consolidation and strengthening, including an increase in the efficiency of the pension fund system and the diversification of investment portfolios through the development of local equity markets and the introduction of new financial instruments.

As of 30 September 2005 the Bank had committed EUR 1,800.9 billion which attracted a further EUR 5,856.3 billion from sponsors and co-financiers. 2003 and 2004 were record years in terms new commitments and new business in 2005 is promising. In the upcoming strategy period, the Bank can continue to play a role by focusing selectively on transition challenges where it is additional.

The Bank's activities in Hungary will be based on the following operational objectives:

- Continue to work closely with local financial intermediaries on providing funding to the MSME sector.

- Provide higher risk products such as equity and structured debt for local corporations to fund their growth, in particular in the context of cross border expansion. Support foreign direct investment by medium sized companies in the less developed regions by providing higher risk products not offered by the private sector.

- Work on a limited number of high quality public private partnerships in the infrastructure sector, including in cooperation with EU structural and cohesion funds.

- Identify and fund energy savings projects and renewable energy projects.

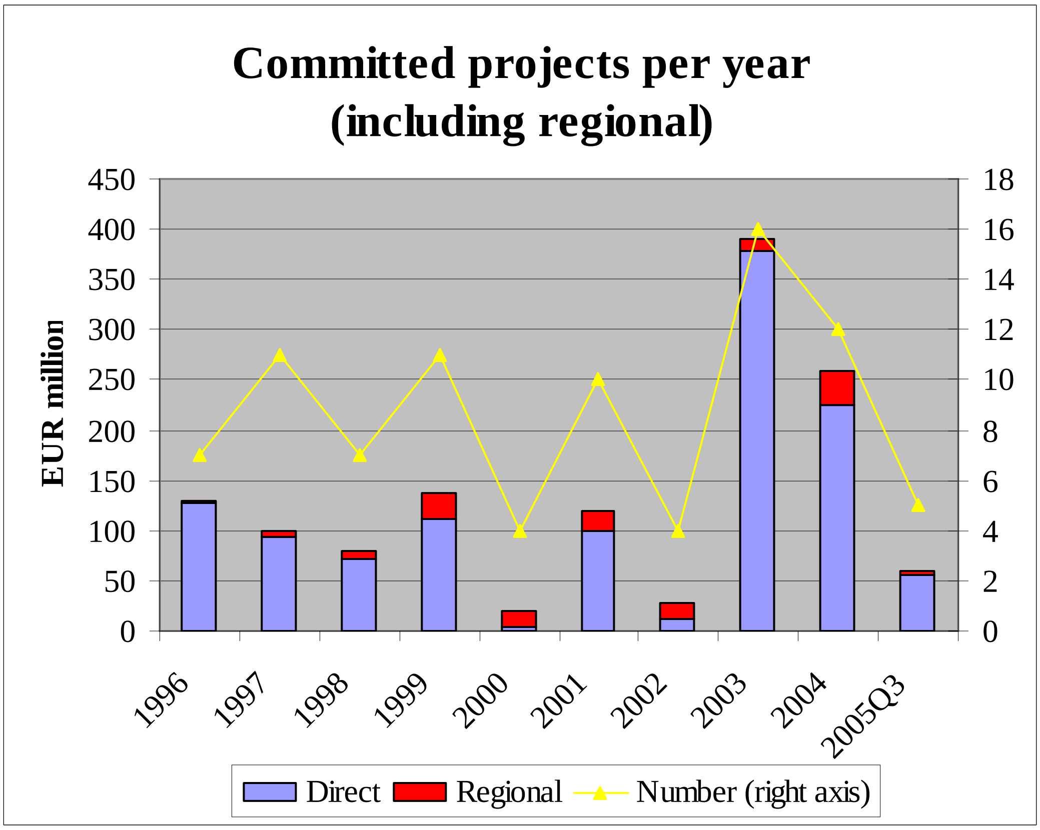
The Bank will continue to ensure that all its operations in Hungary meet sound banking principles, have transition impact, are additional and comply with the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans.

1. THE BANK'S PORTFOLIO

1.1 Overview of activities to date

As of 30 September 2005, the Bank's net cumulative commitments to projects in Hungary amounted to EUR 1,800.9 million (of which EUR 165.3 million was through regional projects) and accounted for 6.3% of the Bank's total commitments. Since the early years of the Bank's presence in Hungary the distribution of investments in the three major sectors of corporates, financial institutions and infrastructure has been well balanced as detailed in Annexes 1 and 2.

As illustrated by the following chart, EBRD's annual commitments increased during the last strategy period as compared to the two previous strategy periods. The increase was generated mainly by a new impetus to Public Private Partnership (PPP) financing of motorways and to the emergence of MOL, the Hungarian oil and gas company, as a regional player.



The current portfolio as of 30 September 2005 stood at EUR 800.5 million, representing 5% of the Bank's total portfolio. Undrawn commitments stood at EUR 152.1 million and impaired assets at EUR 36 million.

Current Portfolio by Industry (including regional projects)
(as of 30 September 2005)

Sector	**No. of projects**	**EBRD finance** (EUR million)	**Portfolio share**
General Industry	**3**	**15.4**	**2%**
Industry and Commerce	**10**	**108.9**	**14%**
Agribusiness	3	61.7	8%
Property, Tourism & Shipping	5	43.7	5%
Telecom, Informatics & Media	2	3.5	0%
Financial Institutions	**30**	**287.1**	**36%**
Bank Equity	1	15.9	2%
Bank Lending	4	76.2	10%
Non-Banking Financial Institutions	9	119	15%
Equity Funds	16	76	9%
Infrastructure	**13**	**389.1**	**49%**
Transport	6	209.8	26%
Municipal & Environmental Infrastructure	3	12.4	2%
Energy Efficiency	3	16.9	2%
Power & Energy	0	0	0%
Natural Resources	1	150	19%
TOTAL	**56**	**800.5**	**100%**
Of which debt	32	595	74.33%
Of which equity	23	205.1	25.62%
Of which guarantee	1	0.4	0.05%
Of which private	53	726.2	91%
Of which state	3	74.3	9%
Of which direct	29	692.1	86%
Of which regional	27	108.4	14%
Of which non-sovereign	53	726.2	91%
Of which sovereign	3	74.3	9%

1.2 Implementation of the previous country strategy

The last Country Strategy, approved on 2 September 2003, outlined the following strategic priorities for the Bank in Hungary:

- 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.
- support for the privatisation of the last few remaining fully or partially state-owned assets as well as for the restructuring, consolidation and regional

expansion of the local private sector, with particular attention to the provision of equity, mezzanine and other structured products. The Bank will support foreign direct investment, focusing on (i) projects in underdeveloped regions; (ii) projects developed by medium size foreign investors with 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.

- support infrastructure projects that do not rely on sovereign guarantee and effectively allocate risks among participants and increase the supply of long-term capital to the sector, including through public-private partnerships. This may include support through re-financings, where such financings are a customary feature of project implementation in developed markets and where re-financings may help develop local financial markets. The Bank will seek to co-operate on projects with EU Cohesion and Structural Funds. It will explore the scope for its potential contribution to the energy market liberalisation and to the much needed railways restructuring as well as to financing small municipalities through local financial institutions.

During the past two years the Bank signed 32 new projects with an aggregate value of EUR 704.7 million. The Bank has continued to play an important role in Hungary by providing financing to private companies and local financial institutions and working with private investors and the government in developing the country's infrastructure.

Infrastructure has been a very important part of operations in the period 2003-2005. Projects signed include loans for the M5 and M6 motorways, both built under PPP schemes as well as a loan for the MOL waste-water treatment outsourcing project. The Bank has sought to identify municipal projects in line with the strategic objective. However, the few larger municipalities were expecting EU grant funding and Government grants for their larger investment projects and local banks considered they have enough, quality (good pricing and tenor) resources available to finance small municipalities. Railway restructuring remains outstanding, while the gradual liberalisation of the energy market has not yet presented an appropriate investment opportunity for the Bank.

In the enterprise sector the Bank supported regional property projects (e.g. Orco Apart Hotels, Trigranit) with Hungarian components, the retailer Cora's regional expansion and MOL's major environmental investment programme. Local companies typically have acceptable gearing levels and enjoy access to affordable debt financing, making them wary of considering more structured financing instruments.

In line with its strategy for **financial institutions and SMEs**, the Bank has provided financing for SMEs through the EU/EBRD SME Facility channelled through six leasing companies and Volksbank. Over 4,000 SMEs have benefited from such EU/EBRD financing as of 30 September 2005. The Bank has facilitated the leasing market's move towards equipment leasing and the EU funded advisors have been able to assist the leasing companies in extending their financing to new sectors (e.g. agricultural machinery, construction plants, medical equipment leasing). The Bank took an equity stake in Uniqa insurance company, the subsidiary of an Austrian parent, which was aiming to increase competition in the Hungarian insurance sector and to expand into other insurance sub-sectors in Hungary, particularly health insurance, Uniqa's special area of competence. The Bank has also contributed to increasing the availability of equity financing through its financing for regional investment funds covering Hungary as well as for Euroventures III, an investment fund with Hungary as its primary investment target.

1.3 Transition impact of the Bank's operations

1.2.1 Financial Sector

The Bank has been present in the Hungarian banking sector from the beginning of the sector's reform in 1994, supporting privatisation and the involvement of strategic foreign investors. EBRD's engagement started with a convertible bond issue for Foreign Trade Bank (MKB), followed by investments in four major Hungarian banks. The Bank focused in its operations on mitigating regulatory risk in order to improve the investment climate for private investors, and – through its extensive presence on the 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.

EBRD has also been successful in reaching the SME segment, first through sectoral credit lines (ARP projects) and more recently through dedicated credit and leasing lines under the EBRD-EU SME facility and equity funds.

The Bank has contributed significantly to the reform of Hungary's secured transactions law and the establishment of a centralised collateral registration system. In light of the inadequacies of the regulation of mergers and acquisitions and minority shareholders' protection, 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.

Overall, high transition impact has been achieved in the Financial Sector.

1.2.2 Infrastructure and Environment

EBRD 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, M1/15, M5 and M6) and it promoted the involvement of private sector equity investors and pioneered the use of commercial finance in the sector. Slow reform and restructuring of the railway sector has hampered the Bank's efforts to contribute to this sector's development beyond the two transactions in the 1990s (Budapest Intermodal Logistic Center and MAV Railcars).

The Bank has supported the Hungarian ESCO market through, for example, its investments in the Dalkia-owned ESCO Prometheus as well as in the Dexia-FondElec Energy Efficiency and Emissions Reduction Fund. The latter is a regional equity fund where a substantial portion of capital has been invested through a Hungarian ESCO whose projects range from the leasing of co-generation engines to larger outsourcing projects with industrial clients.

EBRD has had some success in promoting the privatisation and outsourcing of waste-water management and improving environmental standards (Budapest Waste Water Privatisation, MOL WWTP Outsourcing and Environmental projects). Other efforts, however, have been hampered by fragmentation of local government (over 3,000 municipalities and only five Hungarian cities with population over 150,000) and the concentration of EU and central budget grants on the larger projects, thus reducing co-financing needs to small amounts.

Overall, moderate impact has been achieved in the Infrastructure and Environment Sector but higher impact in the transport sub-sector.

1.2.3 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). Owing to a much improved investment climate and the availability of commercial financing, the Bank has reduced its involvement in this market segment in the past few years and limited itself to projects in more difficult sectors (Ozdi Mini Steel Mill).

EBRD has played an active role in opening the international debt and equity markets for many large Hungarian corporates, including MOL, Matav, Trigranit, BorsodChem and Raba. Many of these clients have been able to capitalise on their transaction with the Bank and return to the market on their own. The Bank, however, has kept a role with some of these clients by financing selected projects as these clients have experienced lending limit issues with local banks or expanded regionally.

The Bank has also been active in supporting privatisation and restructuring of medium size Hungarian companies with local or foreign partners. In particular, it has actively made equity investments in such companies with an overall mixed experience.

Through its investments in the telecommunications sector, the Bank has fostered the restructuring and privatisation of the national operator (Matav, now Magyar Telekom) and the progressive emergence of a credible challenger (Vivendi Telecom Hungary, now Invitel) to the incumbent. Together, these investments contributed to creating what is today one of the most decentralised and competitive telecommunications industries in the region.

Overall, moderate transition impact has been achieved in the Enterprise Sector

- **Overall assessment and rating**

In general terms, the Bank's strategies for Hungary have shown a good understanding of the economic environment with well defined areas for the Bank's involvement. The Bank's efforts have yielded modest results in municipal financing as there are only a few sizeable municipalities that could consider major investment projects and they were anticipating EU funding for such projects. The small municipalities' investment project could be financed by local banks with keen interest in gaining/maintaining municipal clients for a range of their products and thus having high appetite for municipal risk.

1.4 Financial performance of the existing portfolio

The Bank’s portfolio in Hungary is sound. During the last two years the quality of the Hungarian portfolio remained stable on a very good level with the overall portfolio risk category being 4.78 (compared to 5.23 at the time of the adoption of the previous country strategy). It reflects the Bank’s portfolio management/clean-up efforts as well as the quality of the transactions signed during the past two years.

1.5 Mobilisation of co-financing

The Bank has mobilised EUR 5,856.3 billion in additional funds since it began operations in Hungary. In the past two years the mobilisation ratio increased from 4.0 to 4.25, mainly as an effect of the MOL Environmental Loan syndicated facility, the M5 Phase II and M6 Phase I motorway projects as well as the Euroventures III investment fund.

1.6 Selected Lessons Learnt

- Equity investments in companies with no strategic investor should be subject to confirmation of the quality of management, medium-term corporate strategy and of good corporate governance structure – or related changes should be agreed upon in a shareholders’ agreement. (Borsodchem, Raba)

- The EU/EBRD, incentive based SME programme helped to change the attitude of leasing companies to smaller clients and equipment leasing and thus speeded up the availability of funding to this segment.

- Subsequent involvement in projects in the same sector coupled with active sector policy dialogue and TC assistance can help shape government policy and bring innovative financing structures. (M0, M1/15, M5, M6)

2. OPERATIONAL ENVIRONMENT

2.1 The General Reform Environment

2.1.1 Political environment

Hungary successfully implemented major transition reforms in the early 1990s. Its dynamic enterprise and bank privatisation and favourable investment climate attracted significant foreign direct investment, including in green field projects and major utilities. Strong local corporates emerged in the late 1990s, now increasingly aspiring for regional role, while the growing SME sector is still undercapitalised and is in dire need of innovation and improved management skills. Recent years have been dominated by the adoption of the EU acquis communautaire and the entry to the EU in May 2004. Since EU accession attention has focused on completing the privatisation of the remaining state-owned companies, restructuring commercial motorway financing and working on the National Development Plan for 2007-2013 with increasing use of PPP schemes.

After parliamentary elections in April 2002, a coalition government made up of the Hungarian Socialist Party (MSZP) and the Alliance of Free Democrats (SZDSZ) was formed under Peter Medgyessy as Prime Minister. Medgyessy resigned in August 2004. Sports Minister and successful businessman Ferenc Gyurcsany was elected Prime Minister on 29 September 2004. Mr Gyurcsany launched the "100 steps" programme envisaging gradual improvements in a vast array of sectors ranging from healthcare to labour market regulations. National elections are due in May 2006.

While the legal and regulatory systems are largely transparent, corruption remains a problem with only little improvement during the last two years.

2.1.2 Environmental Issues

Legal Progress: Hungary has achieved almost full alignment with the environmental "acquis communitaire" of the EU by its accession in May 2004. There were only four areas of derogation:

1. Compliance with the large combustion plant directive, which was achieved by the end of 2004.
2. Compliance with the hazardous waste incineration directive, which was achieved by June 2005.
3. Compliance with the directive requiring 50% recycling of packaging materials, which is expected to be achieved by end of 2005.
4. However, compliance with the communal waste water treatment directive is expected only by the end of 2015 and there is a significant need for financing of new waste water collection and treatment projects.

Ozone Protection: Hungary is a party to the Convention for Protection of the Ozone Layer and its amendments. The complete phase out of ozone depleting agents was completed prior to EU accession.

Climate Change: Hungary has adopted a national green house gas allocation plan and the legal framework for monitoring and permitting procedures in June 2005. This programme offers opportunities for the Bank to finance new energy efficiency and renewable energy projects.

2.1.3 Legal Reform

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.

Hungary's normative laws are approaching international standards, supported by institutional mechanisms to implement these laws, and as a result the country compares well overall with other transition countries. In particular, the legal regime for secured transactions and the rules relating to corporate governance are well developed. However, improvements are still needed in some areas crucial to the business environment and to foreign investment, in particular in the field of insolvency and concessions. In addition, the surveys of legal implementation conducted by the EBRD indicate that at times commercial laws may suffer as a result of not always being sufficiently accessible or through inadequate administrative and judicial support.

2.2 Progress in transition and the economy's response

2.2.1 Macroeconomic conditions for the Bank's operations

After a relatively strong expansion in 2004 (4.2 per cent GDP growth), economic growth slowed down to an annualised 3.5 per cent in the first half of 2005 and is expected to reach about 3.5 per cent in the whole year. Last year's performance was driven primarily by exports, which grew by about 14.9 per cent, as domestic demand was held back by increasing unemployment and low real wage growth. Fixed capital investments rose by a robust 8.3 per cent year-on-year in the half of 2005, largely triggered by the extensive motorway building programme of the government.

Hungary's GDP per capita in 2004 stood at 61 per cent of the average of the enlarged EU (EU-25) which was below the levels of the Czech Republic (72 per cent) and of Slovenia (78 per cent) but above all other transition economies that joined the EU on 1 May 2004. In terms of regional differences, the 2002 GDP per capita in the capital region of Central Hungary was at 96 per cent of the EU-25 average, while GDP per capita in the poorest Northern Hungary region was only at about 37 per cent of the EU-25 average, making it the sixth poorest region in the enlarged EU.

The persistent fiscal deficit remains the main macroeconomic problem. The government has repeatedly missed its own deficit targets and avoided structural reforms that could lead to reduction of the most persistent budgetary expenditures, which include state pensions, salaries of public sector employees as well as healthcare and education expenditures. Insufficient revenues and weak expenditure discipline persisted in the first half of 2005. As a result, the original full-year budget deficit target of 3.8 per cent of GDP (according to a methodology that treats contributions to the third pension pillar as budgetary revenues) could have only been kept by transferring large infrastructure projects to off-budget financing. As the Eurostat rejected this practice and following additional fiscal slippage, the 2005 budget deficit is now expected to be around 6.1 per cent of GDP. This compares to 6.5 per cent of GDP in 2003, 5.4 per cent in 2004, and the 2005 target of 3.6 per cent of GDP recommended under the excessive deficit procedure in March 2005, following an update of Hungarian convergence programme in December 2004.

2004 inflation reached 6.8 per cent, largely driven by one-off effects of value added tax (VAT) and excise tax rate hikes in early 2004 and higher oil prices. Inflation has nevertheless been falling since June 2004 reaching about 3.7 per cent by July 2005. The decline over the past year has allowed the Central Bank to lower the reference rate, in a series of cuts to 6 per cent by September 2005, down from 9.5 per cent in January 2005. The central bank continues to operate an inflation targeting regime, with the 2005 and 2006 inflation targets at 4 and 3.5 per cent (± 1 per cent), respectively. The Hungarian forint trades against EUR within a band of ± 15 per cent around a central parity which was fixed at forint 282.36 per EUR in June 2003.

The current account deficit was 8.8 per cent of GDP in 2004, same as in 2003, and is expected to remain at a similar level in 2005. The external balance was financed by government and corporate borrowing, significant (but volatile) portfolio investments, and foreign direct investment (FDI). Due to large Hungarian investments abroad and repayment of inter-company loans, net FDI had declined in 2003 even though net equity inflows exceeded the 2002 value. However, it recovered to an estimated 3.7 per cent of GDP in 2004. About half of it has been financed by inflows of FDI, both in the form of retained profits and new flows.

2.2.2 Transition successes and challenges

Hungary has made remarkable progress in transition since the early 1990s. In many areas of structural reforms the country took the lead among the transition economies. The transition indicator scores published in the *2005 Transition Report* indicate that Hungary is, on average, the most advanced in transition among the new EU member states in the seven measured categories, though it is closely followed by Estonia and the Czech Republic. In three categories, price liberalisation, trade and foreign exchange liberalisation and small-scale privatisation, Hungary has already achieved standards of a well functioning market economy.

Nevertheless, a number of transition challenges remain in Hungary. These challenges, identified in the 2005 Assessment of Transition Challenges, are described in the following paragraphs. Please refer to the snapshot table in Annex 5 for individual sector-by-sector ratings.

Enterprise sector

Enterprise performance: *Despite high productivity, there is a need for efficiency improvements, a more flexible labour market and diversification towards services*

Hungary has the second highest level of productivity of all transition economies that joined the EU on 1 May 2004. When measured by the GDP generated by each employed person in purchasing power parity terms, Hungary's productivity in 2004 was estimated at around 65.1 per cent of the average of the European Union prior to the May 2004 enlargement (EU-15), compared to only about 52.9 per cent in 1995. Hungary made most of its substantial gains in competitiveness between 1992 and 2000. In 2001-03, the country's competitiveness was seriously eroded by an appreciating real exchange rate, slowing productivity growth and rapidly rising wages. Although this trend was arrested in 2004, further developments will depend on improvements in productivity and constrained growth in real wages.

There is also room for adjustment in the structure of the Hungarian economy. In 2004 industry (excluding construction) represented 27.2 per cent of total value added against 21 per cent on average in the EU-15, while services accounted for 62.2 per cent of total value added compared to 71.4 per cent in the EU-15. This is, to some extent, an indication of the room for further development in new service activities, in the SME sector in particular. There is also room for development in high value-added sectors, including in new technologies.

Specialised Industries

In ***agribusiness*** land privatisation is close to completion, but title registration of privatised land is progressing slowly. Foreigners and legal persons (e.g. companies and corporations) cannot own agricultural land and there is a 300 ha limit set for individual land ownership. The privatisation of agro-processing, input supply and service companies is close to completion, but new owners still have to reduce costs, improve efficiency and upgrade hygiene standards in order to become internationally competitive. An appropriate financial system for agriculture is developing only slowly. The state still relies on interest rate subsidies and credit guarantee schemes. However, frameworks for using warehouse receipts financing and appropriate insurance services are developing.

The ***real estate*** sector is developing fast, including new types of property as well as financing instruments. Private sector involvement in operation of industrial parks, development of logistic centres as well as in major tourism and city/cultural rehabilitation projects is next on the agenda.

SME: *Need to develop better tailored financial instruments*

Small and medium enterprises (SME) form the backbone of the Hungarian economy and are crucial providers of employment and services, particularly in the poorer areas of the country. Due to their size and business model, SMEs have the most difficult access to external finance. Nevertheless, most commercial banks now have dedicated SME departments, and bank credit to enterprises is growing albeit only at one quarter of the rate at which bank credit to households is growing. Several highly subsidised microfinance programmes are in place making it difficult to establish commercially-based microfinance, although some loans/leases are being extended under IFI-supported credit lines. Collateral and bankruptcy legislation are supportive of SMEs and microfinance lending. The cost of registering collateral is moderate. A credit registry exists and provides information on 3.3 per cent of the population.

Foreign investment: *Reinvested profits are the main source of FDI which increasingly concentrate on high value-added areas and is slowly moving to the eastern, less developed part of the country*

After a slowdown in 2003, foreign direct investments (FDI) picked up to about USD 3.7 billion in 2004. About half of this amount came in the form of reinvested profits and the country lost a number of new visible investments to its neighbours, including most notably Slovakia and Romania. As the era of large scale green-field investments in Hungary might be over, Hungarian industry has moved up the value-added chain, implying that low labour costs have become less important in investment decisions. Companies increasingly consider locating headquarters functions in Hungary, such as research and development or regional centres. Some foreign investors have relocated to lower-wage destinations, such as the eastern part of Hungary or to neighbouring countries, and others are thinking about doing so. Rising labour costs and shortages of skilled workers tend to be cited as key issues. In addition, other countries in the region have become serious competitors for investment.

Financial sector

Banking sector: *The banking system is sound but the increasing share of foreign currency loans may become a problem in medium term*

The privatisation of the banking sector is almost finished, with state-owned banks having no significant asset share. The ratio of domestic credit to the private sector to the country's GDP ratio is high by regional standard. The basic regulatory framework is in place. The number of banks is stable and a majority of them are foreign-owned. Although loans to corporate clients form most of the banks' portfolios, the share of loans to households is growing rapidly. Most of the new household loans are mortgages, usually denominated in foreign currencies. Among the corporate loans, there is an increasing shift in focus towards SMEs and foreign currency denominated lending.

Private Equity Funds: *The equity funds are yet to become more visible providers of finance to enterprises.*

Hungary has one of the most developed private equity fund sectors in the transition economies. Private equity investment as percentage of GDP in Hungary is comparable to that of Austria and exceeds that of Greece. The importance of domestic investors is increasing, though they are still dominated by government agencies and banks (mainly the Hungarian Development Bank).

Non-banking financial institutions: *The insurance and pension sectors are growing but their portfolios are tilted toward government bonds. Improvements in regulation of the pension sector are needed.*

Although the financial sector is still dominated by commercial banks, the share of non-banking financial institutions in the total assets of the financial sector is growing steadily. Most of the Hungarian financial enterprises are involved in financing household car purchases and car leasing. Insurance legislation and regulation almost fully meet IAIS standards with high quality of staff at the regulatory authority. The growth in the non-life insurance sector is partially fuelled by the expansion in consumer and housing loans and the accompanied insurance demands. The portfolio composition of insurance companies is conservative in comparison with their counterparts in other EU member states, being heavily weighted toward government bonds and other fixed income assets. The sector also appears to be in need of some consolidation.

The private pension system is still small and accounted for only about 7 per cent of the assets of the financial sector at the end of 2004. There are 18 mandatory and more than 150 voluntary privately managed pension funds. The return performance of the system has been rather disappointing, as the annualised net rate of return between 1998 and 2003 (10.7 per cent) was slightly above the level of inflation (8.6 per cent) and short of the average wage growth (12.7 per cent). This was partially due to the large share of government bonds in funds' portfolios (about 75 per cent). Competition between pension funds also suffers from lack of comparability between fee structures and rates of return, while portfolio diversification is negatively affected by a conservative investment culture of asset managers and a lack of alternative investment instruments. As a result, the pension system appears to be in need of some fine-tuning to improve its efficiency and enhance the process of collecting the contributions, investment allocation and future payout of benefits.

Capital markets: *Capital markets are developing but the number of available instruments is still small*

Although the Hungarian capital markets have grown in the recent years, they still remain underdeveloped by EU standards. The Budapest Stock Exchange market capitalisation has recovered to around 25 per cent of GDP after a drop to 18 per cent in 2002. Mortgage bonds have been introduced and their outstanding stocks reached around 6 per cent of GDP. There is also some derivative trading, mainly in futures. The market is nevertheless dominated by traded government debt which grew to an equivalent of about 44 per cent of GDP in 2004. Corporate and municipal debt is nearly non-existent. The legislative framework for securities markets almost meets IOSCO standards but the effectiveness of the regulator could be strengthened with respect to disclosure obligations, and shareholders' rights.

Infrastructure and environmental sector

Energy sector: *Full unbundling, further liberalisation and development of energy efficiency and renewable energy sectors are the main challenges*

The Hungarian Government is currently reviewing a proposal for modifying its electricity market model in order to enhance competition and achieve full compliance with the relevant EU Directives. Recently, MAVIR (the independent system operator) was reintegrated into the state-owned power company, Magyar Villamos Muvek (MVM), owner of the transmission network and a major electricity wholesaler, as a first step towards the new Transmission System Operator (TSO) model. Generally, there is substantial private sector participation in the distribution and generation through early privatisation to strategic investors. Partial liberalisation of the electricity market started in 2003 with the launch of regular biannual auctions for electricity trading companies and commercial users. Since early 2004 all non-residential customers are free to choose their electricity provider. The process of liberalisation, however, is hindered by both technical difficulties and rigid legislation. In particular, MVM, which controls about 80 per cent of Hungary's generation capacity through long term contracts, appears to limit the amounts of energy available to be traded in the free market. In addition, the Hungarian energy market remains characterised by high prices and cross-subsidies, with large industrial consumers subsidising relatively low household energy prices.

Energy intensity in Hungary is still 0.21 (2002 data calculated against GDP at purchasing power parity), which is approximately 24% higher than the corresponding figure for EU-25 countries. There is significant potential for energy savings throughout the economy and the development of the energy efficiency sector remains an important transition challenge. Hungary has promising potential for renewable energy (in particular biomass and wind) and has committed itself to generate 3.6% of its electricity output from renewable sources by 2010, which compares to a most recent figure of approximately 0.7%.

The ESCO market is reasonably developed, with some commercial and residential energy efficiency projects. Hungary has ratified the Kyoto protocol and as a new EU member is part of the Emissions Trading System (ETS). However, government agencies have been slow in considering and approving renewable energy projects and the scheme of obligatory purchase of energy from renewable sources together with a supportive tariff system has not yet been extended beyond 2010 – impeding significant investment.

The oil and gas company, MOL, has developed into an international quality oil and gas company. Although MOL remains vertically integrated, it has divested some non-core assets, including its gas distribution companies.

Transport: *Railway reform is a priority; private involvement in road construction and management of transport facilities is expected to pick up*

The Hungarian government has embarked on an ambitious motorway construction programme. Most of the investments are to be implemented by the state owned State Motorway Management Company (AAK.) PPP structures have been extended to a handful of projects, including the M1/M15 motorway and, the more successful, M5 and M6 motorways. Road sector finance in Hungary has been in line with EU standards but the quality of secondary roads remains poor and PPP structures are being considered for their development.

The railway sector is a clear laggard in the overall reform process. MAV, the national railway company has yet to undergo major restructuring, although operating and policy setting functions have been separated and core railway functions have been divided into individual business units within the company while ancillary services have been divested. Access to the track is legally available but not fully working in practice. There is limited private participation in the sector and a long term government vision has yet to be presented.

The privatisation of Budapest Airport Ltd, the airport operator in Budapest, is likely to be completed in 2005. Regional airports are slowly being developed, with selective government support and limited private involvement, for charter and low cost flights as well as air cargo.

Municipal and environmental infrastructure: *Expected injection of EU funds needs to be matched by local absorption capacity and readiness to involve private sector whenever appropriate*

The municipal sector in Hungary remains fragmented, and is often suffering from poor administrative capacity. With more than 3,000 municipalities in reality, only few large cities can access external financing on reasonable terms. There is also a high degree of intervention by the government into municipal finances and investments. The regions, established for statistical and planning purposes, are intended to gain an increasing role. There is noteworthy private sector participation in water and to a lesser extent in district heating, but very little in public transport, waste water and solid waste management. The institutional framework for municipal finance is in place and tariffs have been mostly adjusted to reflect costs, but experience of revenue-based financing is very limited.

The sector faces substantial challenges related to the implementation of infrastructure and environmental projects co-financed from the EU funds. When co-financing is not available from the central budget, there is scope for private sector involvement through PPPs but there is little experience, both at the levels of central and local governments, in implementing municipal PPP projects. In addition, many investments will go beyond one municipality and there will be a need for regional cooperation. Besides the necessity of meeting EU environmental standards, Hungarian municipalities will face the challenge of upgrading their aging housing stock, local healthcare and educational facilities, as well as roads and urban transport systems.

Telecommunication: *Market is fully liberalised but further competition in fixed line services would be useful*

Hungary is widely regarded as being one of the most advanced of the region. The dominant fixed line incumbent, Magyar Telekom ("MT", former MATAV), has been fully privatised through an IPO. The government was committed to the introduction of competition, as highlighted by the ending of the monopoly of the incumbent a year earlier than originally envisaged. The mobile telecommunication market is fully competitive and there is a group of strong fringe players challenging the dominant position of MT on the slowly contracting fixed line market, though in June 2004 MT still controlled about 79 per cent of fixed lines in service.

3. Strategic orientations

3.1 Bank's Priorities for the Strategy Period

In response to the analysis of Hungary's remaining transition challenges, the Bank's main focus during the strategy period will be to

- Continue to work closely with local financial intermediaries on providing funding to the MSME sector.

- Provide higher risk products such as equity and structured debt for local corporations to fund their growth, in particular in the context of cross-border expansion; support foreign direct investments by medium sized companies in less developed regions by providing higher risk products not offered by the private sector.

- Work on a limited number of high quality public private partnerships in the infrastructure area, also in cooperation with EU structural and cohesion funds.

- Identify and fund energy savings projects and renewable energy projects.

The Bank will continue to ensure that all its existing projects comply with the Bank's environmental requirements and new projects will be structured in accordance with the Environmental Policy. The challenges raised within Section 2 have environmental dimensions (such as energy efficiency and communal waste water treatment) which will be a focus of attention and of awareness-raising, not only during environmental due diligence but also during on-going dialogue with the Bank's clients.

Policy dialogue
The Bank will build on its good relationship with local authorities to find appropriate solutions for the efficient use of EU structural and cohesion funds to implement infrastructure and environmental projects, including through PPP structures, where appropriate. The Bank will explore how to assist best the Government's recently re-launched railways restructuring efforts as well as its renewable energy/energy efficiency programme.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Enterprise Sector

Transition Goals
Based on the analysis in section 2.2.2 the following Transition Goals are relevant for the Enterprise Sector:

- Development of higher value added activities through support of FDIs, cross-border cooperation and local entrepreneurs, particularly in the less developed regions of the country.
- Development of better tailored financial instruments for MSMEs.

Operational Priorities

- Provide higher risk products such as equity and mezzanine financing to the private sector for local operations as well as cross border expansion targeting countries of East and South East Europe.
- Support FDI targeting green-field and brown-field projects in less developed regions of the country and acquisitions/expansions of their existing local operations.

3.2.2 Financial Sector

Transition Goals

Based on the analysis in section 2.2.2 the following Transition Goals are relevant for Financial Sector:

- Assist in the consolidation and development of the non-banking financial sector and in the introduction of innovative financial products.
- Broaden accessibility of local corporate sector, particularly medium size companies, to equity, quasi-equity and structured finance.

Operational Priorities

- Selectively commit capital to new equity funds with a focus on SMEs.
- Mobilise local institutional investors to provide capital to the corporate sector through the development of appropriate investment instruments

3.2.3 Infrastructure and Environmental Sector

Transition Goals

Based on the analysis in section 2.2.2 the following Transition Goals are relevant for the Infrastructure and Environmental Sector:

- Reform and improved efficiency of the railway sector.
- Full unbundling and further liberalisation of electricity markets.
- Increase of energy efficiency and development of a stable regulatory framework that facilitates the financing of renewable energy projects.
- Sound management and implementation of the PPP based motorway projects
- Environmental investments in municipalities, wherever possible with private sector involvement or the use of local commercial co-financing.

Operational Priorities

- Support of private sector participation in financing of at least two major infrastructure or municipal/environmental services projects.
- Develop an energy efficiency credit line or risk-sharing facility for the residential and/or SME sector; the Bank will seek to mobilise technical assistance and, possibly, grant co-financing.
- Support at least one renewable energy or co-generation project, if possible with the use of carbon credits.
- Develop and finance stand-alone energy efficiency projects with industrial clients.

4. Other IFI's and the European Union

4.1 European Union (EU)

Hungary was allocated EU structural and cohesion funds in excess of EUR 3.2 billion for 2004-2006. The Community co-financing of EUR 1.99 billion under the structural funds is allocated according to the following priorities:

- Increasing the competitiveness of the productive sector, including agriculture and rural development.
- Promoting employment and human resource development.
- Improving transport infrastructure and protecting the environment.
- Strengthening regional and local potential.

Under the cohesion fund a further EUR 1.1 billion is available for Hungary to co-finance infrastructure in the environment and transport sectors and an amount of EUR 88 million has been made available for technical assistance.

4.2 European Investment Bank (EIB)

Since 1990 the EIB has lent in excess of EUR 5.5 billion in Hungary. The most recent projects include support for the 4th underground line in Budapest, the Budapest Central Waste Water Treatment Plant, a student loan scheme, loans for the construction of the Budapest Ring Road M0, the rehabilitation of the railway line connecting Budapest with the border to Romania and for the financing of smaller projects mainly implemented by SME's and municipalities by means of EIB Global Loans extended to local banks.

4.3 International Monetary Fund (IMF)

Hungary has been a member of the IMF since 1982. The last stand-by agreement with the IMF expired in 1998. The IMF undertakes annual consultation visits to Hungary. Its assessment of the Hungarian economy (Article IV consultations) was published in June 2005, while a concluding statement after a staff visit was published in September 2005. .

4.4 World Bank

Hungary has been a member of the World Bank since 1982. The aggregate World Bank's commitments to Hungary exceeded US$ 4 billion for around 40 operations. There is one ongoing project - for municipal waste water focusing on Budapest and Dunaujvaros and supported by a US$ 31.6 million loan. Project completion is expected by December 2006.

4.5 International Finance Corporation (IFC)

Hungary has been a member of the IFC since 1985. IFC invested in 28 projects involving around US$ 250 million from its own account and US$ 70 million in syndications from other banks. The most recent IFC project in Hungary, supporting financing of SMEs, was approved in 2003.

ANNEX 1: COMMITTED PROJECTS PER YEAR

Year	Op Name	Direct/Regional	Total Project Value	EBRD Finance	Debt	Equity	Operation Stage
1991	Petofi Nyomda Rt.	Direct	5.1	5.1	5.1	0.0	Completed
1991	**1**		**5.1**	**5.1**	**5.1**	**0.0**	
1992	Hungarian Telecommunications Project	Direct	215.5	33.6	33.6	0.0	Completed
1992	Westel Radiotelefon KFT	Direct	8.2	8.2	8.2	0.0	Completed
1992	Fusion Inv. Co. Fast Food Restaurant Chain	Direct	20.7	3.0	0.0	3.0	Completed
1992	General Motors	Direct	82.1	30.7	30.7	0.0	Completed
1992	Budapest Orbital Motorway (MO) Project	Direct	108.8	21.0	21.0	0.0	Completed
1992	TVK/Columbian Tiszai Koromgyarto KFT	Direct	46.0	7.4	7.4	0.0	Completed
1992	**6**		**481.2**	**103.9**	**100.9**	**3.0**	
1993	Kner Nyomda RT	Direct	5.5	1.5	1.5	0.0	Completed
1993	Eurocorp	Direct	2.6	0.1	0.0	0.1	Completed
1993	New Europe East Investment Fund	Regional	23.0	4.9	0.0	4.9	Repaying
1993	PCA-Budafok (Kartongyar) KFT	Direct	13.4	3.3	3.3	0.0	Completed
1993	HungarianForeign Trade Bank (MKB) - Bond Issue	Direct	33.2	7.7	7.7	0.0	Completed
1993	Magyar Hotec (Formulae 1 Hotel), under RZB ag line	Direct	1.7	0.9	0.9	0.0	Completed
1993	Dun & Bradstreet	Regional	0.3	0.3	0.0	0.3	Completed
1993	ARP - Budapest Bank RT	Direct	6.6	6.6	6.6	0.0	Completed
1993	ARP - Kereskedelmi (Credit and Commercial Bank)	Direct	33.6	33.6	33.6	0.0	Completed
1993	ARP - OTP (National Savings Bank)	Direct	17.7	17.7	17.7	0.0	Completed
1993	Budapest Public Transport Rehabilitation Project	Direct	85.4	45.4	45.4	0.0	Completed
1993	Goldsun	Direct	4.1	4.1	4.1	0.0	Completed
1993	Hungarian Telecommunications Equity Investment	Direct	272.9	50.9	0.0	50.9	Completed
1993	Pannonia	Direct	48.8	6.3	0.0	6.3	Completed
1993	EGIS Pharmaceuticals - Partial Privatisation	Direct	37.8	37.8	0.0	37.8	Completed
1993	M1-M15 Motorway Project	Direct	249.7	72.2	68.2	4.0	Completed
1993	**17**		**836.4**	**293.2**	**188.9**	**104.3**	
1994	Budapest Wholesale Market	Direct	19.7	4.4	4.4	0.0	Completed
1994	Framochem - Borsod Chem/SNPE	Direct	5.1	0.6	0.6	0.0	Completed
1994	ARP - Magyar Hitel Bank (Hungarian Credit Bank)	Direct	9.2	9.2	9.2	0.0	Completed
1994	Hungarian Foreign Trade Bank (MKB) - Privatisation	Direct	31.4	17.5	0.0	17.5	Completed
1994	Advent Private Equity Fund - Central Europe LP	Regional	21.7	5.8	0.0	5.8	Repaying
1994	OTP Bank	Direct	10.7	10.7	10.7	0.0	Completed
1994	Central Business Center	Direct	18.5	5.9	4.9	1.0	Completed
1994	MOL Rt: Zsana Gas Container Project	Direct	70.0	20.6	20.6	0.0	Completed
1994	**8**		**186.3**	**74.6**	**50.2**	**24.3**	
1995	Hungarian Capital Fund	Direct	19.0	9.4	0.0	9.4	Completed
1995	Cofinec SA (Kner)	Direct	10.1	4.2	0.0	4.2	Completed
1995	MBA Loan Project (guarantee)	Regional	1.2	0.4	0.4	0.0	Repaying
1995	Graboplast Capital Increase	Direct	5.4	2.4	0.0	2.4	Completed
1995	East European Food Fund	Regional	37.9	7.8	0.0	7.8	Disbursing
1995	Investel Syndicated Loan Facility	Direct	764.1	13.2	13.2	0.0	Completed
1995	ARP - Budapest Bank Rt- Extension	Direct	0.4	0.4	0.4	0.0	Completed
1995	M5 Concession Motorway B.O.T.	Direct	310.7	61.0	61.0	0.0	Completed
1995	Budapest Bank Privatisation (equity)	Direct	36.6	36.6	0.0	36.6	Completed
1995	Prometheus ESCO Financing	Direct	3.8	3.8	3.8	0.0	Completed
1995	Deltav Rt. - Hungary Regional Telecommunications	Direct	153.6	23.5	21.6	1.9	Completed
1995	**11**		**1,342.9**	**162.8**	**100.4**	**62.4**	

1996	ARP - Kereskedelmi (Bank Extension)	Direct	30.9	30.9	30.9	0.0	Completed
1996	Borsod Chem Rt Privatization	Direct	14.8	14.8	0.0	14.8	Completed
1996	Digitel 2002 Rt	Direct	95.1	15.3	13.9	1.4	Completed
1996	Szikra Lapnyomda Rt.	Direct	10.9	6.1	4.1	2.0	Repaying
1996	New Europe Insurance Ventures	Regional	3.2	0.9	0.0	0.9	Repaying
1996	OTP Subordinated Loan	Direct	41.2	41.2	41.2	0.0	Disbursing
1996	Budapest Bank Credit Line for Environment and Energy	Direct	26.8	9.3	9.3	0.0	Repaying
1996	**7**		**222.9**	**118.4**	**99.4**	**19.1**	
1997	Winterthur MPF/CS L&P Penztarszolgaltato (equity)	Direct	8.5	4.5	0.0	4.5	Disbursing
1997	Hungarian Equity Partners	Direct	19.7	9.3	0.0	9.3	Repaying
1997	Raba Rt.	Direct	69.2	9.6	0.0	9.6	Disbursing
1997	DBG Osteuropa Holding GmbH	Regional	7.1	2.6	0.0	2.6	Repaying
1997	Prometheus II	Direct	28.9	16.1	9.6	6.5	Repaying
1997	Hungarian Foreign Trade Bank (MKB) Capital Increase	Direct	65.4	11.5	0.0	11.5	Completed
1997	Kereskedelmi es Hitelbank Rt	Direct	26.2	26.2	0.0	26.2	Completed
1997	Baring Communications Equity	Regional	12.7	2.5	0.0	2.5	Repaying
1997	Hungarian Commercial Television	Direct	52.4	12.2	12.2	0.0	Completed
1997	Advent Central & Eastern Europe II - Regional Fund	Regional	16.5	5.8	0.0	5.8	Repaying
1997	SRP - Hungarian SRP - Ganz Gipgyar Holding Kft	Direct	4.0	4.0	0.0	4.0	Completed
1997	Environmental Investment Fund	Regional	2.2	0.5	0.0	0.5	Disbursing
1997	**12**		**313.0**	**104.9**	**21.8**	**83.1**	
1998	Winterthur MPF/CS L&P Biztosito (equity)	Direct	10.1	4.9	0.0	4.9	Disbursing
1998	MAV - Railcar Modernisation and Marketing Project	Direct	220.0	40.0	40.0	0.0	Repaying
1998	Innova/98 LP	Regional	9.8	2.0	0.0	2.0	Repaying
1998	MBA Loan Project II (guarantee)	Regional	0.2	0.0	0.0	0.0	Completed
1998	Budapest Waste Water Services Privatisation	Direct	38.3	11.9	11.9	0.0	Disbursing
1998	CGE MPF Budapest Wastewater Service Privatisation	Direct	38.3	11.9	11.9	0.0	Disbursing
1998	**6**		**316.8**	**70.6**	**63.7**	**6.9**	
1999	Info. and Comm. Tech & Industrial Electronic Fund Ltd.	Regional	11.3	2.5	0.0	2.5	Disbursing
1999	AIG New Europe Fund	Regional	40.5	7.1	0.0	7.1	Repaying
1999	M1-M15 Motorway Restructured Project	Direct	204.8	65.8	65.8	0.0	Repaying
1999	L&G ESCO Hungary	Direct	3.5	1.2	0.9	0.3	Completed
1999	OTP Equity Investment	Direct	21.5	21.5	0.0	21.5	Repaying
1999	Ozdi Acelmuvek Kft Minimill Project	Direct	19.9	10.2	10.2	0.0	Repaying
1999	Honeywell ESCO Hungary	Direct	10.6	0.4	0.0	0.4	Disbursing
1999	Regional/Private Equity Fund Facility - Trigranit	Regional	37.5	6.8	0.0	6.8	Completed
1999	Energy Efficiency and Emissions Reduction Fund	Regional	10.7	3.0	0.0	3.0	Disbursing
1999	Emerging Europe Capital Investors LDC	Regional	20.4	5.5	0.0	5.5	Disbursing
1999	Budapest Intermodal Logistics Centre - Basic Infrastructure	Direct	18.1	4.7	4.7	0.0	Repaying
1999	**11**		**398.8**	**128.8**	**81.6**	**47.1**	
2000	Argus Capital Partners	Regional	48.7	11.7	0.0	11.7	Repaying
2000	Heitman Central Europe Property Partners Fund	Regional	37.8	9.3	0.0	9.3	Repaying
2000	Winterthur MPF/CS L&P Biztosito - 1st Capital Increase	Direct	6.0	2.1	0.0	2.1	Disbursing
2000	Winterthur MPF/CS L&P Penztarszolgaltato - Capital In	Direct	4.2	1.5	0.0	1.5	Disbursing
2000	**4**		**96.7**	**24.6**	**0.0**	**24.6**	
2001	Regional/Private Equity Fund Facility - Trigranit II	Regional	2.3	0.8	0.0	0.8	Repaying
2001	EU/EBRD Phase I - Euroventures Danube BV	Regional	15.0	3.0	0.0	3.0	Disbursing
2001	DVI, Inc. (debt)	Regional	4.3	1.1	1.1	0.0	Completed
2001	Innova/3	Regional	37.7	4.5	0.0	4.5	Repaying
2001	Winterthur MPF/CS L&P Biztosito - 2nd Capital Increase	Direct	9.6	3.3	0.0	3.3	Disbursing
2001	Raiffeisen EU Enlargement Fund	Regional	9.2	4.7	0.0	4.7	Repaying

2001	Viking River Cruises	Regional	5.8	5.8	5.8	0.0	Repaying
2001	Invitel	Direct	268.2	47.4	47.4	0.0	Completed
2001	Tecnicredito Hungary (syn loan)	Direct	25.0	10.0	10.0	0.0	Repaying
2001	EU/EBRD Phase II ext - Volksbank Hungary	Direct	10.2	10.2	10.2	0.0	Disbursing
2001	**10**		**387.1**	**90.8**	**74.5**	**16.3**	
2002	Accession Mezzanine Capital LP	Regional	16.6	7.8	0.0	7.8	Repaying
2002	Winterthur MPF/CS L&P Biztosito - 3rd Capital Increase	Direct	7.8	2.5	0.0	2.5	Disbursing
2002	Parmalat MPF - Hungary	Direct	27.7	9.0	0.0	9.0	Disbursing
2002	Heitman Central Europe Property Partners Fund II	Regional	28.7	8.8	0.0	8.8	Repaying
2002	**4**		**80.8**	**28.1**	**0.0**	**28.1**	
2003	DBG Osteuropa Holding II	Regional	21.8	6.6	0.0	6.6	Disbursing
2003	ORCO APARTHOTELS	Regional	16.3	1.7	0.0	1.7	Disbursing
2003	MOL - Duna WWTP Outsourcing Project	Direct	39.0	12.3	12.3	0.0	Completed
2003	Dalkia Prometheus III	Direct	3.0	0.6	0.0	0.6	Disbursing
2003	Winterthur MPF/CS L&P Biztosito - 4th Capital Increase	Direct	5.4	1.9	0.0	1.9	Disbursing
2003	Winterthur MPF/CS L&P Penztarszolgaltato - 2nd Cap. Incr.	Direct	2.4	0.8	0.0	0.8	Disbursing
2003	Internet Framework - Laserbit	Direct	5.9	1.7	0.0	1.7	Completed
2003	EU/EBRD Phase II ext. - MKB Euroleasing	Direct	9.8	9.8	9.8	0.0	Disbursing
2003	MOL Environmental Loan	Direct	750.0	150.0	150.0	0.0	Disbursing
2003	Volksbank FW - Volksbank Hungary Sub Debt	Direct	10.0	10.0	10.0	0.0	Disbursing
2003	Cora - Hungary	Direct	274.0	55.0	55.0	0.0	Repaying
2003	EU/EBRD Extension 4 - Volksbank Hungary II	Direct	5.0	5.0	5.0	0.0	Disbursing
2003	Euroventures Hungary III	Direct	46.0	10.0	0.0	10.0	Disbursing
2003	TUI advance payments	Regional	2.0	2.0	2.0	0.0	Completed
2003	EU/EBRD Extension 3 - Budapest Leasing	Direct	20.0	20.0	20.0	0.0	Disbursing
2003	**15**		**1,210.6**	**287.4**	**264.2**	**23.3**	
2004	Polish Enterprise Fund V	Regional	1.4	1.4	0.0	1.4	Repaying
2004	EU/EBRD Extension 4 - CIB Leasing	Direct	10.0	10.0	10.0	0.0	Disbursing
2004	Accession Fund	Regional	60.0	15.0	0.0	15.0	Disbursing
2004	Hungary M5 Refinancing	Direct	221.3	67.5	67.5	0.0	Completed
2004	TriGranit III	Regional	45.5	10.0	0.0	10.0	Repaying
2004	Advent Central & Eastern Europe Successor Fund	Regional	33.0	5.0	0.0	5.0	Disbursing
2004	Prometheus IV	Direct	15.0	3.0	0.0	3.0	Disbursing
2004	M5 Phase II	Direct	750.0	100.0	100.0	0.0	Repaying
2004	Europolis II	Regional	15.0	3.8	2.8	1.0	Disbursing
2004	UNIQA Biztosito Rt. (Hungary)	Direct	11.0	11.0	0.0	11.0	Disbursing
2004	EU/EBRD Extension 5 - SG Equipment Finance, Hungary	Direct	10.0	10.0	10.0	0.0	Disbursing
2004	EU/EBRD Extension 5 - HVB Leasing Hungary	Direct	10.0	10.0	10.0	0.0	Disbursing
2004	**12**		**1,182.2**	**246.7**	**200.3**	**46.4**	
2005	EU/EBRD Extension 4 - Merkantil	Direct	10.0	10.0	10.0	0.0	Signed
2005	EU/EBRD Extension 6 - CIB Leasing II	Direct	3.0	3.0	3.0	0.0	Signed
2005	Winterthur MPF/CSL&P Penztarszolgaltato - 3rd Capital Incr.	Direct	3.7	1.3	0.0	1.3	Disbursing
2005	EU/EBRD Extension 6 - Budapest Leasing II	Direct	5.0	5.0	5.0	0.0	Signed
2005	Eurventures III	Direct	46.0	5.0	0.0	5.0	Signed
2005	M6 Motorway	Direct	410.9	32.0	32.0	0.0	Disbursing
2005	Emerging Europe Convergence Fund II	Regional	60.0	3.6	0.0	3.6	Disbursing
30/09/2005	**7**		**492.5**	**59.9**	**50.0**	**9.9**	

ANNEX 2: NET CUMULATIVE BUSINESS BY INDUSTRY

Sector Business group (SIC)	Sector Team (SIC)	EBRD Finance	Share of Commitments
Energy		**198.8**	**11%**
	Power	0.0	0%
	Energy Efficiency	28.1	2%
	Natural Resources	170.7	9%
Financial Insitutions		**546.8**	**30%**
General Industry		**137.8**	**8%**
Infrastructure		**551.9**	**31%**
	Municipal & Env Inf	82.1	5%
	Transport	469.8	26%
Specialised Industries		**365.6**	**20%**
	Agribusiness	80.2	4%
	Property & Tourism	74.1	4%
	Telecoms Informatics & Media	211.3	12%
HUNGARY TOTAL		**1800.9**	**100%**

ANNEX 3: PIPELINE STOCK

(in EUR million as of 30 September 2005)

	Structure Review	**Final Review**	**Board Approval**	**Pipeline**	**Number of Operations**
HUNGARY	0.0	0.0	0.0	144.0	4.0
DEBT	0.0	0.0	0.0	89.0	3.0
EQUITY	0.0	0.0	0.0	55.0	1.0
PRIVATE	0.0	0.0	0.0	144.0	4.0
STATE	0.0	0.0	0.0	0.0	0.0
Non-Sovereign	0.0	0.0	0.0	144.0	4.0
Sovereign	0.0	0.0	0.0	0.0	0.0
Energy Efficiency	0.0	0.0	0.0	0.0	0.0
Natural Resources	0.0	0.0	0.0	0.0	0.0
Power and Energy	0.0	0.0	0.0	25.0	1.0
Energy	0.0	0.0	0.0	25.0	1.0
Bank Lending	0.0	0.0	0.0	0.0	0.0
Bank Equity	0.0	0.0	0.0	0.0	0.0
Equity Funds	0.0	0.0	0.0	5.0	1.0
Non Bank Financial Institutions	0.0	0.0	0.0	0.0	0.0
Small Business Finance	0.0	0.0	0.0	0.0	0.0
Financial Institutions	0.0	0.0	0.0	5.0	1.0
General Industry	0.0	0.0	0.0	0.0	0.0
General Industry	0.0	0.0	0.0	0.0	0.0
Municipal & Env Inf	0.0	0.0	0.0	14.0	1.0
Transport	0.0	0.0	0.0	100.0	1.0
Infrastructure	0.0	0.0	0.0	114.0	2.0
Property and Tourism	0.0	0.0	0.0	0.0	0.0
Telecoms Informatics & Media	0.0	0.0	0.0	0.0	0.0
Specialised Industries	0.0	0.0	0.0	0.0	0.0

ANNEX 4: SELECTED ECONOMIC INDICATORS

	1999	2000	2001	2002	2003	2004 *Estimate*	2005 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.2	5.2	3.8	3.5	2.9	4.2	3.5
Private consumption	4.8	4.9	6.0	9.4	7.2	2.5	na
Public consumption	1.8	1.2	5.3	5.7	6.5	-3.9	na
Gross fixed capital formation	5.9	7.7	5.9	9.3	2.5	7.9	na
Exports of goods and services	12.2	22.0	8.0	3.9	7.8	14.9	na
Imports of goods and services	13.3	20.2	5.3	6.5	11.0	11.6	na
Industrial gross output	10.4	18.7	3.6	2.8	6.4	7.4	na
Agricultural gross output	0.4	6.3	12.0	5.7	6.6	na	na
Employment			*(Percentage change)*				
Labour force (annual average)	2.1	0.6	-0.4	0.2	1.4	0.3	na
Employment (annual average)[1]	3.1	1.2	0.3	0.1	1.3	-0.3	na
			(In per cent of labour force)				
Unemployment (end-year)	7.0	6.4	5.7	5.8	5.9	6.3	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	10.0	9.8	9.2	5.3	4.7	6.8	3.8
Consumer prices (end-year)	11.2	10.1	6.8	4.8	5.7	5.5	3.5
Producer prices (annual average)	5.1	11.7	5.2	-1.8	2.4	3.5	na
Producer prices (end-year)	8.2	12.4	-0.4	-1.3	6.2	1.6	na
Gross average monthly earnings in economy (annual average)	13.9	13.5	18.2	18.3	12.0	6.2	na
Government sector			*(In per cent of GDP)*				
General government balance[2]	-5.6	-3.0	-3.5	-8.5	-6.5	-5.4	-6.1
General government expenditure	49.9	47.7	48.7	52.6	50.4	49.9	na
General government debt	61.2	55.3	52.2	55.5	57.4	57.4	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	15.8	12.1	16.8	13.8	13.6	9.9	na
Domestic credit (end-year)	0.4	11.8	4.7	15.3	19.8	11.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	44.5	43.1	44.7	45.1	46.6	46.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	14.5	11.0	9.8	8.5	12.5	9.5	na
Interbank interest rate (up to 30-day maturity)	14.5	11.9	10.0	8.9	10.2	9.5	na
Deposit rate weighted average (fixed for less than 1 year)	11.9	9.9	9.4	7.4	8.7	9.1	na
Lending rate weighted average (maturing within 1 year)	19.4	12.8	12.0	9.7	11.2	11.0	na
			(Forints per US dollar)				
Exchange rate (end-year)	252.5	284.7	279.0	225.2	207.9	180.3	na
Exchange rate (annual average)	237.3	282.2	286.5	257.9	224.3	202.7	na
External sector			*(In millions of US dollars)*				
Current account[3]	-3,773	-4,060	-3,236	-4,675	-7,343	-8,846	-9,056
Trade balance[3]	-2,170	-2,911	-2,235	-2,120	-3,366	-2,970	-2,800
Merchandise exports[3]	25,579	28,734	31,068	34,780	43,238	55,291	66,000
Merchandise imports[3]	27,749	31,645	33,303	36,900	46,604	58,261	68,800
Foreign direct investment, net[3]	2,991	2,200	3,568	2,716	515	3,629	3,500
Gross reserves, excluding gold (end-year)	10,978	11,229	10,766	10,394	12,791	15,963	na
External debt stock	31,316	30,287	33,951	36,883	53,761	70,574	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.1	3.7	3.4	2.9	2.8	2.8	na
			(In per cent of exports of goods and services)				
Debt service[4]	17.9	15.5	14.6	13.9	14.4	15.4	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	10.1	10.0	10.2	10.1	10.1	10.1	na
GDP (in millions of forints)	11,393,499	13,172,293	14,849,800	16,740,400	18,408,800	20,338,000	22,138,931
GDP per capita (in US dollar)	4,757	4,648	5,092	6,491	8,207	10,031	na
Share of industry in GDP (in per cent)	26.7	27.9	27.2	26.8	27.5	28.3	na
Share of agriculture in GDP (in per cent)	5.3	4.6	5.5	4.7	4.4	4.6	na
Current account/GDP (in per cent)	-7.9	-8.7	-6.2	-7.2	-8.9	-8.8	-8.0
External debt - reserves (in US$ million)	20,338	19,058	23,185	26,490	40,970	54,611	na
External debt/GDP (in per cent)	65.2	64.9	65.5	56.8	65.5	70.4	na
External debt/exports of goods and services (in per cent)	101.7	88.2	90.0	88.5	105.0	107.9	na

[1] Data from labour force survey.
[2] ESA-95, excluding part of the cost of pension reform. Figures from 2003 onwards are subject to methodological revisions as accounting is brought into compliance with the Eurostat standards.
[3] Data from balance of payments.
[4] Excluding inter-company loans.

ANNEX 5: RATINGS FROM THE 2005 ASSESSMENT OF TRANSITION CHALLENGES

HUNGARY	Structure	Institutions	Conduct	Comments
Agribusiness	*Small*	*Small*	*Small*	Poorly functioning land market. Agro-processors still need to improve efficiency and standards. Improvements to distribution and traceability are necessary. An appropriate financial system for agriculture is developing slowly (incl. warehouse receipt and insurance schemes).
Banking	*Negligible*	*Small*	*Negligible*	Regulatory framework in place. Number of banks is stable and majority foreign owned. Domestic credit to private sector (as % of GDP) is high for the region. Banking system that intermediates efficiently.
Energy Efficiency	*Small*	*Medium*	*Small*	The energy service (ESCO) market is one of the most developed in the region. The legal framework is set out in the energy efficiency law. Hungary has ratified the Kyoto and is part of the EU ETS.
General Industry	*Negligible*	*Negligible*	*Small*	The country is a regional leader in industry reforms. Improvements needed to increase labour market participation and lower state interference in the economy, but similar problems in other market economies. Completion of enterprise restructuring and expansion of local enterprises are remaining challenges.
MEI	*Small*	*Medium*	*Small*	There is noteworthy private sector participation in water and to a lesser extent in district heating, but very little in public transport. The institutional framework for municipal finance is in place and tariffs have been adjusted to reflect costs, but experience of revenue-based financing is limited.
MSMEs	*Medium*	*Small*	*Medium*	Starting a business is costly. A credit registry exists. Collateral and bankruptcy legislation are supportive of MSME lending. The cost of registering collateral is moderate. Most commercial banks now have dedicated SME departments and bank credit to enterprises is growing. Several highly subsidised microfinance programmes are in place making it virtually impossible to establish commercially based microfinance.
Natural Resources	*Small*	*Small*	*Small*	MOL has developed into an international quality oil and gas company. Remains vertically integrated but has divested non-core assets. Some further environmental improvements required to upgrade facilities. Otherwise tariff reform, governance and legislation sound.
NBFIs	*Negligible*	*Small*	*Small*	Securities and insurance markets legislation/regulation almost meet IOSCO/ IAIS standards. Capital markets are relatively developed with respect to the range of financial instruments available although stock market capitalisation has been declining over years. Insurance penetration is relatively small. There are mandatory and voluntary privately managed pension funds. Thriving leasing and consumer finance.
Power	*Small*	*Small*	*Small*	Sector not fully unbundled but substantial PSP in distribution and generation through early privatisation to strategic investors. Competition is hindered by presence of long term power purchase agreements. There is a strong independent regulator. Tariffs are cost oriented and tariff rebalancing has been largely completed.

Private Equity Funds	*Small*	*Small*	*Small*	One of the most developed sectors in region. Private equity investment % of GDP is comparable to that in Austria. The importance of domestic investors is increasing, though they are still dominated by government agencies and banks. The equity funds are yet to offer a broader range of products and become more visible providers of finance to enterprises. Small pool of experienced fund managers.
Property + Tourism	*Small*	*Small*	*Negligible*	Full tradability of land except foreigners. Sector is developing fast, including new types of property and financing instruments. The main issue is the subsidisation of residential housing by the government.
Telecoms	*Negligible*	*Small*	*Small*	Sector regarded as one of the most advanced of the region. The dominant fixed line incumbent has been fully privatised. The Government was committed to the introduction of competition, as highlighted by the ending of the monopoly of the incumbent a year earlier than had been originally envisaged.
Transport	*Medium*	*Small*	*Small*	In railways, operating and policy setting functions separated. Core railway functions separated into individual business units while ancillary services divested. Limited PSP. Infrastructure access granted legally but not fully working in practice. In roads, have been a number of PPP projects, but experience mixed (e.g. M1/M15). Road construction/maintenance contracted out to private sector. Sector finance in line with EU.

ANNEX 6: COMPARATIVE STRUCTURAL CHANGE INDICATORS

	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia
Liberalisation								
Share of administered prices in CPI (in per cent)	10.9	26.9	17.9	16.0	19.8	1.0	19.9	16.1
Number of goods with administered prices in EBRD-15 basket	1.0	3.0	2.0	2.0	1.0	0.0	2.0	1.0
Share of trade with non-transition countries (in per cent)	80.6*	72*	84*	65.5	63.6	81.7	66.1	77.7
Share of trade in GDP (in per cent)	125.4	125.8	113.9	82.3	93.7	69.8	138.6	100.2
Tariff revenues (in per cent of imports)	0.3	0.1*	na	0.3	0.5	1.5*	0.5*	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.0
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation								
Privatisation revenues (cumulative, in per cent of GDP)	21.9	7.5	31.1	5.3	13.4	14.5	35.0	4.7
Private sector share in GDP (in per cent)	80.0	80.0	80.0	70.0	75.0	75.0	80.0	65.0
Private sector share in employment (in per cent)	70*	na	na	76.0	na	72*	na	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	3.7	3.7	3.3	4.0	3.0
Enterprise and markets								
Budgetary subsidies and current transfers (in per cent of GDP)[1]	9.3	1.8	20.2	5.1	0.4	2.5	1.6	1.5*
Share of industry in total employment (in per cent)	29.7	25.2	33.3*	19.7	20.7*	22.3	29.2	36.3*
Change in labour productivity in industry (in per cent)	10.8	3.9*	7.6*	8.2	14.1*	11.9	2.9	8.8*
Investment/GDP (in per cent)	35.7	29.3	22.5	32.6	21.9*	22.0	na	25.3*
EBRD index of enterprise reform	3.3	3.3	3.3	3.0	3.0	3.3	3.0	3.0
EBRD index of competition policy	3.0	2.7	3.0	2.7	3.0	3.0	3.0	2.7
Infrastructure								
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.0 (96.5)*	33.9 (72.3)*	33.4 (78.3)	28.3 (52.9)*	25.3 (66.6)	31.9 (45.1)*	24.1 (68.4)*	40.7 (87.1)*
Internet penetration rate (per 10,000 inhabitants)	274.4*	498.9*	357.8*	178.8*	203.8*	203.8*	212.2*	214.8*
Railway labour productivity (1989=100)	69.9*	267.3*	133.9*	129.9*	67.8*	106*	60.5*	150.3*
Electricity tariffs, USc kWh (collection rate in per cent)	8.4 (na)*	6.5 (na)*	11.4 (99)*	7.1 (99)*	9.4 (90)*	9.8 (na)*	10.9 (na)*	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.2**	2.8**	4.7**	4.1**	3.7**	3.9**	3.1**	4.5**
EBRD index of infrastructure reform	3.3	3.3	3.7	3.0	2.7	3.3	2.7	3.0
Electric power	3.3	3.0	4.0	3.3	3.3	3.3	4.0	3.0
Railways	3.0	4.3	3.3	3.3	2.3	4.0	2.7	3.0
Roads	2.3	2.3	3.3	2.3	2.3	3.0	2.3	3.0
Telecommunications	4.0	4.0	4.0	3.0	3.3	4.0	3.3	3.0
Water and waste water	4.0	4.0	4.0	3.3	3.3	3.3	2.3	4.0
Financial sector								
Number of banks (foreign-owned)	35 (26)*	7 (4)*	39 (29)	23 (10)*	13 (7)*	58 (46)*	21 (16)*	22 (6)*
Asset share of state-owned banks (in per cent)	3*	0*	7.4*	4.1*	0*	25.7*	1.5*	12.8*
Non-performing loans (in per cent of total loans)[2]	5*	0.5*	3.8*	1.5*	2.6*	25.1*	9.1*	9.4*
Domestic credit to private sector (in per cent of GDP)	17.7*	33.7*	42.3*	38.8*	19.9*	17.8*	25*	43.2*
Stock market capitalisation (in per cent of GDP)	17.8*	41.5*	18.7*	9.6*	17.2*	17.3*	7.6*	17*
EBRD index of banking sector reform	3.7	4.0	4.0	3.7	3.0	3.3	3.7	3.3
EBRD index of reform of non-bank financial institutions	3.3	3.3	3.7	3.0	3.0	3.7	2.7	2.7

[1] Subsidies to enterprises and financial institutions, including the Czech Consolidation Agency.

*Data is for 2003.
**Data for 2001

ANNEX 7: POLITICAL AND SOCIAL ASSESSMENT

Political background

The 1920 Treaty of Trianon, signed in the aftermath of the defeat and collapse of the Austro-Hungarian Empire in 1918, reduced Hungary's territory from 288.000 sq km to 93,000 sq km and the population from 18.2 million to 7.6 million, leaving large Hungarian minorities in neighbouring Czechoslovakia, Romania and Yugoslavia. During the Second World War Hungary managed, with the help of Nazi Germany, to regain some of the pre-Trianon territories. But when Hungary wanted to leave the German side in March 1944, it was occupied by Germany and remained so till German troops were pushed out by the Soviet Army in early 1945. Under the Communist regime imposed on Hungary after 1945, it lost all the territories regained in the 1939-45 period. A revolution in October 1956 against the country's Moscow-dominated Communist regime was crushed by the Soviet Army. A period of political relaxation and economic experimentation followed under the regime of Janos Kadar, with many ups and downs. Karoly Grosz replaced Kadar as Communist Party leader in 1985. Reformists led by Imre Pozsgay and Rezso Nyers, architect of the 1968 economic reform, gained control of the Communist Party in 1989. Prime Minister Miklos Nemeth implemented political liberalisation. The Communist Party changed its name into the Hungarian Socialist Party (MSZP) and joined the opposition groups in national round-table negotiations about the establishment of a multiparty democratic system, which occurred in 1990.

Post-Communist Hungary showed a high degree of political stability. The four democratic parliamentary elections since 1990 brought an alternation between centre-right and centre-left governments. In the 1990 parliamentary elections, the Hungarian Democratic Forum (MDF) formed a coalition government with two other conservative parties, the Independent Smallholders' Party and the Christian Democratic People's Party. The Socialists were joined in opposition by the liberal Alliance of Free Democrats (SZDSZ) and the Federation of Young Democrats (Fidesz). MDF's leader Jozsef Antall became Prime Minister. The MDF government's spending programme in 1993-94 caused a serious budget deficit and problems with the current account. Following their victory in 1994, the Socialists formed a coalition with the Free Democrats. In 1995 the government introduced austerity measures designed to curb the budget deficit and external account imbalances. By 1997 there were signs of economic recovery, but it came too late for the government.

Fidesz, which had by then changed into a conservative party, won the 1998 parliamentary election and formed a coalition with the MDF and the Independent Smallholders Party under Viktor Orban as Prime Minister. The government continued with a programme of economic reform. The April 2002 parliamentary elections resulted in a slim victory for the Socialists and the Free Democrats who had formed an electoral alliance. Fidesz and the MDF went into opposition. The MSZP achieved a landslide victory in the October 2002 municipal elections. The successful completion of EU accession negotiations in December 2002 strengthened the government. However, by mid-2003 economic policy was in disarray, with the government failing to curb the budget deficit. Mistakes in monetary policy weakened the forint. Public dissatisfaction with the government continued to grow despite wage increases granted immediately after the 2002 election. Fidesz won an overwhelming victory in

Hungary's first election to the European parliament in June 2004, held immediately after Hungary joined the EU on 1 May. Under Ferenc Gyurcsany, who replaced Peter Medgessy as Prime Minister in September 2004, the government's position improved slightly at first, but has worsened since. Fidesz continues to have a commanding lead in the opinion polls. The government suffered a serious blow on 7 June 2005 when its own presidential candidate, Katalin Szilli, the Speaker of the Parliament, was beaten by Laszlo Solyom, a former Constitutional Court judge president put forward by the conservative parliamentary opposition. The election took place in Parliament and the result was 185 votes for Solyom and 182 for Szili. Nevertheless, like all three previous governments since 1990, the Gyurcsany government is likely to serve out its full four-year term, which expires in the spring of 2006.

International relations

Hungary's top foreign-policy priorities are the European Union, relations with the United States and bilateral relations with neighbouring countries, especially those like Romania, Serbia and Slovakia, which have sizeable Hungarian minorities. Since the collapse of Communism, successive Hungarian governments have sought to balance the need for constructive relations with neighbours with the wish to provide greater support for the 2.4 million ethnic Hungarians in those countries than was possible under Communism. Relations with Romania, which has some 1.4 million Hungarians, are developing smoothly. An ethnic Hungarian party has supported - or been a member of - successive Romanian governments since 1990. Relations with Slovakia, which has about 520,000 Hungarians, are progressing steadily after a long and bad period in the 1990s when Slovakia's Prime Minister was the nationalist-populist Vladimir Meciar. Those with Serbia are overshadowed by the uncertain plight of the local, recently much diminished in numbers Hungarian minority in Vojvodina, Serbia's northern province, which was a part of Hungary until 1918. Relations with Romania and Slovakia were put under a strain by the adoption by the Hungarian parliament in June 2001 of the so-called Status Law by the Hungarian Parliament. The Law offered Hungarians living in neighbouring states 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. After protests from Romania and Slovakia and pressure from the international community, the available benefits were limited mainly to cultural support measures. Hungary, which has been in NATO since 1999, has 150 troops with the NATO's training mission in Iraq. Russia is an important partner for Hungary as a supplier of most of the country's energy.

Integrity issues

Hungary is regarded as one of the less corrupt states in post-Communist Europe and was ranked 42nd out of 145 countries in the 2004 Corruption Perceptions Index by Transparency International - after 31st-ranked Estonia and Slovenia. Nevertheless, there is widespread perception in the country of corruption in the executive and legislative branches. Anecdotal evidence suggests significant corruption in public procurement (especially of military articles), party financing and in internal financial control. The debate about corruption is heavily politicised and accusations of corruption form part of the political struggle between government and the opposition. This is reflected in the fact that parliamentary committees are simultaneously in the process of examining allegations of illegal enrichment by Prime Minister Gyurcsnay from privatisation in the early 1990s as well as allegations of corruption by the close family of Viktor Orban, Prime Minister during the 1998-2002 period and now leader of the opposition party Fidesz. Low-level corruption among law enforcement officials remains a problem and the current government is taking steps to address the issue. However, the much publicised ‘glass pockets’ initiative introduced by the Medgyessy Cabinet in 2003 appears to have petered out, having been met with a good deal of scepticism both by the public and the media.

Social conditions

Population

At the end of May 2004, Hungary’s population was 10,104,000, according to an estimate by the Central Statistical Office. This represented a decline from the February 2001 census figure of 10,198,315. The population has been falling since 1981, when the death rate began to exceed the birth rate. The birth rate stood at 9.3 per 1,000 population compared with 12.3 per 1,000 in 1991. The death rate peaked at 14.5 per 1,000 in 1993 and fell to a preliminary 13.4 per 1,000 in 2003. The ageing population has placed an increasing strain on the generous pensions and early retirement. In 1998 a public-private three-pillar pension system was implemented, creating a more sustainable long-term pension structure but putting a strain on the system in the short term by reducing revenue in the state-run pay-as-you-go (PAYG) system.

Ethnic factor

Hungary’s population is homogenous, compared with most other countries in the region. Ethnic minorities account for about 8% of the population. According to the 2001 census, Roma constituted approximately 2% of the population, (though, according to some NGO and government office, estimates the figure is up to 5%). Ethnic Germans, the second largest minority, constitute 0.7% of the population. Smaller communities of Slovaks, Croats, Romanians, Poles, Ukrainians, Greeks, Serbs, Slovenes, Armenians, Ruthenians and Bulgarians are also recognised as ethnic minorities. Education is available to varying degrees in most minority languages. Living conditions for the Roma communities are significantly worse than for the general population. Roma are less well educated and have far-below-average income and life expectancy. Their unemployment rate is estimated at 70%. Considerable efforts are being made by the government to promote faster Roma integration. The Minority Affairs Ombudsman plays an active role in the examination of allegations of discrimination against the Roma community. The Law on Equal Treatment was passed by Parliament in December 2003.

Poverty

Despite seven years of strong economic growth, an estimated 12 percent of the population live below the poverty line[1]. The elderly, large families and the Roma are the most affected. Living standards in the north-eastern region of the country still fall below those of the EU average.

Education

Hungary's high standard of general education has played an important role in attracting foreign investment – especially in new-technology sectors. However, annual state spending on education as a percentage of GDP dropped from 5.8% in 1990 to 5% in 1998. Governments tend to focus on higher education at the expense of primary and secondary schooling. In the 1998-2002 period under the Fidesz government, the number of university graduates grew each year by almost 30%, but without any major rise in overall spending on education. In broad terms the structure of the educational system has changed little from Communist times. Schooling is compulsory for children between six and 16. The grammar school ('gymnasium') is the primary feeder of students to universities. Since 1989 there has been a decline of vocational schools for training of skilled workers as a destination for secondary schools. University and college education expanded rapidly in the 1990s. By 2002/03 the number of university students was three times higher than a decade earlier. In 1990/91 8.5% of the population aged 18-22 was attending university or college. By 2002/03 enrolment had reached 35%. There are 66 universities, colleges and other institutions of higher learning compared with 91 in 1992-95, following a programme of institutional consolidation.

Health

The health of the Hungarian population is poor by international standards. Among OECD countries, the Hungarians' average life expectancy of 72.4 years in 2001 was only higher than the Turks', at 68.3 years. Hungary has had the highest death rate among all current OECD member-countries since 1978; the highest death rates from cancer, liver disease and cirrhosis since 1989; and the highest suicide rate since 1960, the earliest year covered by OECD statistics. The country is also near the top of the death rate from cardiovascular diseases. In 2002 life expectancy at birth was 68.3 years for men and 76.6 for women – the highest difference in life expectancy between men and women in the OECD. Hungary has the highest infant mortality rate in the OECD, besides Mexico and Turkey. However, infant mortality has continued to decline from 47.6 per 1,000 live births in 1960 to 7.3 per 1,000 in 2003. Hungary's healthcare system is under-funded. Hungary spent 6.8% of GDP (or $911 per head) on healthcare at purchasing power parity (PPP) terms in 2001, placing it near the bottom of OECD healthcare spending. Rising costs for pharmaceuticals are putting strong pressure on government budgets. Cutting government subsidies has been a politically explosive issue in a country used to cheap medication in the Communist period. Average annual drug consumption in Hungary is the second highest in Europe (after France), and the drugs bill accounted for almost 20% of state healthcare spending in

[1] World Bank report on "Growth, Poverty and Inequality in Eastern Europe and the Former Soviet Union"

the first half of 2004 compared with 10-15% in similar countries. The main issue is related to the need to re-orient the sector from institutional care towards care at the primary level. The number of hospital beds per 1,000 of population fell from 11 at the start of the 1990s to six in 2001. The hospital sector has been hit by numerous cash crises and threatened strikes in recent years. A law that would allow the partial privatisation of hospitals has been struck down by the Constitutional Court.

Labour issues

Although Hungary’s unemployment rate remains relatively low, at about 7.1 per cent in the second quarter of 2005, its employment rate, at 56.4 per cent, is significantly below the EU average of around 63 per cent, as internal labour mobility remains low and the existing benefit system offers little incentives to enter the labour force. There is also some evidence of regional disparities in unemployment, with the highest unemployment registered in Northern Hungary (10.8 per cent in the first half of 2005 as compared to the national average of 7.1 per cent), and youth non-employment, as only 23.6 per cent of Hungarians aged 15-24 were employed in 2004 compared to around 43 per cent of the relevant age group in the EU-15 countries.

The Labour Code recognises the right of unions to organise and permits trade union pluralism. There are six trade union federations, each roughly targeting a different sector of the economy. The largest trade union body is the National Confederation of Hungarian Trade Unions, the independent successor to the former monolithic Communist union, with approximately 235,000 members. An indication of total union membership is the fact that in 2003 some 600,000 taxpayers declared a reduction for payment of union fees.

ANNEX 8:

Hungary – 1991/2005 **Overview of the EBRD TC Fund and Official Co-financing**
1. Aggregate TC Funds Commitment and Official co-financing signed projects; 2. Future scenario.
Appendix 1: Breakdown of TC Projects Appendix 2: Breakdown of Official Co-financing (signed) projects

1. *Aggregate TC Funds Commitment and Official co-financing signed projects;*

- Since 1991, the Bank has been actively cooperating with multi and bilateral donors in the framework of both TC projects (for which the aggregate commitments value for the period 1991 - 07/2005 reached the value of € 8.9 million) and Official co-financing initiatives (€ 736.4 million is the total amount of the signed projects at the end of July 2005).

- TC Fund: four Donors (EU: €3.2 million, Japan: €2.7 million, UK; €0.7 million and Germany: €0.6 million) account for 80% of the total aggregate commitments. Three are the sectors having more benefited from the EBRD TC Fund. Finance & Business (€ 3.7 million), Transport (€ 2.3 million) and manufacturing (€ 1.4 million). Other sectors having benefited for the TC Support have been Telecommunications, Energy, Agro-business and Commerce.

- Official Co-financing: three IFIs are the largest official co-financer and, with a total contribution of € 460 million, are covering the 65% of the total. The IFC is the largest co-financier with € 208 million followed by KfW with 156 million and the EIB with €100 million. Other co-financers are the JIC, the EC and the Hungarian development bank with more than 115 million. Transport and telecom have been the key sectors of official co-financing.

TC FUNDS and Donors
Aggregate Commitments (1991-2005): € 8.9 million

DONOR	EUR Committed
European Commission	3,184,403
Japan	2,718,543
UK	755,495
Germany	612,545
France	425,280
Taipei China	386,949
Luxembourg	353,349
Spain	137,953
Switzerland	131,280
Finland	97,824
Italy	75,509
Austria	60,463
The Netherlands	9,976
Greece	5,680
Denmark	5,534

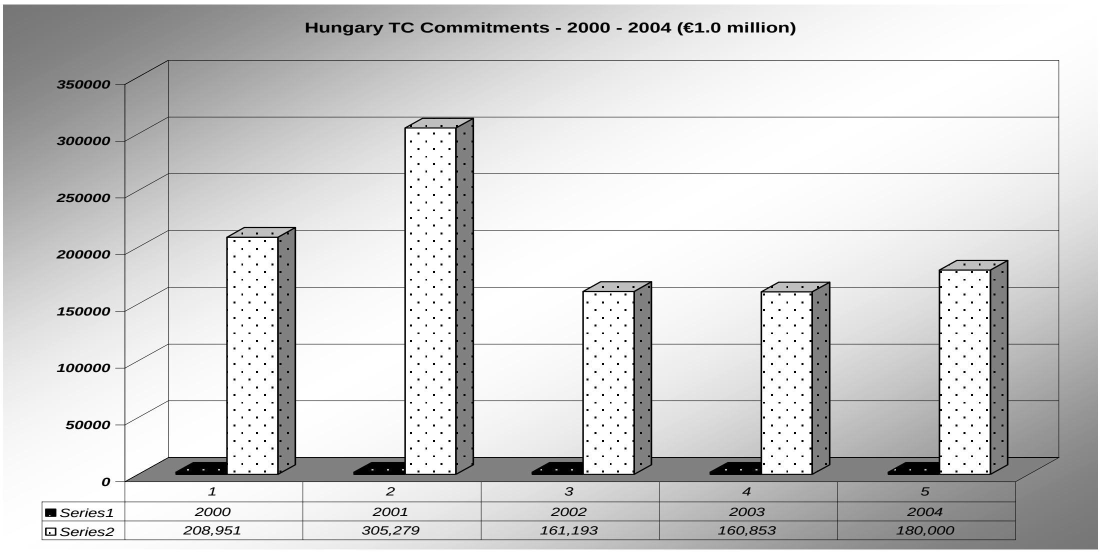
Official Co-financing and Donors
Signed projects - Signing years: 1993-2005)
€ 736.4 million

DONOR	Million EUR Committed
IFC	208.7
KfW	152.8
HDB	115.0
EIB	100.0
JIC	80.0
European Commission	51.4
EIF	15.0
Caisse Depot et Consignations	5.9
DEG	4.2
JAIDO	2.9

Future scenario

2. *Future scenario;*

Over the period 2000-2004 there has been a confirmation of a trend showing a reduced interest by donors for funding initiatives in Hungary.



For the period 2005 – 2006 it seems difficult to expect a yearly commitment from bilateral Donors bigger than € 200,000. Spain could be one of the Donors interested in developing joint initiatives in Hungary, particularly in the field of MEI and PPP type project structures.

However, Hungary should have access – from 2006 – to the already allocated EU Structural and Cohesion Funds as well as from the newly established Swiss Cohesion Fund.

EU Structural and Cohesion funds:

As a new member State, during the period 2004-2006 Hungary will receive aid of almost €3.21 billion, out of which €1.9 billion under the EU Structural. Among other, the following could be of interest for the EBRD initiatives in the Country:

- *Transport Infrastructure development*: €188.8 million.
- *Investment promotion*: €98.7 million.
- *SME development:* € 119.9 million

Appendix 1: Breakdown of TC Projects

Fund Name	Commitment Name	Euro Committed	Euro Disbursed	Fund Currency	Fund Code	Fund Approved Date	Commit. Stage Name	Sector Type Name
Austrian Technical Assistance Co-operation Fund	Prefeasibility study - Telecommunications	25,609	25,609	31,852	USD	01/07/91	Closed	Telecommunications
Austrian Technical Assistance Co-operation Fund	Culture-based tourism study	34,854	34,854	46,345	USD	30/05/94	Closed	Commerce, Tourism
Danish Technical Assistance Co-operation Fund	TurnAround Management Programme - Transelektro II	4,524	4,524	4,524	EUR	15/08/97	Closed	Manufacturing
EBRD-ICEX Technical Co-operation	Foreign trade financing	137,953	137,953	137,953	EUR	12/08/94	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Danube River Basin Development Programme - environmental management in the chemical industry	237,180	237,180	237,180	EUR	10/08/92	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Danube River Basin Development Programme - project financing and investment	155,336	155,336	155,336	EUR	15/09/92	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Budapest wholsale market project expansion - rationalisation of market operations/establishment of Market Information System	323,750	323,750	323,750	EUR	17/12/93	Closed	Manufacturing
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	M1-M15 monitoring study	165,765	165,765	165,765	EUR	15/11/95	Closed	Construction
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Special restructuring programme - fund enterprise portfolio - Investment Development and Implementation Team (IDIT)	1,024,683	1,024,683	1,024,683	EUR	02/01/96	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Special Restructuring Programme framework contract - pre-investment enterprise support - Team I	326,941	326,941	326,941	EUR	02/01/96	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Special Restructuring Programme framework contract - pre-investment enterprise support - Team II	173,727	173,727	173,727	EUR	02/01/96	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	MAV Hungarian Railways - passenger rail services study	345,948	345,948	345,948	EUR	10/02/97	Closed	Transport, Storage
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Environment project preparation	106,369	106,369	106,369	EUR	13/02/97	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	Environment project preparation	174,704	174,704	174,704	EUR	13/02/97	Closed	Finance, Business
EU-EBRD Cooperation Agreement, Bangkok Facility (PHARE programme)	MAV Passenger Railway Services Study, Phase II	150,000	150,000	150,000	EUR	08/02/00	Closed	Transport, Storage
Finnish Technical Cooperation Fund	National Labour Centre	46,870	46,870	46,870	EUR	02/12/92	Closed	Community/Social Services
Finnish Technical Cooperation Fund	Danube river basin development - pulp and paper assessment	50,954	50,954	50,954	EUR	20/01/93	Closed	Finance, Business
Finnish Technical Cooperation Fund	National Labour Centre - project start-up	32,528	32,528	32,528	EUR	22/10/93	Closed	Finance, Business

France Technical Cooperation - Foreign Affairs	Budapest wholesale market	20,305	20,305	20,305	EUR	13/07/92	Closed	Manufacturing
France Technical Cooperation - Foreign Affairs	Municipal development - Hungarian Communal Bank	28,597	28,597	28,597	EUR	28/05/93	Closed	Transport, Storage
France Technical Cooperation - Foreign Affairs	Budapest public transport - fares system restructuring study	85,797	85,797	85,797	EUR	09/07/93	Closed	Transport, Storage
France Technical Cooperation - Foreign Affairs	Meat processing industry restructuring	185,795	185,795	185,795	EUR	10/12/93	Closed	Manufacturing
France Technical Cooperation - Foreign Affairs	Energy efficiency project development - financing through energy service companies	104,786	104,786	104,786	EUR	17/07/95	Closed	Energy
German Technical Assistance Cooperation Agreement	Tiszai Vegyi Kombinat Rt - investment preparation	69,791	69,791	69,791	EUR	16/03/94	Closed	Energy
German Technical Assistance Cooperation Agreement	Combined transport feasibility	52,774	52,774	52,774	EUR	24/10/94	Closed	Transport, Storage
German Technical Assistance Cooperation Agreement	Hungary Special Restructuring Programme - feasibility study	170,423	170,423	170,423	EUR	03/11/94	Closed	Finance, Business
German Technical Assistance Cooperation Agreement	Hungary Special Restructuring Programme Feasibility study - extension	12,194	12,194	12,194	EUR	24/10/95	Closed	Finance, Business
Germany, KfW-EBRD Technical Cooperation Agreement	Magyar Hiltel Bank - due diligence	307,363	307,363	307,363	EUR	01/05/96	Closed	Finance, Business
Hellenic Technical Cooperation	Secured Transactions: Institution Building in Hungary	5,680	5,680	5,680	EUR	05/09/01	Closed	Community/Social Services
Italian Technical Co-operation	Budapest wholesale market	75,509	75,509	75,509	EUR	01/07/92	Closed	Manufacturing
Japan-Europe Co-operation Fund	GIRO Bankcard	79,962	79,962	13,086,500	JPY	01/08/91	Closed	Finance, Business
Japan-Europe Co-operation Fund	Budapest urban infrastructure	545,261	545,261	90,930,698	JPY	01/01/92	Closed	Construction
Japan-Europe Co-operation Fund	M1-M15 motorway concession	462,064	462,064	53,702,500	JPY	01/01/92	Closed	Transport, Storage
Japan-Europe Co-operation Fund	Export credit guarantee	21,490	21,490	2,979,903	JPY	01/02/92	Closed	Finance, Business
Japan-Europe Co-operation Fund	Agricultural restructuring	209,998	209,998	32,113,614	JPY	01/10/92	Closed	Agriculture, Forestry, Fishing
Japan-Europe Co-operation Fund	Clearing and depository centre for Budapest Stock Exchange	176,702	176,702	21,970,760	JPY	01/01/93	Closed	Finance, Business
Japan-Europe Co-operation Fund	Establishment of National Guarantee Scheme for SME's	4,181	4,181	512,175	JPY	01/07/93	Closed	Finance, Business
Japan-Europe Co-operation Fund	Environmental training for bankers	99,000	99,000	12,125,520	JPY	01/08/93	Closed	Finance, Business
Japan-Europe Co-operation Fund	Budapest public transport rehabilitation project - parking control scheme	125,000	125,000	14,942,402	JPY	01/08/93	Closed	Transport, Storage
Japan-Europe Co-operation Fund	Budapest public transport rehabilitation project - commercialisation study	246,987	246,987	29,877,329	JPY	01/08/93	Closed	Transport, Storage
Japan-Europe Co-operation Fund	TurnAround Management Programme - Ajka	27,822	27,822	3,386,883	JPY	01/09/93	Closed	Manufacturing
Japan-Europe Co-operation Fund	TurnAround Management Programme - Caola	4,198	4,198	510,542	JPY	01/09/93	Closed	Manufacturing
Japan-Europe Co-operation Fund	Agricultural restructuring project - advisory assistance to four banks	239,437	239,437	29,253,978	JPY	17/11/93	Closed	Finance, Business
Japan-Europe Co-operation Fund	Agricultural restructuring project - training assistance to four banks	207,818	207,818	25,208,062	JPY	17/11/93	Closed	Finance, Business
Japan-Europe Co-operation Fund	Budapest wholesale market expansion project - project design, tender preparation and supervision	167,908	167,908	20,802,694	JPY	01/12/93	Closed	Manufacturing
Japan-Europe Co-operation Fund	TurnAround Management Programme - Tanselektro	49,748	49,748	5,619,089	JPY	01/05/95	Closed	Manufacturing
Japan-Europe Co-operation Fund	TurnAround Management Programme - Eger East-West Limited	25,624	25,624	2,894,259	JPY	01/05/95	Closed	Manufacturing
Japan-Europe Co-operation Fund	TurnAround Management Programme - Transelektro II	10,815	10,815	1,609,108	JPY	15/08/97	Closed	Manufacturing
Luxembourg - European Bank Technical Co-operation	TAM Programme in central, eastern & southern Europe	58,951	58,951	58,951	EUR	13/09/00	Closed	Manufacturing

Luxembourg - European Bank Technical Co-operation	Femfeldogozo	54,398	54,398	54,398	EUR	12/05/03	Closed	Manufacturing
Luxembourg - European Bank Technical Co-operation	TAM - Matrametal	60,000	52,630	60,000	EUR	09/09/03	Committed	Manufacturing
Luxembourg - European Bank Technical Co-operation	TAM - Aranypok Handels	60,000	39,684	60,000	EUR	31/03/04	Committed	Manufacturing
Luxembourg - European Bank Technical Co-operation	TAM - Ajka Electronical Ltd	60,000	31,347	60,000	EUR	16/06/04	Committed	Manufacturing
Luxembourg - European Bank Technical Co-operation	TAM - Emika Elektromechanikai	60,000	29,131	60,000	EUR	13/10/04	Committed	Manufacturing
Netherlands Technical Assistance Co-operation	Establishment of national guarantee scheme for SME	9,970	9,970	9,970	EUR	01/11/92	Closed	Finance, Business
Swiss Technical Co-operation	Combined transport feasibility	131,280	131,280	200,767	CHF	17/10/94	Closed	Transport, Storage
Taipei China-European Bank Cooperation	Hungary Telecommunications Company	52,281	52,281	72,500	USD	01/04/92	Closed	Telecommunications
Taipei China-European Bank Cooperation	Study of Hungarian Telecommunications Company - due diligence	198,772	198,772	222,000	USD	01/01/93	Closed	Telecommunications
Taipei China-European Bank Cooperation	TAM Programme - Malyi Brick	46,262	46,262	53,164	USD	15/01/02	Closed	Manufacturing
Taipei China-European Bank Cooperation	TAM Programme - Salgotarjan Konfekcioipari	44,932	44,932	52,399	USD	15/01/02	Closed	Manufacturing
Taipei China-European Bank Cooperation	Felina	44,699	40,371	54,269	USD	11/03/03	Disbursing	Manufacturing
UK-EBRD Technical Cooperation Fund (Central and South-Eastern Europe)	Regional - close-out netting legislation	50,000	50,000	31,044	GBP	08/11/99	Closed	Finance, Business
UK-EBRD Technical Cooperation Fund (Central and South-Eastern Europe)	Hungarian Financial Supervision (HFSA) - Supervision Assistance	100,000	100,000	63,610	GBP	19/01/01	Closed	Community/Social Services
UK-EBRD Technical Cooperation Fund (Central and South-Eastern Europe)	Legal Advisory Services to Hungary in connection with drafting a New Comprehensive Securities Act	49,684	49,684	30,512	GBP	20/03/01	Closed	Community/Social Services
UK-EBRD Technical Cooperation Fund (Central and South-Eastern Europe)	Secured Transactions: Institution Building Project	149,915	135,646	96,459	GBP	03/05/01	Disbursing	Community/Social Services
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Budapest public transport rehabilitation project - commercialisation study	17,000	17,000	13,224	GBP	01/05/94	Closed	Transport, Storage
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Transelektro group - environmental audit	3,378	3,378	2,654	GBP	01/09/94	Closed	Energy
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Transelektro group - technical study	88,693	88,693	73,030	GBP	07/09/94	Closed	Energy
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Assistance in developing a register for charges over movable assets	49,793	49,793	33,013	GBP	12/12/95	Closed	Community/Social Services
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Technical update on the gas distribution sector	18,480	18,480	13,030	GBP	25/09/96	Closed	Energy

UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	Assistance in implementing registration under new law for charges over moveable assets	200,389	200,389	125,956	GBP	29/01/97	Closed	Community/Social Services
UK-Know How Technical Co-operation Agreement (Central and Eastern Europe)	TurnAround Management Programme - Transelektro II	28,163	28,163	16,779	GBP	15/08/97	Closed	Manufacturing
	Report Total Euro Amount:	**8,977,761**	**8,871,957**					
	No of Commitments: 72							

Appendix 2: Breakdown of Official Co-financing Projects

Operation Name	Signing Date	Status	Organisation Name	Country Name	Finance Type	EUR Amount	CYY Amount	CCY
Hungarian Telecommunications Equity Investment	31/12/93	Signed	International Finance Corporation	UNITED STATES	IFI Equity	26,033,341	26,033,341	EUR
Hungarian Telecommunications Project	25/04/93	Signed	Japan Bank for International Cooperation	JAPAN	Parallel Loan	43,459,810	85,000,000	DEM
Hungarian Telecommunications Project	31/12/93	Signed	Japan Bank for International Cooperation	JAPAN	Parallel Loan	36,652,665	44,500,000	USD
Central Business Center	31/12/94	Signed	JAIDO	JAPAN	Parallel Loan	2,980,832	5,830,000	DEM
M1-M15 Motorway Project	23/12/93	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	3,567,362	6,977,154	DEM
M1-M15 Motorway Project	23/12/93	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	9,399,462	11,411,887	USD
M1-M15 Motorway Project	23/12/93	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	10,001,043	19,560,340	DEM
M5 Concession Motorway B.O.T.	11/12/95	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	4,269,436	28,005,664	FRF
M5 Concession Motorway B.O.T.	11/12/95	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	28,278,734	185,496,336	FRF
MAV - Railcar Modernisation and Marketing Project	31/12/98	Signed	European Investment Bank	LUXEMBOURG	IFI Loan	100,000,000	100,000,000	EUR
MAV - Railcar Modernisation and Marketing Project	31/12/98	Signed	European Commission	BELGIUM	Grant	40,000,000	40,000,000	EUR
Investel Syndicated Loan Facility	31/12/95	Signed	International Finance Corporation	UNITED STATES	IFI Loan	182,690,112	182,690,112	EUR
Budapest Bank Credit Line for Environment and Energy	31/12/96	Signed	European Commission	BELGIUM	Parallel Loan	7,500,000	7,500,000	EUR
Hungarian Foreign Trade Bank (MKB) Capital Increase	31/12/97	Signed	DEG	GERMANY	Equity	4,200,000	4,200,000	EUR
Budapest Intermodal Logistics Centre - Basic Infrastructure	31/12/99	Signed	European Commission	BELGIUM	Grant	3,900,000	3,900,000	EUR
M1-M15 Motorway Restructured Project	23/12/93	Signed	Caisse des Dépôts et Consignations	FRANCE	Participation	5,979,033	5,979,033	EUR
M1-M15 Motorway Restructured Project	23/12/93	Signed	Kreditanstalt fur Wiederaufbau (KfW)	GERMANY	Participation	21,793,879	21,793,879	EUR
Euroventures Hungary III	17/12/03	Signed	European Investment Fund	LUXEMBOURG	IFI Equity	15,000,000	15,000,000	EUR
M5 Phase II	21/09/04	Signed	Hungarian Development Bank	HUNGARY	Parallel Loan	100,000,000	100,000,000	EUR
M5 Phase II	17/12/04	Signed	KFW Bankengruppe	GERMANY	Participation	3,439,394	3,439,394	EUR
M5 Phase II	09/12/04	Signed	KFW Bankengruppe	GERMANY	Parallel Loan	16,834,928	16,834,928	EUR
M6 Motorway	18/07/05	Signed	Hungarian Development Bank	HUNGARY	Parallel Loan	15,237,500	15,237,500	EUR
M6 Motorway	18/07/05	Signed	KFW Bankengruppe	GERMANY	Parallel Loan	55,296,053	55,296,053	EUR
						736,513,583		

ANNEX 9: ASSESSMENT OF HUNGARY'S COMMERCIAL LAWS

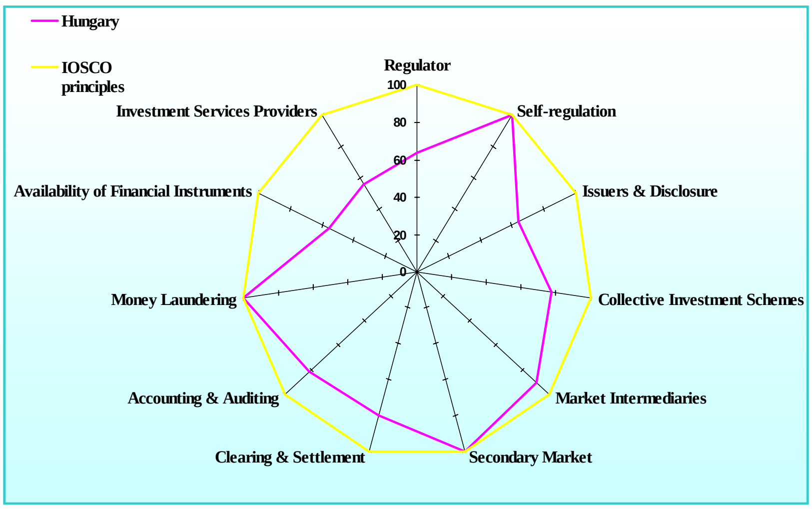
The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws "on the books" (also referred to as "extensiveness") and the actual implementation of laws (also referred to as "effectiveness"). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for Hungary, accompanied by critical comments of the Bank's legal experts who have conducted the assessments.

Capital Markets

The primary legislation governing the Hungarian securities markets is Act CXX of 2001 on Capital Markets (the "Act on Capital Markets"), as amended. The Act on Capital Markets 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 Act on Capital Markets 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. Following Hungary's accession to the European Union in May 2004, the Act on Capital Markets introduced the general principle of freedom to provide financial services within the European Union without discrimination.

The regulator of capital markets in Hungary is the Hungarian Financial Supervisory Authority ("PSZAF"), established in April 2000. PSZAF replaced the three different supervisory authorities previously existing for the securities market, banking and insurance sectors respectively. Legislation was amended in January 2002 to reinforce the independence of PSZAF. However, PSZAF does not have the power to issue its own regulations. Strengthening the powers of PSZAF is therefore essential to achieving further improvement in terms of securities market regulation.

Quality of securities market legislation –Hungary (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2004

According to the EBRD Securities Markets Legislation Assessment conducted in 2004, Hungary was found to be in "*medium compliance*" with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) – see above chart - showing the weaknesses in the regulator, availability of financial instruments and investment service providers areas.

The 2004 assessment was updated in 2005. Amendments to the Act on Capital Markets designed to improve investor protection, encourage new listings on the Budapest Stock Exchange and bring Hungarian regulations into line with European Union rules entered into effect on 1 July 2005. The amendments extend the scope of the definitions of "insider", "insider trading", and "market manipulation" in accordance with the respective definitions under EU law. Disclosure of information to PSZAF was strengthened and new regulation on PSZAF's international cooperation requirements and sanctioning policies were also enacted. Finally, new rules on the issuance of prospectuses prepared for public offerings and the listing of securities were introduced, regulating cross-border public offerings and providing more detailed requirements for the private placement of securities.

Company Law and Corporate Governance

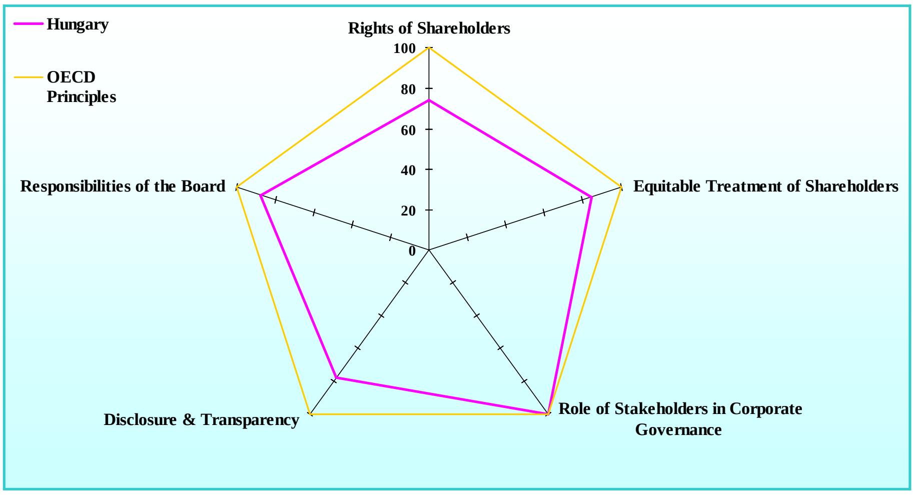
The primary legislation dealing with corporate governance is contained in Act CXLIV of 1997 on Companies (the "Companies Act") as amended on 12 July 2001 and 1 January 2004. The Companies Act provides the basic regulation concerning limited liability companies and joint stock companies, which are the two most widely used corporate forms in Hungary.

A new draft law dealing with corporate governance issues is currently being developed by the Hungarian Ministry of Justice. The new law, aimed at strengthening the rules for large and listed companies while requiring fewer formalities for smaller companies, is expected to be passed in 2006.

When benchmarking company laws with the OECD Principles of Corporate Governance, the existing Hungarian legislation appeared to be among the best in the Bank's countries of operations, according to the results of the 2004 EBRD Corporate Governance Sector Assessment (see chart below). The emphasis of the assessment was 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).

In 2005, the EBRD launched a survey aimed at analysing the effectiveness of corporate governance legislation with reference to related party transactions. While Hungary offers some effective mechanisms for minority shareholders to obtain disclosure, the redress mechanisms available should be improved. 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 these good laws are made fully efficient in practice.

Quality of corporate governance legislation – Hungary (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the 'web', the more closely the corporate governance laws of the country approximate these principles

Source: EBRD Corporate Governance Sector Assessment, 2004 assessment

Concessions

Concessions legislation in Hungary is multiple: arrangements are governed by a combination of a general concessions law and sector specific legislation. There seems to exist some sort of a government policy framework (although written evidence was not found) for improving the legal environment and promoting the concept of the Public Private Partnership ("PPP") pursuant to which a PPP task force was set up by the Ministry of Economy and Transport in 2003. However, the PPP secretariat within the ministry was dissolved earlier in 2005 and its functions absorbed by another department.

The 1991 Concessions Act, as amended (the "Concessions Act") is a general framework law and contains references to various sector-specific legislation. 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.

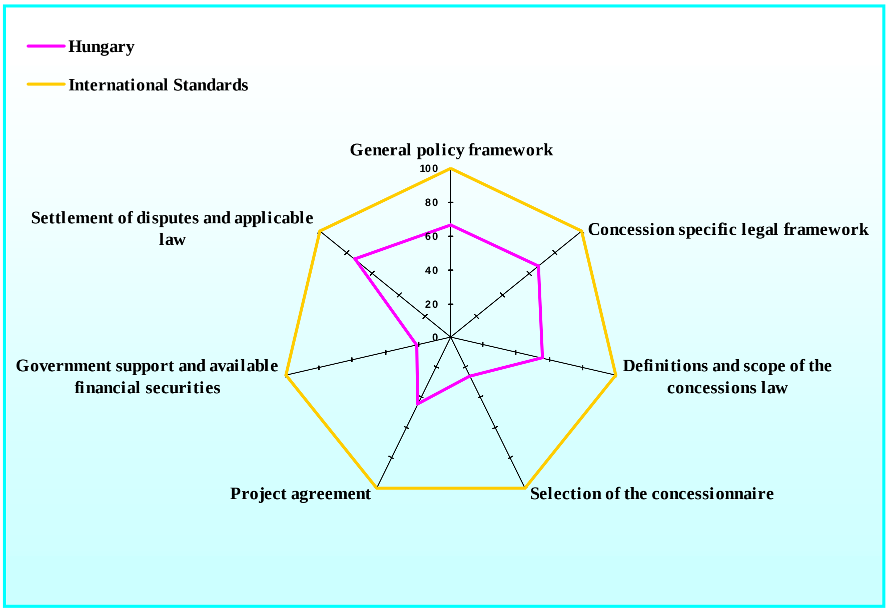
The Concessions Act contains rules on contracting arrangements, concession granting procedures and provides for the possibility of international arbitration for dispute settlement. It regulates the tendering process and also refers to a special tender law and to the relevant provisions of the Civil Code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

The Concessions Act appears somewhat superficial and inflexible. For example, assignment of concession rights to a third party is restricted. Other difficulties include the absence of a stability clause concept and the lack of clarity of the concession definition and the application of a fair compensation mechanism. It contains very few provisions regarding project agreements (in particular, insufficient termination/compensation provisions). The Concessions Act needs serious improvement especially in the areas of concessionaire selection, government support and the availability of financial securities, in particular, the introduction of a prequalification procedure, a detailed procedure for requesting proposals and the regulation of unsolicited proposals.

A certain number of positive elements do however bring clarity to the law: a possibility for the sector-specific act to apply subject to the Concessions Act, a clear identification of major sectors eligible for PPP and requirements to publish concession award notices and maintain records accessible to public.

Thus, even though Hungary does have concessions on its records, the actual Concessions Act appears to be somewhat outdated and unclear in many respects. The multiple nature of legislation is not ideal either and the government's plans to reform the regime are welcome. In the context of EU accession and legal harmonisation and the adoption of the new Public Procurement Law in 2004, a new PPP enabling law, based on modern internationally accepted standards, would contribute to the development of PPP in Hungary.

Quality of concession legislation –Hungary (2004)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2004

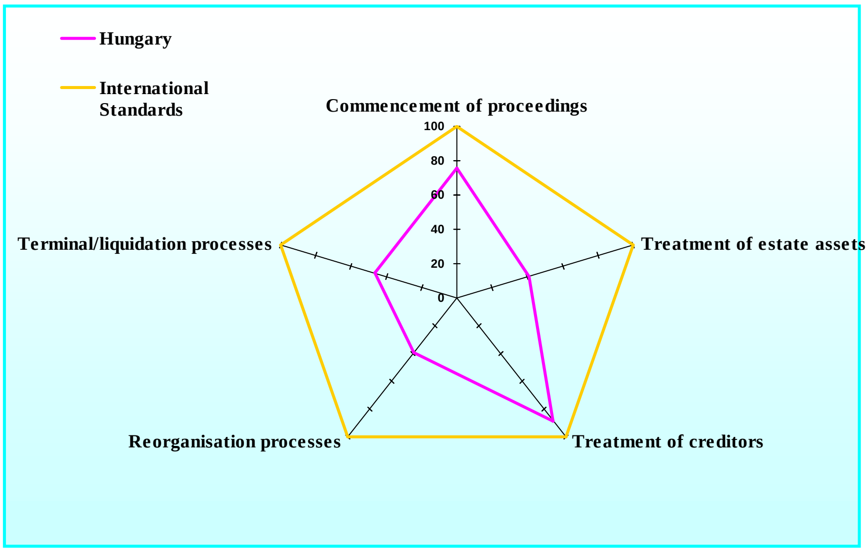
The EBRD's recent Assessment of Concessions Laws undertaken to evaluate applicable regimes throughout the EBRD's 27 countries of operations (the laws on the books only rather than how they work in practice), revealed that Hungarian concessions laws had "low compliance" with internationally accepted standards in this sector. As can be seen from the above spider graph, while concession related rules generally as well as rules covering settlement of disputes, for instance, are regulated fairly extensively, most other areas, in particular, selection of a concessionaire and availability of financial instruments and state support need to be dramatically improved in order to meet the requirements of a modern legal framework facilitating private sector participation.

Insolvency

Bankruptcy and insolvency in Hungary are governed by the Bankruptcy Proceedings, Liquidation Proceedings and Member's Voluntary Dissolution Act (as amended) (the "Insolvency Act"). This law has been under review by the Hungarian government for some time and proposed amendments are currently being prepared by a local working group. Any new legislation is not expected to be passed before late 2005.

As it currently exists, the Insolvency Act scored "low compliance" when compared with international standards in the EBRD's 2003 Sector Assessment Survey. The graph below displays the data collected in this project and shows the levels of compliance of the Insolvency Act with international standards in five core areas:

Compliance of the Hungary's Insolvency Law with International Standards
Quality of insolvency legislation – Hungary (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank's Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on"Legislative Guidelines for Insolvency Law", and others. The fuller the 'web', the more closely insolvency laws of the country approximate these standards.

Source: EBRD Insolvency Sector Assessment Project, 2003/4

As the above graph reveals, this law is deficient in many key areas of insolvency. Specifically, the Insolvency Act does not provide a clear definition for what constitutes 'insolvency'. In addition, the law allows the court up to 60 days to hear an initial insolvency application. This timeline is far too long and is inconsistent with the leading international standards on the topic. Secured creditors are also treated in a manner inconsistent with international standards as, under the Insolvency Act, secured assets are subject to the cost of administration of the bankrupt estate.

As is common in insolvency legislation in EBRD countries of operations, the Insolvency Act is particularly deficient in addressing the issue of reorganisation. A meaningful reorganisation scheme should allow for the compromising of obligations, in a timely fashion, to facilitate recovery. Under the current Hungarian scheme, virtually no ongoing financing during restructuring will be available and the percentage of creditor support required to approve a restructuring plan is too high.

Both of these issues must be addressed. Finally, given Hungary's increasing business relationships with foreign countries, it would be worthwhile for the law to address the issue of cross-border insolvency proceedings (although, admittedly, this is not as pressing an issue as the other deficiencies discussed herein).

Other concerns appear when one looks at the practical implementation of Hungary's insolvency legislation. The results of the EBRD 2004 Legal Indicator Survey on Insolvency which examined the 'effectiveness' (or how the law works in practice) of insolvency regimes revealed two unique characteristics about insolvency in Hungary. First of all, it is one of the few countries to score better on creditor-initiated insolvencies than on debtor initiated ones. This is consistent with the extremely poor quality of Hungary's reorganisation legislation but creditors should not take false comfort in this situation. While it appears that creditors can commence bankruptcy proceedings fairly easily and cheaply, over 80% of all bankrupt estates in Hungary do not contain sufficient assets, *at the time of bankruptcy*, to fund the cost of liquidation. In other words, in an overwhelming majority of Hungarian insolvencies, unsecured creditors (trade suppliers, utilities, etc.) will have little or no recovery.

The poor access for debtors evident from the debtor-initiated insolvency graph suggests not only weakness in the legislation but also an unduly slow and complex legal regime that makes reorganisation (and therefore business continuity) extremely unlikely.

All of these factors, together with the law's deficiencies, militate against the insolvency regime functioning properly as a 'stick' to induce debtors to act in good faith and as a 'carrot' to induce insolvency debtors, with businesses that are fundamentally viable, to try to promote the rescue of such businesses.

Secured Transactions

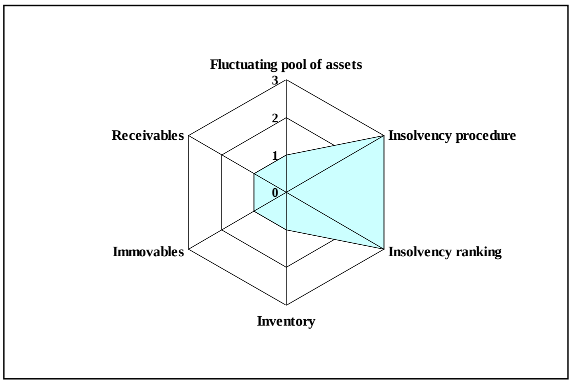
Hungarian law provides a comprehensive, flexible and modern system for charging all kinds of assets. Registered charges over movable (tangible) assets are registered in the centralised electronic Charges Registry, which has been operated since May 1997 by the Hungarian National Chamber of Public Notaries. In recent years, 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 (for example by the creditor selling directly the collateral to get repaid) is now possible and is reported to work well.

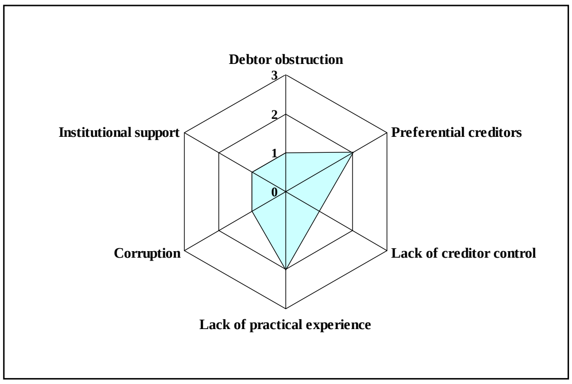
Also, in March 2004, Hungary implemented the EU directive on financial collateral. Under the new law, financial collateral is a special form of pledge to which the general rules also apply.

Obstacles to charge enforcement process – Hungary (2003)

Scope



Process



Note: The fuller the web, the more serious the problems are in each of the respective categories. "Process" factors measure the impact that specific obstacles would have on the enforcement proceedings. "Scope" factors give an indication on how effective enforcement would be when conducted on various types of collateral and in the case of debtor insolvency.

Source: EBRD Legal Indicator Survey 2003

Areas where improvements could be made are in the enforcement of an enterprise charge, which remains quite hazardous. Also, charges over rights and receivables are not registered anywhere, so they are not an attractive type of security. Finally, the treatment of secured creditors in the case of the debtor's insolvency is highly unsatisfactory and needs to be addressed.

Complete reform of the Civil Code has been under way for some time. Whilst this may bring substantial benefits in many areas, it is essential that reform of the rules that relate to or have an indirect effect on secured transactions should not undermine the considerable progress that has been made since 1998.

Telecommunications

The telecommunications sector is currently regulated by the Nemzeti Hírközlési Hatóság ("NHH") and is governed by the Electronic Communications Law of 2003 (the"Communications Act"). The Communications Act and the adoption of all necessary of secondary legislation up to May 2004 finalised Hungary's transposition of the 2002 EU regulatory framework in accordance with the country's obligations as a new EU member state.

In addition to the transposition of the 2002 EU regulatory framework the Communications Act sought to provide a framework for market analysis and re-structured the National Regulatory Authority. The Communications Act replaced the existing regulator, the Hungarian Telecommunications Authority (HIF) with the NHH, enhancing the status and independence of the regulator. NHH's role includes registration of service providers, market supervision, market surveillance and frequency management. In addition, NHH approves of reference offers, accounting separation models and provides dispute resolution services. The NHH is governed and managed by a board of seven communications experts.

Hungary is widely regarded as being one of the more advanced of the transition economies in aligning its telecoms legislation with EU standards, with national policies being heavily influenced by the EU strategy for liberalising markets. The regulation of the communications sector has been relatively clear and consistent from the outset and Hungary was early to liberalise the telecom marketplace beginning in 1992 and continuing over the following decade. In 2001, the Law on Communications sought to implement the 1998 EU liberalisation framework and full market liberalisation was formally introduced in 2001-2002. Similarly, Hungary was one of the earliest of the central European countries to embrace sector privatisation, beginning in 1993. All operators are now understood to be privately owned, though the state retains a golden share in the former incumbent.

Notwithstanding Hungary's significant progress in sector development there have been concerns about the impact some of the delays in implementation are having. While the formal legislative and regulatory framework is virtually complete, delays in full implementation of important measures have likely had an impact upon market development. In this respect, though now resolved, the delays in extending obligations with respect to carrier selection/pre-selection across the market are notable, as was the absence of an appropriate implementing framework for number portability. Other apparent legislative/regulatory deficiencies have included the absence of authority for NHH in certain areas of universal service and the fact that, despite NHH being assigned responsibility for market analysis and imposition of remedies, legislation has empowered certain ministries to issue decrees fixing certain prices without requiring such decrees to be preceded by a market analysis or a formal determination of significant market power.

While Hungary has achieved much success in the development of a private-sector led liberalised market-place, it is clear that the formal adoption of EU standard legal and regulatory framework does not guarantee a competitive market. Effective implementation and robust regulatory intervention is the cornerstone of a modern competitive marketplace. To obtain the full benefit from the significant sectoral advances over almost a decade and a half, the authorities must ensure timely and appropriate actions to support the functioning of the marketplace and rapidly address legislative lacunae and market failure.

ANNEX 10: MAP OF HUNGARY