DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR HUNGARY

As approved by the Board of Directors at its meeting on 11 October 2011

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Hungary is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

Over the past two decades, Hungary has achieved significant progress overall towards development of a functioning market economy and a multiparty democracy. At the same time, some recent legislative initiatives have altered the balance between the state and the market in public governance. While many crisis-affected countries in the transition region have re-configured this balance – strengthening state institutions and regulatory oversight, for example – it is important for Hungary's further transition progress to continue to adhere to the high standards set in the European Union for political inclusiveness and open and competitive markets. Many elements of the government's new multiyear Széll Kálmán structural reform plan are steps in the right direction.

The global financial crisis in 2008-09 hit the country hard, partly due to its high public debt and a history of private borrowing in foreign currencies. GDP growth was less than 1 per cent in 2008 and the economy contracted sharply by 6.7 per cent in 2009. The post-crisis recovery thus far has been sluggish by regional standards, with growth in 2010 at about 1.2 per cent and early 2011 showing little new dynamism and continued fragility. Household consumption and investment remain weak, held back by rising unemployment and a continued contraction of credit. However, recent indicators point to some strength of both industrial production and in exports, both of which continue to benefit from the recovery in the core eurozone economies, and subdued domestic demand has contributed to build up of current account surpluses.

Throughout the crisis the concerted and substantial EU/IMF financial programme played a substantial role in stabilising the economy, in particular by preventing a destructive adjustment in the exchange rate. The crisis has revealed vulnerabilities, particularly in the financial sector, which had not been fully appreciated earlier, and a number of measures introduced over the past year have impacted economic governance and the investment environment, dealing a set-back to transition. To sustain the recovery all actors will need to adapt to the post-crisis environment: credit markets to resume their normal functioning; banks to clean up their balance sheets; businesses to shake off the effects of the crisis through corporate restructurings; and the policy framework to provide a stable and supportive environment for investment and growth.

The Bank has sought to cushion the impact of the crisis through a robust crisis response in 2009 and 2010, combining ramped up investments in the financial and energy sectors with policy dialogue.

Although Hungary is amongst the most advanced countries in the transition region in terms of market reform, significant transition gaps remain in several areas. Overall, demand persists for Bank finance in areas where EBRD is highly additional and can continue to deliver transition impact through well-structured, bankable projects, supported by policy dialogue. The key remaining transition challenges that are relevant for the Bank include:

- Strengthening resilience of the financial sector, including through the development of **local currency capital market** structures and instruments in support of real sector growth;

- Addressing deep-rooted inefficiencies in **transport** sectors, stemming in part from inefficient use of energy, insufficient private sector participation and lack of restructuring of transport companies;
- Diversifying sources of **energy supply, promoting renewable energy and energy efficiency** investments, and improve access to finance for related investments;
- Securing and expanding the country's role as an export platform of **technology and skills-intensive products**.

Strategic Directions

While Hungary is expected to graduate during the CRR-4 period (2011-2015), this three-year strategy, effective to end-2014, will seek to support the authorities' efforts to create more sustainable and balanced growth. In light of the impact of the recent crisis, the external environment and the remaining transition challenges outlined above, the Bank's activities in Hungary will be based on the following selective strategic objectives:

- Support post crisis recovery of the **financial sector** by providing targeted long-term financing and new products to selected financial institutions. Facilitate the development of local capital markets, which is an objective shared by both the Bank and the Government and where possible, contribute to manage the high non-performing loans stock. The Bank will continue to offer advice on building capacity for local currency finance and on creating a more conducive environment for local institutional investors, and will conduct policy dialogue under the successor to the Vienna Initiative on financial regulation and restructuring of bank assets.
- Provide long term financing to promote **public transport and municipal infrastructure** investments in close co-ordination with other IFIs, particularly the European Investment Bank (EIB). Focus will be on restructuring, thereby relieving associated budget pressure, and on potential for energy savings and emission reduction. Public transport reform is a key area of the structural reform plan approved by the Government. The Bank will continue to offer advice on key areas of reform to be implemented and continue active policy dialogue in terms of the scale and scope of the reforms.
- Promote investments in the diversification of **energy** supply, in energy efficiency and renewable energy to enhance energy security, reduce energy intensity and meet environmental targets set to combat climate change. The Bank will continue its policy dialogue in the area of energy efficiency and renewable energy, with a particular focus on the private residential sector.
- The Bank will selectively provide **higher-risk products** for local corporations, particularly MSMEs, to fund their investments, with a focus on energy efficiency, R&D, innovation and/or knowledge economy leading to higher competitiveness. The Bank will consider supporting domestic companies in their attempts to tap the local capital markets. The Bank will also support the regional expansion of Hungarian companies through **cross-border investments**.

Progress in implementing the Bank's strategy in Hungary will depend on the existence of a conducive policy and reform environment to enable investments to go forward and attract foreign investors into the sectors where Hungary has a comparative advantage. The Bank will work closely with other IFIs, as it did throughout the crisis period, to ensure coordination and effectiveness of its assistance to Hungarian businesses and institutions.

1. THE BANK'S PORTFOLIO

1.1. Overview over Bank activities to date

The Bank has been supporting Hungary's transition to a market economy by financing mainly private sector projects across a broad spectrum of economic sectors since 1991. As of the end of March 2011, the Bank has signed 164 operations with total net cumulative business volume of approximately EUR 2.5 billion. EUR 253 million was financed through regional projects and EUR 649 million is in equity representing 26 per cent of the cumulative business volume. Business volume is well diversified with Financial Institutions representing 28 per cent of the historic business volume, Infrastructure 28 per cent, Industry, Commerce and Agribusiness representing 26 per cent and Energy representing 18 per cent.

During the three full years since the last strategy was adopted (2008-2010), the Bank has signed 20 projects with a total volume of EUR 840 million, out of which EUR 512 million has been disbursed. Consequently, the Hungarian portfolio has increased by EUR 444 million from EUR 515 million at end 2007 to EUR 959 million at end 2010. Operating assets increased by 66 per cent to EUR 707 million, out of which 36 per cent is in Energy, 32 per cent is in Infrastructure, 19 per cent in Financial Institutions and 13 per cent in Industry, Commerce and Agribusiness.

2009 was a year of heavy crisis response activity with a total of EUR 582 million signed. EUR 317 million (54 per cent) of the volume was in Financial Institutions and about one-third was provided to support Hungary's energy security policy. In 2010 the Bank continued its support in the post crisis environment providing EUR 178 million in total, out of which 56 per cent was in Financial Institutions and about one-third to address energy security, mostly through investment in renewable energy generation.

The current private sector portfolio ratio (as a percentage of the total outstanding portfolio) is 97 per cent, which is well above the Bank's 60 per cent mandated ratio. All the projects signed during the last strategy period were in the private sector.

Table 1: Portfolio in Hungary as of 31 December 2010

SECTOR	NET CUMULATIVE BUSINESS VOLUME				CURRENT PORTFOLIO STOCK				
Amount in EUR million	Number of projects	Total Project Costs	EBRD signed	*EBRD % of Total*	Number of projects	Portfolio	*% of Portfolio*	Operating Assets	*% of Operating Assets*
Energy	**7**	**1,274**	**439**	**18%**	**6**	**270**	**28%**	**255**	**36%**
Natural Resources	4	1,053	384	15%	2	215	22%	201	28%
Power and Energy	3	221	56	2%	4	56	6%	54	8%
Financial Institutions	**51**	**876**	**701**	**28%**	**16**	**315**	**33%**	**132**	**19%**
Bank Equity	6	194	133	5%	3	46	5%	47	7%
Bank Lending	19	450	390	16%	6	209	22%	85	12%
Insurance & Financial Services	26	232	178	7%	7	60	6%	0	0%
Industry, Commerce & Agribusiness	**82**	**3,159**	**647**	**26%**	**36**	**141**	**15%**	**96**	**14%**
Agribusiness	6	262	68	3%	2	20	2%	20	3%
Equity Funds	35	506	167	7%	27	93	10%	55	8%
Manufacturing & Services	16	339	139	6%	0	0	0%	0	0%
Property & Tourism	14	319	67	3%	5	27	3%	21	3%
Telecom, Informatics, Media	11	1,733	207	8%	2	1	0%	0	0%
Infrastructure	**24**	**4,402**	**696**	**28%**	**8**	**232**	**24%**	**224**	**32%**
Municipal & Environmental Infrastructure	12	317	131	5%	3	30	3%	22	3%
Transport	12	4,085	565	23%	5	202	21%	202	29%
TOTAL	**164**	**9,711**	**2,483**	**100%**	**66**	**959**	**100%**	**707**	**100%**

Table 2: Portfolio Development in Hungary in 2008-2010

Amount in EUR million	**2007**	**2008**	**2009**	**2010**	**Development over 2008-10**
					(end 2007 vs end 2010)
Net Cumulative Business Volume	1,843	1,919	2,492	2,483	+ 35 %
Cumulative Number of Operations	149	149	160	164	+ 10 %
Current Portfolio Stock	515	509	1,036	959	+ 86 %
Number of Operations	72	71	73	66	- 8 %
Operating Assets	425	403	475	707	+ 66%
% Undrawn	18%	21%	52%	23%	
					(cumulative 2008-10)
Annual Business Volume	39	80	582	178	+ €840m
Number of Operations	10	2	11	7	+ 20 projects
Gross Disbursements	51	58	116	285	+ €459m
Annual Cancellations	20	14	3	204	+ €221m
Active Pipeline Stock	511	183	480	316	
Private Sector Share (% Portfolio)	94%	94%	97%	97%	
Non Sovereign (% Portfolio)	97%	98%	99%	99%	

- % Undrawn excludes guarantees.
- Current Portfolio includes active operations only.
- Active pipeline stock includes Regional projects.
- Operating Assets do not include utilization of SWAP facility of EUR30m due to incompatibility of accounting systems between Treasury and Banking departments.

1.2. Implementation of the previous country strategy

The previous strategy period coincided with the global economic and financial crisis of 2008-09. 2010 was also a particularly difficult year in Hungary because of weak post crisis recovery. In addition, some economic decisions taken in the past year have negatively affected market sentiment. The significant increase in the Bank's activity during this period reflected the Bank's swift response to the economic and financial crisis, including under the Vienna Initiative.

The previous Country Strategy for Hungary, approved in January 2008, outlined the following strategic priorities for the Bank in Hungary:

- **Infrastructure**: Support the involvement of the private sector in the provision of public services, including through public-private partnerships in the infrastructure area and also in cooperation with EU Cohesion/Structural Funds.
- **Energy:** Promote investments in the diversification of energy supply, in energy efficiency and renewable energy to enhance energy security, reduce energy intensity and meet environmental targets.
- **Corporate sector:** Provide higher-risk products such as equity and structured debt for local corporations to fund their growth, with particular attention to local companies' investments in the context of cross-border expansion.
- **Financial Institutions:** Participate in the introduction of new capital market products by financial institutions and support innovative products/financial institutions that provide financing for SMEs.

However, in 2009-2010, crisis response became the highest priority due to scarce medium to long-term liquidity, the need to stabilise bank balance sheets as a result of structural FX mismatches as well as to strengthen their capital base.

Responding to key transition challenges and the crisis, the Bank has delivered an increased business volume, including the following targeted operations:

- **Financial Institutions:** The Bank provided crucial support to financial institutions during the previous strategy period at a time when the country was hit by the global financial crisis. As part of the Joint IFI Action Plan and coordinated under the Vienna Initiative, the Bank provided strong support to the financial sector in 2009 and 2010, committing a total of EUR 417 million to Hungarian banks, including EUR 220 million in the form of equity. One of the Bank's first responses was to develop a new cross-currency swap product to help banks address the large structural currency mismatches (long dated FX assets versus short dated local currency liabilities) on their balance sheets that could not be hedged during the crisis due to the disappearance of such markets. OTP was the first customer for this product, which was later on rolled out to other banks in the region. The Bank also implemented a new product for Hungary, the EU/EBRD Municipal Finance Facility Energy Efficiency credit line, supporting energy efficiency improvements by municipalities through local banks. The first credit line of EUR 25 million with a local bank was signed in 2009. The Bank has engaged the authorities in an active policy dialogue to support the development of a local currency and capital market.
- **Infrastructure:** The Bank supported the involvement of the private sector in the provision of public services through public-private partnerships in the infrastructure by participating in the financing of the M6-M60 motorway concession.
- **Energy:** The Bank promoted investments in the diversification of energy supply with a subscription of a 25 per cent equity stake in Magyar Wind, the Hungarian wind power business of Iberdrola Renewables. This investment is helping to significantly scale up the Hungarian installed wind capacity and has high demonstration effects as an example of utilising an alternative energy source. The Bank supported Hungary's energy security agenda by providing financing to a

large gas storage project. Further, a regional Central Europe Oil Company transaction facilitates development of domestic resources for fuel and thereby promotes energy security by introducing enhanced recovery technologies, proving reserves and increasing production in formerly neglected sites. The Bank has also engaged in active policy dialogue in the energy sector by assisting with Hungary's preparation of a Renewable Energy Action Plan.

- **Corporate sector**: The Bank continued to support the corporate sector through eight new regional private equity funds, including one dedicated to renewable energy investments (EnerCap Renewable Energy) and another one dedicated to support distressed companies (CEE Special Situations Fund). Unfortunately, regional expansion of local companies has stalled during the period of financial crisis and therefore, the Bank had no real opportunities in this area during the last strategy period.

Through these and other operations the Bank effectively addressed each of its strategic objectives during the past three years. The impact of crisis required a stronger emphasis on the financial sector than was originally expected, and the Bank's business volume in Hungary far exceeded expectations due to the robust crisis response of the Bank in coordination with other IFIs. This puts the Bank in a strong position to assist Hungary in addressing its remaining transition challenges and its most urgent post-crisis recovery needs in the coming Strategy period.

1.3. Transition impact of the Bank's portfolio

Since the previous strategy was adopted in January 2008, nine out of ten operations signed were ex-ante rated "Good" for transition impact potential, exceeding the Bank's target of 80 per cent at "Good" or better. One project was rated "Satisfactory". Seven of the ten projects were in the financial sector, two in the Power and Energy sector and one project in the Transport sector.

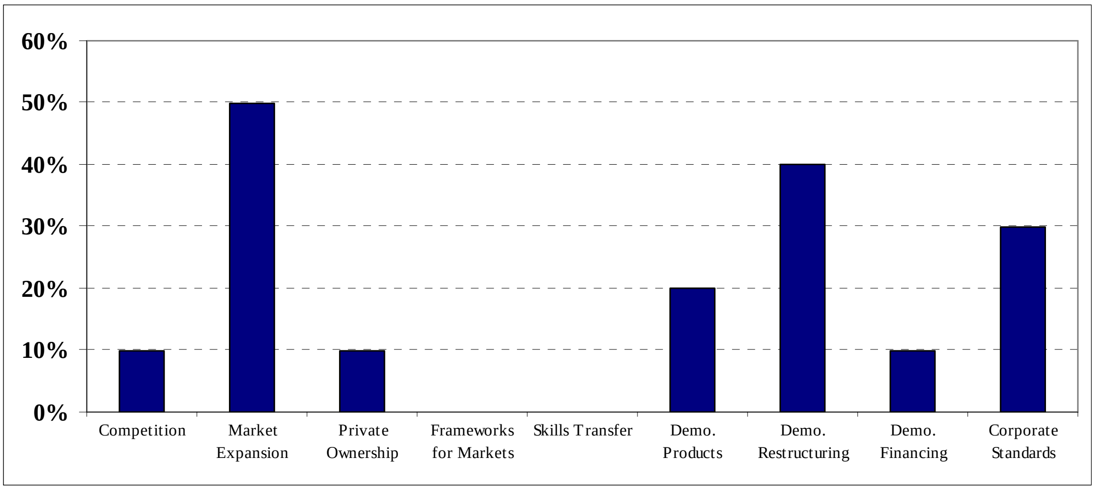
The transition objectives of projects signed during the strategy period reflect the Bank's response to the financial crisis. In 50 per cent of the cases, supporting market expansion was a key transition objective, in particular through the increase in lending by banks (Figure 1). 40 percent of the Bank's crisis response operations targeted demonstration of successful restructuring, or supporting companies in their post crisis restructuring efforts to ensure long-term sustainability. 30 percent of operations signed in Hungary since 2008 addressed improvements in corporate standards.

As of end-April 2011, all active operations in Hungary which are under implementation (i.e. at least 6 months since signing and are monitored for their transition impact at least once) have a transition rank in the range from 1 to 6 according to the Bank's Transition Impact Monitoring System (TIMS).[1] Hungary's active TIMS portfolio was rated 4.18 as of end-April 2011, above the Bank's target for country-level portfolio transition impact 4.35. An analysis of the portfolio shows

[1] Rank is a combination of the relevant rating for transition impact potential and risks to transition impact. Expected transition of operations is usually monitored once a year and is ranked numerically from 1 to 8, with 1 to 3 indicating the mostly realised impact, 3 to 6 – generally on track to achieve transition objectives, and 7 to 8 – minimum transition impact or excessive risks.

that all 17 projects in the portfolio are on track to achieving their transition potential. Eleven operations are generally on track, while the other six operations have almost achieved their desired transition impact.

Figure 1. Targeted transition objectives (share of projects), 2008 - present



2. OPERATIONAL ENVIRONMENT

2.1. Political Context

General elections in April 2010 were won by the opposition centre-right Fidesz party. Its landslide victory was reinforced by an even stronger performance at the local elections held in October 2010. As a result, the governing coalition currently controls 68 per cent of the seats in the national Parliament, positions of the Prime Minister and the President, a majority in all county Assemblies, and positions of mayors in 22 out of 23 large cities, including the capital Budapest. The ruling Fidesz maintains strong popular support, in contrast to the previous ruling party, whose ability to implement its policies was hampered by lack of popular support.

Since the transition began no one party has enjoyed such an unprecedented concentration of power, which allows Fidesz to pass key legislative acts without the need to seek support from the opposition. This concentration of power in the hands of a single party, some recent initiatives to curtail the competences of the Constitutional Court and Fiscal Council, and the lack of meaningful involvement of the opposition in the political process has caused concerns regarding the effectiveness of checks and balances and has affected the business environment. There were questions regarding the process of preparing and adopting a new Constitution in April 2011, which the European Commission for Democracy Through Law of the Council of Europe (Venice Commission) assessed in opinions issued in March and June 2011.

See Annex 1 for a more detailed political assessment.

2.2. Macroeconomic context

Post-crisis, Hungary continues to suffer from a number of macroeconomic and financial vulnerabilities. External debt remains high at over 140 per cent of GDP at end-2010, following several years of substantial private and public sector borrowing.

In part as a result, about 60 per cent of the stock of bank loans to the private sector remains denominated in foreign currency, including in Swiss franc. Public debt at 80 percent of GDP at end-2010 is among the highest in the transition region and the prospect of protracted low growth has raised investor concerns over private and public sector debt sustainability. Nevertheless, Hungary has remained relatively insulated from the problems in sovereign debt markets of the eurozone periphery thus far. An additional vulnerability lies in the high dependence on fluctuations in industrial production in western Europe, given the large share of exports in national income (about 85 per cent). Foreign direct investors, primarily from western Europe, remain an important and stabilising factor in the Hungarian economy, generating about 6 per cent of GDP in annual income over recent years, and showing sustained gross inflows over the duration of the crisis.

Hungary's recovery remained weak by regional standards, with growth in 2010 at only about 1.2 per cent and early 2011 showing little new dynamism. Recent indicators point to the strength of both industrial production and in exports, both of which continue to benefit from the recovery in the core eurozone economies. However, domestic demand remains weak, as it is held back by rising unemployment (which remains at 11 per cent according to Eurostat) and the continued contraction in credit to both households and the corporate sector. Despite a cut in personal income taxes, consumption has shown little sign of reviving.

The government's recent fiscal reform programme seeks to address the long-standing fiscal risks, though the majority of savings will accrue in 2012-13, and implementation of the programme will be challenging. In the early stages of its tenure the new government favoured unconventional one-off revenue measures, such as the so-called 'crisis taxes' on a number of sectors (telecommunications, energy, retail and financial services). These taxes have been criticised by investors as discriminatory in targeting industries with significant sunk costs and foreign investors within these sectors. They have contributed to renewed concerns by investors over regulatory risks. Despite these measures, the deficit target under the EU/IMF programme in 2010 was narrowly missed with the deficit reaching 4.3 per cent of GDP. In 2011 the budget will likely record a substantial surplus, at least in an accounting sense, following the shift of private pensions into the state system that is recorded as revenue (accounting for about 9 per cent of GDP). This short-term measure comes however at the cost of deterioration in the long term fiscal position as the government has taken over the associated high future pension liabilities.

In March 2011 the government announced a significant consolidation programme (the Széll Kálmán Plan) which sets the objective of reducing the budget deficit to below 2 per cent of GDP by 2015, mainly through expenditure reductions, such as social and health benefits. The measures are back-loaded for 2012 and 2013, and important implementation details are yet to be announced.

A positive side effect of much diminished domestic demand is that the country has been running current account surpluses. This has reduced pressures on the currency, which has been one of the best performing among emerging markets. Taking a shorter-term view, international bond investors have also been encouraged by the government's fiscal strategy, as underlined by the government's successful international bond issues in the first half of 2011.

The new government also introduced a number of changes in the area of economic governance, such as in curtailing the rights of the Constitutional Court to review tax legislation and other fiscal measures, and in the appointment procedures of members of the Central Bank's monetary policy committee. A new Fiscal Council has a re-defined mandate in assessing the medium term fiscal outlook, while the Constitution sets a new debt limit. Independence of the Central Bank and Fiscal Council are important underpinnings of sound economic governance and should be preserved in the interests of credible and sustainable macroeconomic and fiscal policy making.

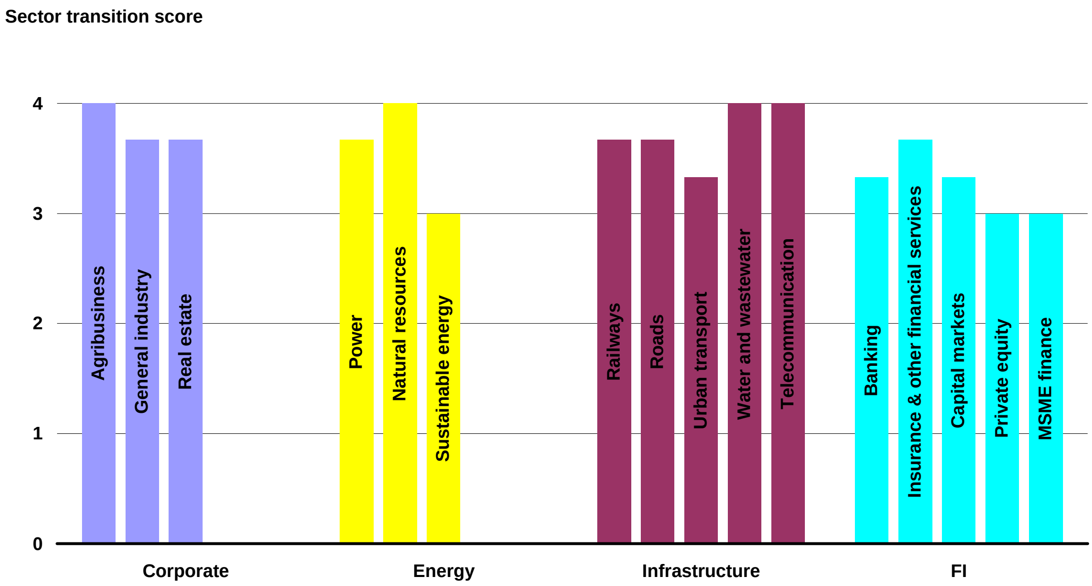
In sum, Hungary remains vulnerable to external shocks such as loss of capital market access (despite recent successful bond issues) or exchange rate depreciation. Impairment to the functioning of the banking system and continued regulatory uncertainty will be the overriding context to the Bank's operations in the coming strategy period, creating risks but also significant demand for the Bank's finance.

See Annex 5 for a table with selected macroeconomic indicators.

2.3. Structural reform context

Hungary is an advanced transition country, though many structural reforms remain incomplete, and some have been reversed recently. An overview of transition indicators in Figure 2 shows mainly small and medium transition gaps remaining, with one (Banking) rated as medium following a downgrade.

Figure 2: EBRD transition indictors for Hungary



Progress was made in fiscal consolidation and with the introduction of some structural reforms, and important initiatives in financial regulation were introduced, including pioneering macro-prudential regulations on foreign exchange lending. Since summer 2010, the Fidesz-led government has emphasized a more inclusive growth model, in particular by reducing the tax burden on SMEs and through the introduction of a flat-rate personal income tax.

In the financial sector the regulator and the central bank undertook several initiatives to address risks from foreign currency lending to retail borrowers, including in 2010 through limitations on loan-to-value ratios. Requirements regarding disclosure and transparency in business with retail borrowers were also strengthened.

There were also several initiatives to deal with the stock of foreign currency loans to retail borrowers, of which about 92 per cent are denominated in Swiss franc, which experienced a rapid appreciation during 2011. In May of that year the government announced an agreement with the banking association to shield mortgage borrowers from exchange rate fluctuations while at the same time lifting the ban on foreclosures of delinquent mortgage loans. This option saw only limited interest from borrowers.

In mid-September 2011, the Parliament adopted legislation without prior consultation with industry stakeholders, that allowed pre-payment of foreign exchange denominated loans by eligible mortgage borrowers at substantially discounted currency rates (in the case of the CHF, about 23 per cent versus market rates at the time), with the resulting foreign exchange losses to be absorbed fully by the banks. The law effectively overrules the terms underlying private loan contracts entered between banks and domestic borrowers.

This measure was sharply criticised by the Hungarian Banking Association, which questioned its consistency with the Hungarian Constitution and EU law. The Association also pointed to risks from growing funding costs and the likely depreciation of the forint. The extent to which eligible households can avail themselves of forint funds to pre-pay their debt within a limited timeframe remains unclear. It is likely that only the most well-off among households will benefit from this measure, while the position of the much larger number remaining in foreign currency debt (because they are already in default or have no access to new HUF funds) may deteriorate even further should the forint and house prices fall as a result of this measure. While the scale of the resulting erosion in banking system capital is as yet unclear, this is likely to set back any recovery in credit to the real sector, possibly leading to further deleveraging, and thus harming economic growth.

The new government in 2010 already imposed a substantial financial sector levy (of about 0.6 per cent of GDP for the sector) which raises a further cost to bank profits until 2012, at which point it is to be cut in half. This levy discouraged maintaining capital or significantly expanding business. In the fall of 2010, the government also decided to offer strong incentives for shifting assets held in private pension funds back into the state system, which nearly all beneficiaries did. This measure was in part motivated by the fact that European fiscal accounting rules offer very limited off-sets for fiscal transition costs to fully funded systems. Through this near complete abolition of the second pillar pension system the government again assumes future pension liabilities, raised questions regarding private property rights over financial assets and could retard the growth of local institutional investors that underpin the development of local capital markets.

In the power sector, the dominant position of the state-owned supplier, MVM, has been curtailed somewhat in previous years, although full unbundling of the sector remains to be completed, as MVM still retains activities in the wholesale and transmission areas. In mid-2010, the new government submitted legislation to parliament regarding a cap on prices that can be charged by universal suppliers of gas and electricity to households and other consumers. Such broad regulation of prices in an essentially competitive wholesale market could interfere with the operation of the market. In May 2011 the Government sought to clarify the ownership of the refinery company MOL and announced the acquisition of a minority stake, purchased from the Russian company Surgutneftegas for about EUR 1.9 billion (about 2 per cent of GDP).

In the transport sector, the railway company and several municipal companies are heavily loss making. The financial performance of MAV, the state-run company operating the rail network, remains poor and requires ongoing and substantial support from the budget. The government seeks efficiencies through a substantial investment programme. The national airline (Malev) was re-nationalised in February 2010, as a foreign investor surrendered the largest part of its stake three years after privatisation.

See Annex 2 for a detailed sector-by-sector assessment of remaining transition challenges.

2.4 Business environment

Hungary has traditionally been an attractive destination for export-oriented foreign direct investment from other EU countries. Significant investment projects that were recently announced or implemented in the automotive sector confirm this continued potential. Nevertheless, with the onset of the austerity programme first and then the financial crisis, FDI inflows have slowed to about one per cent of GDP last year; existing investors increasingly repatriate rather than reinvest earnings made within Hungary.

The World Bank's *Doing Business* 2011 survey ranks the country at 46, with the tax system and concerns over investor protection flagged as problematic. Positive reforms in dealing with construction permits, registering a property and paying taxes are noted. Hungary implemented a time limit for the issuance of building permits, reduced the property registration fee and simplified taxes and tax bases. Additionally amendments to the bankruptcy law encourage insolvent companies to consider reaching agreements with creditors out of court to avoid bankruptcy.

In the 2008-09 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), tax rates, political instability and tax administration were identified as the main impediments to business, with 37, 26 and 13 per cent of companies respectively indicating that these were significant obstacles. In Transparency International's Corruption Perception Index (CPI), Hungary ranked 50th globally in 2010, on a par with other advanced transition countries and higher than seven other EU countries.

2.5 Social context

Following strong growth in the early years of transition and up to the mid-2000s, Hungary experienced a sustained improvement in living standards up to the financial crisis, with labour markets deteriorating from the onset of fiscal consolidation in

2006. Poverty rates and income inequality are comparatively low, ranked at 14th and 7th respectively among OECD countries.

Hungary has one of the most rapidly ageing populations in the EU. Given its poor demographic dynamics, over the next fifty years, Hungary is projected to show a drop in total population of about 12 per cent but a drop in the total workforce of about 22 per cent. These developments will also strain the public pension system, given that the dependency ratio (population aged 65 and over relative to the workforce aged 15-64) is expected to deteriorate rapidly from currently 24 to 51 per cent in 2050.

Health standards in Hungary are below those of other OECD countries according to a 2008 OECD report that underlines below average life expectancy for both males and females. Public spending is below the average of EU-15 countries, and private additional spending well above. The ageing population and cost pressures will raise public expenditures on health (along with those in old-age care) over the next 20 years, according to IMF projections by an above average range of between 1.6 and 2.3 per cent of GDP, unless efficiency-enhancing measures, such as those included under the Széll Kálmán plan, are effectively implemented.

Following the severe economic contraction up to 2009, unemployment at first increased, though over the year to mid-2011 fell slightly to just under 10 per cent, according to the Eurostat definition. Youth unemployment at 24 per cent (of those aged under 25) is slightly higher than the EU average. Long term unemployment (lasting more than one year, and particularly destructive in building workforce skills) has also increased to about 5.6 per cent of the workforce. While these indicators are at or slightly above EU averages, Hungary has the second lowest employment rate in the EU, largely due to adverse incentives within the social security system. This is significantly below the 75 per cent target set under the EU 2020 strategy. The government has adopted a number of measures to raise this very low activity rate, including by abolishing early retirement schemes, and revising disability pensions.

Health and pension expenditures will remain a significant burden on Hungary's public finances, while adverse labour market developments will complicate workforce management and finding appropriate skills within the country.

2.6 Legal context

The Bank's recent assessments of commercial and financial laws in the region show that Hungary has an advanced set of commercial laws when compared to other transition countries. As a member of the European Union, Hungary has been able to take advantage of the need to adopt various EU directives to strengthen its legal reform process. Following the global financial crisis, the country also enacted legislative reforms with a view to increasing the stability of the financial intermediary system. Reform, however, has not been uniform and some areas of legislation still need upgrading. These include, in particular, the procedures for mortgage registration and enforcement, the institutional framework for insolvency administrators, as well as the legal framework for public-private partnerships.

Through its Legal Transition Programme, the Bank has identified specific areas in need of improvement in each of the sectors considered crucial to the Bank's investment strategy for Hungary. It is important that Hungary's legal reform efforts continue, both in these specified areas and in general.

See Annex 3 for a more detailed assessment of the legal environment.

2.7 Energy efficiency and climate change context

Energy intensity in Hungary remains relatively high compared to the EU average. As an EU member, Hungary has committed to 20 per cent energy efficiency reductions by 2020, participates in the EU emissions trading scheme (EU ETS) and will also need to implement requirements of other EU Directives such as on Large Combustions Plants, Combined Heat and Power and Energy Services. A recent consultant report[2] concludes that without vigorous energy efficiency and conservation programmes, energy-intensity indicators for the future can be improved only modestly. Thus, in a country like Hungary, where energy intensive technologies still persist, penetration of Best Available Technologies is low and access to financing for energy efficiency is difficult, energy efficiency improvements continue to be important for competitiveness. Energy efficiency is also particularly low in the built environment where action is needed on upgrades and refurbishment of residential and public buildings.

Hungary's Fifth National Communication to the UNFCCC (2009) identifies the most significant climate change vulnerabilities. These include increasing climate aridity, surface temperature and heat dissipation and decreasing annual precipitation. Climate change models indicate that mean annual temperatures in Hungary will increase by 2°C over the period 2030-2049 compared to 1980-1999.

3. STRATEGIC ORIENTATIONS

3.1 Transition challenges

Hungary is an advanced transition country which has implemented the EU body of market regulation prior to its EU accession in 2004 and benefited from that market integration through substantial inflows of foreign direct investment. The 2010 assessment of transition challenges by the EBRD therefore identified small or negligible gaps in terms of market institutions, with the exception of a medium gap in banking due to reform reversals. Market structures also predominantly showed small gaps, though with important exceptions in the sustainable energy and power sectors, and in MSME finance and private equity. The effective closure of the second pillar pension sector in early 2011 will impact the associated transition rating.

Transition gaps in Hungary have narrowed in a number of areas, due to several years of successful reform; however, significant transition challenges remain in a few sectors. In these areas EBRD is additional and can continue to deliver transition impact through well-structured, bankable projects. The strategy will be selective and focus in those areas where transition gaps, either in terms of market structure or market supporting institutions, are rated medium. These include:

---

[2] Ecorys, Development of the Hungary Renewable Energy Action Plan for Submission to the European Union, draft report October 2010.

- Strengthening resilience of the financial sector, including through the development of **local currency capital market** structures and instruments in support of real sector growth;
- Address deep-rooted inefficiencies, including in respect of energy efficiency, in **transport** sectors, stemming in part from insufficient private sector participation and lack of restructuring of transport companies and resulting in associated budget pressures;
- Diversification of **energy supply, renewable energy and energy efficiency** investments, and improve access to finance for related investments;
- Securing and expanding the country's role as an export platform of **technology and skills-intensive products**.

3.2 Bank's priorities for the strategy period

While Hungary is expected to graduate during the CRR-4 period (2011-2015), this three-year strategy, effective to end-2014, will seek to support the authorities' efforts to create more sustainable and balanced growth with structural reforms ahead of and beyond that point. A lesson of the crisis and of the Bank's effective crisis response over the past two years is the need for flexibility in adapting to rapid changes in the domestic environment and to address the underlying vulnerabilities in the financial sector even in the more advanced transition economies. In light of these lessons, of the impact of the recent crisis on the domestic economy, the fluidity of the external environment and the remaining transition challenges outlined above, the Bank's activities in Hungary will be based on the following strategic objectives:

- Support post crisis recovery of the **financial sector** by providing targeted long-term financing and new products to selected financial institutions. Facilitate the development of local capital markets, which is an objective shared by both the Bank and the Government and where possible, contribute to manage the high NPL issue. The Bank will continue to offer advice on building capacity for local currency finance and on creating a more conducive environment for local institutional investors.
- Provide long term financing to promote **public transport and municipal infrastructure** investments in close co-ordination with other IFIs, particularly the European Investment Bank (EIB). Focus will be on restructuring, thereby relieving associated budget pressure, and on potential for energy savings and emission reduction. Public transport reform is a key area for structural reform plan approved by the Government. The Bank will continue to offer advice on key areas of reform to be implemented and continue active policy dialogue in terms of the scale and scope of the reforms.
- Promote investments in the diversification of **energy** supply, in energy efficiency and renewable energy to enhance energy security, reduce energy intensity and meet environmental targets set to combat climate change. The Bank will continue its policy dialogue in the area of energy efficiency and renewable energy, with a particular focus on the private residential sector.
- The Bank will selectively provide **higher-risk products** for local corporations, particularly MSMEs, to fund their investments, with a focus on energy efficiency, R&D, innovation and/or knowledge economy leading to higher competitiveness. The Bank will consider supporting domestic companies in their attempts to tap the

local capital markets. The Bank will also support the regional expansion of Hungarian companies through **cross-border investments**.

3.3 Sectoral Challenges and Bank Operational Response

3.3.1. Financial Institutions

Sectoral challenges

- The financial crisis has highlighted significant transition challenges in several parts of the financial sector. Managing the substantial currency and maturity mismatches as well as addressing increasing stocks of NPLs remain key challenges.
- Currency mismatches and the resulting extensive reliance on the swap markets and lack of access to sustainable long-term funding are key challenges for the banking sector. The development and regulation of long term funding (including covered bonds) that could help banks meet these needs remains poorly developed.
- Lending by banks continues to contract in the post-crisis environment. Apart from the macroeconomic uncertainty, recent regulatory measures (including the substantial tax imposed on the sector) have led to a tightening of credit standards. This is likely to be reinforced by the recent law allowing foreign exchange denominated loan prepayments at below market rates.
- Development of the insurance and asset management industry has substantially regressed, following the shift of assets out of the second pillar mandatory pension funds back into the state system. As a result, the domestic institutional investor base is much weakened, property rights have become more uncertain, and local capital market development is impeded.

Bank's operational response

To address the problem of currency and maturity mismatches, the Bank will support the diversification of banks' funding by providing specific and targeted long-term financing and new products (e.g. long term HUF financing, cross currency swaps, risk sharing, and structured finance including covered bonds and securitisation) to selected financial institutions. Bank equity and equity-type instruments will be considered only in targeted cases where the Bank can support broader restructuring, or in the context of a short to medium term ownership change; such investments will have to be carefully assessed in terms of upside versus the risks both at individual bank and sector levels.

To address the post-crisis problem of credit constraints, the Bank will facilitate access to finance by SMEs, with the full range of EBRD products, including through work with leasing companies. The Bank will also seek to foster energy efficiency initiatives across all sectors through financial intermediaries paired with grant funds from the EU and other donors. The Bank will also explore whether it can facilitate ways of cleaning up of banks' balance sheets through supporting NPL purchase vehicles, as differing views on valuations are more likely to converge at this stage of the crisis.

To address challenges in the non-bank financial sector, the Bank will work with insurance and pension companies to develop products that meet more exacting regulatory standards and at the same time promote the development of the local capital market, in particular by facilitating the issuance of corporate bonds.

Policy dialogue

The Bank will continue policy dialogue in the financial sector with the supervisor, the National Bank of Hungary (NBH) and the government. This dialogue was initiated with the onset of the financial crisis in late 2008 and revolved around local currency market development, addressing the un-hedged foreign exchange exposures, and concerns regarding the capital base of local banks (capital adequacy and rising non-performing loans). Given the recent regulatory intervention by the government and the considerable risks in this area – in particular due to the potentially sharp fluctuations of the forint vis-à-vis the Swiss franc – this dialogue remains central to re-building a sound financial system.

The development of local capital markets is an objective shared by both the Bank and the authorities. The Bank will continue to offer advice on building capacity for local finance and on creating a more conducive regulatory environment.

The growth of local institutional investors, importantly of voluntary pension funds and other asset managers of private assets, is a key element in furthering this objective. Given the pervasive regulatory uncertainty in this sector, the Bank's involvement could be central to define a more conducive regulatory environment and mitigate the remaining private risks.

3.3.2. Infrastructure and Municipal Sector

Sectoral Challenges

- There remain deep-rooted inefficiencies in the railway sector. To date, substantial subsidies have been provided by the state without significant restructuring efforts on the side of the state railway company (MAV) where financial performance remains weak. Within MAV, significant corporate restructuring (including labour restructuring and rationalisation of passenger lines/timetables) and establishment of contractual arrangements are essential.
- The political commitment and the regulatory framework for PPPs remain unclear and subject to considerable risk. This will likely constrain the development and efficient management of a range of infrastructure sectors. There is a need to maintain the private foothold in the sector by reputable operators.
- A key obstacle for the implementation of large investments in the municipal utilities sector is the fragmentation of municipalities. There will need to be a further commercialisation of municipal service companies and expansion of private sector involvement in the provision of public services.
- To meet Hungary's commitment to achieve 20 per cent energy efficiency savings by 2020 (and 9 per cent savings by 2016 under the National Energy Efficiency Action Plan), a number of policies still need to be adopted in the buildings sector.

Bank's operational response

To address restructuring needs in the transport sector, the Bank will provide long term financing supporting public transport sector investments in both transport infrastructure and services with a focus on large-scale sector reforms (particularly in the railway sector) aimed at cost efficiency, transparency and commercialisation. The focus will also be on the potential for energy efficiency initiatives leading to sustainable transport policies within the context of the EU policy drive of modal shift towards rail and inter-modal operations particularly in terms of freight transportation. In this field in particular, the Bank will explore potential co-operation with the EIB and the EU Structural and Cohesion funds for opportunities to co-finance the large scale investment needs in this sector, with appropriately calibrated EU grant elements designed to address affordability constraints. The EBRD value added however lies in its experience to provide assistance on designing and implementing restructuring plans through technical assistance and/or loan covenants.

To promote private sector involvement in infrastructure, the Bank will support private public partnerships and the use of public service contracts. Specifically, the Bank will support the existing PPP concessions in cases where EBRD involvement would be important for preserving the presence of reputable operators in cases of refinancing or sale of shares in existing PPP companies. Projects will be selected according to their transition impact potential and EBRD involvement is expected to last as long as the Bank remains additional to available commercial funding.

To facilitate commercialisation of municipal services, EBRD will continue its financing for energy efficiency in the municipal environment both through its existing municipal financing facility as well as direct financing, particularly for larger investments in the municipal and transport sectors and with private providers of public services. This will be closely co-ordinated with other IFIs. Focus will also be on potential for energy savings and emission reduction in transport and municipal infrastructure including district heating, where there may be an opportunity to generate carbon credits.

To address the existing financing gaps for energy efficiency measures, EBRD will pursue the development of an appropriate financial mechanism in the built environment and seek to support energy efficiency improvements in the public sector. EBRD will consider among others support to ESCOs engaged in energy performance contracting of energy efficiency and/or renewable energy projects on municipal infrastructure or in municipal buildings and also providing municipal services (e.g. district heating, lighting), municipal district heating companies requiring restructuring and capital investment. EBRD will support the Government in development of a financing mechanism for financing small energy efficiency and renewable projects in the residential sector (mainly individual housing and smaller blocks of flats) which has not been reached by other support programmes. Financial mechanisms should use grant elements where necessary and appropriate, potentially supported through structural or other EU funds and/or ETS auction revenues.

Policy dialogue

The Ministry of National Development has been leading the effort in preparation of a railways restructuring plan. This is a key area for structural reform with a goal to conclude the national agreement on its scope and scale, including budgetary support, until the end of 2011. The Bank will continue to offer advice on key areas of reform to be implemented and continue the dialogue with both the railway authorities and the relevant government departments on both scale and scope of the reforms.

There remains considerable scope to leverage the Bank's funds through partnering with EU structural funds directed at municipal infrastructure and other sectors. There will need to be further discussion with the government on the potential involvement of commercial banks, and on mitigating risks resulting from borrowing practices of municipalities.

3.3.3. Energy Sector

Sectoral challenges

- Improving private sector participation and promoting competition. The incumbent state-owned company MVM retains a dominant position in electricity. Further unbundling of the sector is still needed, including the full unbundling of the Transmission System Operator MAVIR, currently owned by MVM. The independence of Hungary's energy regulator (MEH) needs to be strengthened in the future in line with new provisions in European legislation so as to ensure a level playing field for new entrants.
- In order to meet national targets on renewable energy, further development is still needed. Under the EU 20/20/20, Hungary is committed to generate 13 per cent of its energy from renewable sources. Despite the existing legal framework for renewable energy sources satisfying the basic requirements, there have been mixed signals from the government recently on the issuance of new licenses (particularly for wind power) and access to the grid.
- A key challenge that remains in the energy sector is to diversify sources of energy supply and make the energy system more flexible. This diversification will contribute to Hungary's resilience to external shocks and promote cleaner energy production.

Bank's operational response

To promote competition in electricity generation, the Bank will support projects that facilitate open market-based systems and private ownership. EBRD will seek to support regional interconnections, new power generation or re-powering capacities with private investors and further reinforcement of transmission and distribution grids, particularly to facilitate the production of electricity from renewable sources. These projects will be linked to energy efficiency improvements and carbon emissions reductions.

To assist in meeting national targets for renewables, EBRD will examine financing mechanisms for smaller renewable projects (heat and electricity), including working with the government to explore the potential for using revenues from Hungary's EU ETS auctions and/or structural/cohesion funds for grant components.

To promote cleaner energy production, the Bank will seek to link investments to introduction of new technologies, improving demand side energy efficiency and support for potential tariff restructuring, EBRD may also pursue projects in the area of smart grid and smart metering.

To diversify sources of energy supply, the Bank will support the development of Hungary as a key transport corridor for energy, including through the future construction of trans-European pipelines.

Policy dialogue

The Bank has provided assistance to Hungary with the preparation of the Renewable Energy Action Plan (REAP). The Government has identified in the REAP a number of policy initiatives, such as restructuring of the implementation of existing aid schemes, launch of an independent energy support scheme for 2014 and 2020 and a comprehensive adaptation of the mandatory off-take scheme for renewable electricity. The Bank will continue its dialogue based on these initiatives.

Having been approached by the Government with a request for support in the development of a financing mechanism for small energy efficiency and renewable projects in the residential sector, the Bank will pursue alongside this involvement a dialogue on the necessary framework for those financing mechanisms and the use of grant funding from sources such as EU structural funds and/or ETS auction revenues.

Ongoing dialogue with the government will be required so as to reinforce the role of the regulator in ensuring that connections are managed in an open, transparent and timely manner.

3.3.4. Industry, Commerce and Agribusiness

Sectoral challenges

- Innovation and the development of products that better utilise Hungary's skilled labour force and technology remains a challenge.
- Energy efficiency improvements remain important for the competitiveness of Hungary's economy especially the manufacturing industry where older and energy intensive technologies still persist. Penetration of best available practices is still low and access to financing for energy efficiency improvements is limited.

Bank's operational response

To promote innovation and the development of the knowledge economy, the Bank will support corporates aiming to increase their investments in R&D, innovation and the knowledge economy, including infrastructure service providers, such as data centres. This will be done with loans, risk sharing or guarantee schemes; and if feasible with equity and quasi equity investments either directly or through financial intermediaries.

The Bank will selectively commit capital to new and follow-on equity, mezzanine or venture capital funds with particular focus on regional expansion, innovative technologies and SMEs.

The Bank will also selectively provide long term capital in the form of structured debt or equity to companies that require financial restructuring or corporate governance support. The focus will be on energy efficiency improvements (using BAT across all sectors), transfer of modern technologies and innovation (including ICT and support for knowledge based economy) and improved competitiveness (including through gender components of projects).

The Bank will actively support Hungarian companies interested in investing in the transition region through cross border transactions and will consider supporting domestic companies in their attempts to tap the local capital markets.

Policy dialogue

In its interactions with the authorities Bank staff will emphasise that ensuring Hungary's position as a location for export-oriented and technology intensive foreign direct investment remains critical for sustained and stable growth.

3.4. Environmental and Social Implications of Bank Proposed Activities

As a European Union member, Hungary has adopted environmental and social legislation that meets EU requirements and is aligned with EBRD's Environmental and Social Policy and Performance Requirements.

The Bank's Environmental and Social Policy will apply to all projects in Hungary. The focus on energy efficiency and security, infrastructure and transport, and Financial Intermediaries will raise the normal range of issues associated with these sectors. Energy efficiency and security will require EBRD to assess, and where possible, reduce greenhouse gas emissions. Any new power generating capacity will have to meet EU IPPC Best Available Techniques (BAT) requirements for emissions and carbon intensity.

The Bank will aim to ensure that transport and other infrastructure projects are designed to withstand projected extreme climate events such as floods, in line with best practice and relevant EU legislation such as the Floods Directive. EBRD will also aim to contribute to improved management of water resources through investing in improved water infrastructure and water use efficiency, and by encouraging rational water use through water metering and pricing, taking into account best practice and relevant EU legislation such as the Water Framework Directive.

Transport infrastructure projects that involve land acquisition must implement the Bank's requirement for resettlement and economic displacement. Public consultation and information disclosure will be an important part of project development, particularly where there is the potential to impact on vulnerable groups and minorities. Infrastructure projects also have the potential to adversely impact biodiversity and sensitive habitats. Hungary has a relatively high proportion of protected areas, with 21 per cent of the country designated as a Natura 2000 sites.

Health and safety is an important consideration for all EBRD projects, and is a particular issue with transport infrastructure, both because of risks to worker safety during construction, and public safety once operational. EBRD will work with clients in the road and rail sectors to minimise the risk of accidents and fatalities through good project design and best practice in safety management. Where industry restructuring requires the implementation of redundancy programmes, EBRD will aim to ensure that this is done in a transparent, consultative and non-discriminatory way.

As part of the implementation of the EBRD's Gender Action Plan, the Bank will continue to support women's entrepreneurship through Financial Institutions projects on a best effort basis. The Bank will also continue to develop and implement gender interventions in the MEI projects where appropriate to promote equitable distribution of project benefits among men and women in the community. Additionally, the Bank will encourage clients in other sectors to adopt gender balanced approaches in their human resources policies and practices (e.g. equal opportunities in recruitment and career development)**.**

For a more detailed assessment of gender issues see Annex 6.

4. ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1. Access to capital

Hungary remains at the lowest investment grade rating in the assessment of all three principal sovereign rating agencies, of which two have adopted a negative outlook. While S&P confirmed its rating at that level in November 2010, Fitch and Moody's made further downgrades in December of that year. The government's announcement of its fiscal programme in March 2011 has not yet resulted in a rating upgrade (though rating agency Fitch raised the outlook to 'stable'). The premium over benchmark bonds applied to holdings of Hungarian government bonds (the EMBIG spread) has nevertheless remained relatively stable at around 200 bps, while the insurance contract against sovereign default has markedly declined in early 2011 to currently around 250 bps (this remains in line with for instance Croatia, and well above any other new EU member state).

Following sharp capital outflows in 2009, Hungary's capital and financial account has again returned to a small surplus. Hungary has benefited from a global surge in portfolio capital flows, though the amounts received by Hungary have remained relatively modest (at about half a per cent of GDP in 2010). Outflows were largely confined to holdings in private entities, as the market in government bonds has seen a strong revival since the third quarter of 2010. Issuance of a USD 4.25 billion bond in April 2011 (predominantly in 30 year maturities) and of a EUR 1 billion bond in May 2011 were widely regarded as successfully launched on favourable terms. Foreign participation in the domestic (HUF denominated) bond markets has recently risen to about one third, a near record for emerging markets. With these issues the government had met its external bond financing targets for 2011 as a whole. There will nevertheless be a need to maintain market access on similar terms, given the substantial roll-over requirements for the government at similar levels (about 5-6 per cent of GDP) in the period 2012-14, as obligations from the previous IMF/EU programme fall due.

While there have been small outflows in portfolio equity investments made by non-residents, there have been a number of significant investment projects initiated by direct investors in Hungary. Projects such as in the automotive and automotive parts sectors have significant potential for positive spill-over effects on the domestic industry. Nevertheless the amount of inward investment received in 2010, at just over one per cent of GDP, is small compared to amounts received in earlier years (between 6 and 7 per cent in 2005 and 06), and compared to what is still received by other emerging markets currently. External funds borrowed by the Hungarian banking sector also decreased rapidly, with maturities of funds shortening. This is again a marked departure from significant inflows in earlier years, and has been attributed to the regulatory and tax climate in the banking sector.

Capital outflows from the banking sector are also reflected in a further contraction in domestic credit to the private sector, which shrunk in total by an estimated 3.5 per cent of GDP in 2010. The latest financial stability report of the NBH attributes the contraction in corporate credit primarily to tightening lending standards on the side of banks; by contrast in the household segment there are constraints in both credit supply and demand, given the low debt bearing capacity of households due to unemployment and elevated debt servicing costs.

4.2. MDB finance and collaboration with other IFIs and multilateral donors

European Union (EU)

The EU has committed EUR 24.9 billion to Hungary under the European Regional Development Fund (ERDF), European Social Fund (ESF) and the Cohesion Fund (CF) over the period 2007-2013. According to the progress report for the period 2007-10 prepared by KPMG, since the start of programmes until the end of 2010, contracts for co-financing were signed with beneficiaries for the total amount of EUR 15.0 billion. Hungary is ranked in the middle both in terms of contracts and payments compared with other CEE countries.

EUR 7.1 billion is designated for the Transport Operational Programme. Other priority areas include Environment and Energy, Social Renewal and Economic Development.

Following the expiry of the EU/IMF financial programme in October 2010 both institutions are now in a post-programme monitoring phase, in which more intense dialogue is undertaken, though no new funding has been requested or is being offered from the second half of 2009. Under the EU’s Excessive Deficit Procedure and the Fund’s concerns that announced fiscal measures will not lead to a sufficient stabilisation of debt levels are a good basis for cooperation with EU and IMF to support structural reforms, such as in railways and the financial sector. The World Bank’s withdrawal from Hungary makes EBRD the only IFI mandated to support structural reforms in Hungary and makes the Bank’s policy dialogue even more additional.

The Bank and the EC will continue to implement EU/EBRD Municipal Finance Facility – Energy Efficiency Window. In addition, there is a potential for cooperation between the EBRD and the European Commission (EC) in the area of co-financing of municipal projects based on a good experience gained in the other new EU member states.

The Bank's financing, including in the transport and energy sectors and cross-border investments are also relevant in the context of the Danube Region Strategy endorsed by the EU member states during the Hungarian EU Presidency. The EBRD can contribute to the successful implementation of the Strategy at the regional level (also in countries other than Hungary) by facilitating the use of existing technical assistance facilities and multi-donor financing mechanisms (such as the Western Balkans Investment Framework) in close cooperation with the EU and the European Investment Bank (EIB).

The European Investment Bank (EIB)

EIB contributes to the integration, balanced development and economic and social cohesion of the Member States by financing sound investments. EIB loans frequently co-finance projects supported by grants from the EU Structural and Cohesion Funds.

Since 1990, the EIB's lending in Hungary reached EUR 13.4 billion, out of which EUR 10.0 billion has been signed since EU accession of Hungary in 2004. Transport and credit lines to local banks account for more than half of the total amount signed since 1990. During the last strategy period of 2008 to the first quarter of 2011 EIB financed 60 projects in the amount of EUR 5.3 billion which represents 40 per cent of total signed amount in Hungary since 1990. In 2010, the EIB signed 19 transactions with a total value of EUR 1.7 billion in the following areas: credit lines to enhance SME and other lending (29 per cent of total), energy (27 per cent), health and education (25 per cent), telecom (9 per cent), and municipal infrastructure (7 per cent).

The Bank's co-operation with EIB is expected to continue in the coming years as long as the availability of commercial long term funding remains limited. The two institutions will continue their complementary activities. Potential areas for co-operation are in the transport and energy sectors, since the availability of long term funding for infrastructure remains limited. However, both institutions will continue to focus on their comparative strengths, where the major focus of EIB remains in the area of large sovereign infrastructure projects. EIB is increasingly active in funding energy efficiency and renewable energy projects, even in the private sector, an area where mutual co-operation could be fruitful.

World Bank

The World Bank signed the last project in Hungary in December 2006. Hungary graduated from the Bank's financial assistance in Spring 2007. In 2008, Hungary received a financial assistance package of up to EUR 20 billion in aggregate from the IMF, the EU and the World Bank. As part of this international financial support package, there was a possibility to draw down EUR 1 billion from the World Bank based on its Board decision of September 2009, but this has not been signed by the Hungarian authorities.

International Finance Corporation (IFC)

Hungary has been a member of the IFC since 1985. IFC invested in 28 projects involving around USD 372 million from its own account and USD 21 million in syndications from other banks. IFC has not signed any new projects in Hungary during the last strategy period and only one of its previously signed projects (OTP Local Institutions Energy Conservation Programme) still remains active in the monitoring phase.

ANNEX 1 - POLITICAL ASSESSMENT IN THE CONTEXT OF ARTICLE 1

Overview

Hungary is committed to, and applying, the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

Hungary has achieved significant progress overall towards development of a functioning market economy and a multiparty democracy. The six democratic parliamentary elections since 1990 brought an alternation between centre-right and centre-left governments. General elections in April 2010 were won by the main opposition force at the time, centre-right Fidesz. Its landslide victory in general elections was reinforced by an even stronger performance at the local elections held on 3 October 2010. As a result, the governing coalition currently controls 68 per cent of the seats in the national Parliament, positions of the Prime Minister and the President, a majority in all county Assemblies, and positions of mayors in 22 out of 23 large cities, including the capital Budapest.

Since the transition began no one party has enjoyed such an unprecedented concentration of power, allowing the ruling Fidesz to pass key legislative acts without the need to seek support from the opposition. The lack of meaningful involvement of the opposition in the political process caused concerns amongst some observers, exacerbated by the controversy over a package of media laws adopted at the end of 2010, as well as legislative changes designed to limit the competences of the Constitutional Court.

At the same time, the commitment of the current Hungarian authorities to upholding democracy, rule of law, and human rights is unquestionable. The ruling party came to power as a result of fair and democratic elections. Subsequent local elections, organised already with Fidesz in power, were conducted in accordance with international standards for democratic elections. The guarantees for human rights are in place, and the independence of the judiciary has been maintained.

New Constitution

On 18 April 2011, the Hungarian Parliament adopted a new Constitution, which was subsequently signed into law by the President on 25 April 2011 and should enter into force on 1 January 2012. The new Constitution symbolically draws a line under the country’s communist past, since the current Constitution was adopted in 1949, although it was comprehensively amended during the years of transition. The new Constitution was adopted with the votes of MPs representing the governing coalition and one independent MP. The opposition political parties did not participate in the process of drafting the Constitution and either boycotted or voted against it during the adoption of the Constitution. However, the draft was submitted to wide public consultations. The new Hungarian Constitution upholds multiparty democracy the rule of law and fundamental human rights as underlying principles, as well as principles of market economics.

At its session in March 2011, the European Commission for Democracy Through Law of the Council of Europe (Venice Commission) expressed its concerns regarding the process of the adoption of the Constitution, including lack of involvement of the opposition and a limited framework for the preparation and adoption of the Constitution. Various international and local human rights organisations criticised what they described as the excessive focus on promoting conservative values.

In June 2011 the Venice Commission adopted a comprehensive assessment of the new Constitution. The Venice Commission opinion welcomed the fact that the new Constitution establishes a constitutional order based on democracy, the rule of law and the protection of fundamental rights as underlying principles. At the same time, it expressed concern regarding the curtailment of powers of the Constitutional Court, passed into law in 2010 and now confirmed in the new Constitution, which limit the Court's scope of control over the constitutionality of tax and other financial legislation and budgetary matters (effective until the debt-to-GDP ratio declines to below 50 per cent). This could undermine the authority of the Constitutional Court, the opinion stated, and in turn potentially impact the principles of the rule of law and of separation of powers. It also expressed concern that a significant number of issues were subject to 'cardinal laws' requiring a two-thirds majority in parliament to overturn, which could make the political order less adaptable. The Venice Commission also recommended that the Constitution could contain more precise indications regarding the content and guarantees of the constitutional protection of fundamental rights.

While describing the new Constitution as a "major step" for Hungary, the Venice Commission opinion described this as the beginning of a longer process that would require the adoption of numerous pieces of implementing legislation, which should be based on "the largest consensus possible within Hungarian society".

Elections

The Hungarian electoral system allows for free and fair democratic elections. The unicameral National Assembly currently has 386 seats (the new Constitution envisages a limit on the number of MPs at 200), with MPs elected every four years under a mixed single-mandate/proportional representation system. The President, who has a largely ceremonial role, is elected by the National Assembly every five years. Importantly, the system adequately facilitates the smooth succession of power among political parties and provides the basis for a transparent, accountable, fair and equal process. All previous elections were assessed by international observers (OSCE stopped monitoring Hungarian elections after the 2002 parliamentary elections) as having been conducted in a manner consistent with international standards and commitments for democratic elections.

Rule of law and integrity issues

The legal system, which has undergone comprehensive reforms, an independent judiciary, and human rights ombudspersons provide an effective framework safeguarding fundamental rights and freedoms.

According to the 2010 Corruption Perceptions Index by Transparency International, Hungary is ranked 50th out of 178 countries, on par with most of its regional neighbours. However, some corruption issues remain, particularly as regards political party funding and public procurement. While the recent Life in Transition Survey (LiTS), conducted by EBRD in cooperation with the World Bank, revealed that perceived frequency of 'irregular payments' to public officials is relatively low, there has been an increase in this measure of corruption as compared to the 2006 survey. At the same time, the latest LiTS also demonstrated a considerable mismatch between a higher perception of corruption and a lower experience of corruption in daily life.

Media

Freedom of speech is guaranteed by law and respected, and independent media operate freely in Hungary. Foreign ownership of Hungarian media is extensive.

In 2010, the Hungarian Parliament adopted a new package of media laws, which caused critical reactions both domestically and abroad, including from EU partners and in the European Parliament. The experts commissioned by the Office of the OCSE Representative on Freedom of the Media prepared a detailed analysis of the new legislation. Amongst the main areas of concern were the following: excessive centralisation and concentration of power in the hands of the newly established media authority; the fact that it comprises exclusively members or supporters of the ruling party (consequence of the 2/3 parliamentary majority); regulation of different media content – broadcast, online and print media – based on identical principles; and harsh new fines, which, in combination with some ambiguous formulations, could encourage 'self-censorship'. The Representative on Freedom of the Media concluded in her report to the OSCE Permanent Council that the new media package significantly contradicted OSCE standards of media freedom. Following a dialogue with the European Commission in the beginning of 2011, the authorities proposed several amendments to the new media legislation designed to address these concerns, which were approved by the Parliament.

Ethnic minorities

Hungary has an advanced system for protection of ethnic minorities, and a number of mechanisms have been developed to ensure that ethnic minorities enjoy cultural and political rights. Roma represent the largest minority population and at the same time the most vulnerable one. While most of Hungary's other ethnic minorities have been integrated into the mainstream of public life, the Roma remain relatively marginalised: their living conditions are worse than those of the general population, they are less well educated, have below-average income and their unemployment rate is much higher than average. Anti-Roma sentiment is strong among the membership of the far-right Jobbik, a political party that is represented in the national Parliament. There have been cases of violent confrontation between far-right extremist organisations close to Jobbik and the Roma population.

Efforts are being made by the government to promote faster Roma integration. The Ethnic Minorities Ombudsman plays an active role in the examination of allegations of discrimination against the Roma community. In 2010, the government established a new position of State Secretary in charge of minorities, essentially devoted to the Roma issues. Hungary, in its capacity of holder of the EU Presidency in the first half of 2011, made as one of its priorities forging a new European strategy for Roma and played an important role in preparing the European Framework for National Roma Integration Strategies.

ANNEX 2 - ASSESSMENT OF TRANSITION CHALLENGES

The table and the supporting text below provide an overall assessment of Transition Challenges by sector, based on Transition Report 2010. There are two separate scores for each sector, rating market structures and market-supporting institutions. Scores range from negligible, small, medium and large. "Negligible" means that the remaining challenges are minor and that the sector is well advanced in moving towards the standards of a well-functioning market economy. "Large" means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

Sectors	Market Structure	Market-supporting institutions
Industry, Commerce and Agribusiness		
Agribusiness	Small	Small
Manufacturing and Services	Small	Small
Real Estate	Small	Negligible
Telecommunications	Small	Negligible
Private equity	Medium	Small
Energy		
Natural Resources	Small	Negligible
Power	Medium	Negligible
Sustainable energy	Medium	Small
Infrastructure		
Urban transport	Small	Small
Waste and wastewater	Small	Small
Roads	Small	Negligible
Railways	Small	Small
Financial Institutions		
Banking	Small	Medium
MSME	Medium	Small
Insurance and financial services	Negligible	Small
Capital Markets	Small	Small

INDUSTRY, COMMERCE AND AGRIBUSINESS

Agribusiness

Market structure: Small
Institutions/policies: Small

Since accession to the EU in 2004, Hungary has been integrating into the EU's CAP. Although land privatisation is close to completion, the titling of privatised land is progressing slowly due to an inefficient land cadastral system. Foreign individuals and companies and Hungarian legal entities (e.g. companies and corporations) still can not own agricultural land, and even for Hungarian citizens, there is a 300 ha limit set for individual land ownership. The land market continues to function poorly. The privatisation of agri-processing, input supply and service companies has been completed, but many owners still have to reduce costs, improve efficiency and upgrade hygiene standards in order to become internationally competitive. Lastly, it should be noted that there is a considerable disparity between agricultural and agribusiness activities in eastern Hungary (less advanced) and those in western Hungary in terms of efficiency, production, integration, development, and financing.

Manufacturing and services
Market structure: Small
Institutions/policies: Small

Although the manufacturing and services sector in Hungary continues to be very competitive, recent developments may undermine investor confidence in the economy. 'Crisis taxes' on a number of sectors, such as telecommunications, energy, retail and financial services have been widely criticized as discriminatory and punitive and are the subject of EU infringement procedures. Moreover, businesses continue to be burdened by relatively high level of taxes on labour and a low labour participation rate. Ensuring the country's position as a location for export-oriented and technology-intensive FDI is a key priority to raise the country's trend growth rate. This requires adhering to a non-discriminatory and predictable tax policy, addressing some of the impediments to establishing a business, and strengthening innovation and labour participation rates.

Real estate
Market structure: Small
Institutions/policies: Negligible

Although the main segments of the real estate sector are relatively developed in Hungary, the development of secondary property markets has been impaired by a lack of liquidity and scarcity of market entities capable of providing depth, such as large-scale institutional investors or real estate funds. The tourism sector has developed rapidly since 2005, especially in Budapest, which is considered to be a mature hotel market. Hungary scores well with regard to the quality of property-related primary and secondary legislation and has made substantial progress with regard to the process of registering property. Primary and secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) is well developed and public awareness of the sustainability issues is also good.

Telecommunication
Market structure: Small
Institutions/policies: Negligible

The telecommunication regulation in Hungary is already well developed. A number of bitstream, shared access and Local Loop Unbundling (LLU) agreements are in place. Magyar Telecom (controlled by DT) still dominates the fixed-line market, but the competition has been intense at the local level. Competition between the three foreign owned operators (controlled by DT, Telenor and Vodafone) in the mobile market is intense, and moving to value-added services. Internet penetration rates are increasing and the broadband market is growing remarkably fast. In October 2010 the government imposed temporary higher taxes on the telecommunications operators and their duration has been extended according to the government's new reform package. Hungary has a relatively well developed IT sector, with major international players operating in the country and with a significant hardware manufacturing capacities.

Private equity
Market structure: Medium
Institutions/policies: Small

Less than 20 regional fund managers have been identified to include Hungary in their scope of activity, and domestic private equity managers have recently developed, though this market has room to grow. Active capital is estimated to amount to a little more than 0.4 per cent of GDP and capital available for investments stands at an estimated 0.3 per cent of GDP. The majority of committed capital is concentrated in the buyout segment. Remaining challenges include finalising the framework for private equity allocation for local pension funds and expanding to small start-up and technology intensive enterprises through creation of specialised venture capital funds, which along with small capital funds, mezzanine and infrastructure are under-represented. Distressed and restructuring investment strategies are virtually non- existent. Market institutions are fairly well developed. Corporate governance frameworks have the highest conformity with the OECD Principles of Corporate Governance of all countries of the region. Pension and insurance companies are active as limited partners/investors in private equity funds. The domestic equity market is reasonably well capitalised and liquid to provide viable exits.

ENERGY

Natural Resources
Market structure: Small
Institutions/policies: Negligible

The market structure is well developed but MOL, the integrated oil and gas company, still holds a dominant position. In May 2011 the government acquired a substantial share in the equity of the company from Russian investor Surgutneftegas. While this simplified the ownership structure, the government's intentions regarding its nearly 25 per cent holding remain unclear. MOL accounts for half of Hungary's oil production, virtually all of its domestic gas supply and all refining operations. It has approximately 30 per cent of the fuels market and owns gas transmission pipelines, plus a minority share in storage and gas marketing assets. Much of the gas and power sector is in foreign hands, while IOCs are active in fuels distribution (Shell, OMV, Agip, Exxon, Conoco). Retail oil product prices were liberalised in the 1990s, with IOCs free to compete in the Hungarian fuels market. As of February 2008 households have also been able to choose their gas supplier. Tariff reform, governance and legislation are sound. The Hungarian Energy Office (HEO) regulates and supervises energy activities of gas and electricity companies and is fully independent. Reducing MOL's dominant position in the Hungarian oil and gas sector remains the key sector challenge.

Power
Market structure: Medium
Institutions/policies: Negligible

Further progress has been made in improving the market structure of the Hungarian power sector. Notably, as of 2008, the electricity market was fully liberalised. Notwithstanding market liberalisation, the incumbent state-owned power company MVM retained its dominant position which has recently increased by acquiring stakes in its competitors, including its long-term power purchase agreements – which allow it exclusive rights to buy over 70 per cent of electricity output and which hinders competition. One of the remaining challenges is to complete sector unbundling. MVM, the former vertically integrated national electric utility, has so far retained transmission, wholesale activities, and some generation assets, including the only operating nuclear power plant in the country. The majority of generation assets and all regional electricity distribution companies are privately-owned. There is a relatively strong independent regulator. To promote renewable energy development, mandatory off-take and a feed-in system has been in place since 2005. Hungary is also moving towards a green certificate program (target date uncertain), at which time the feed-in tariff will cease to exist.

Sustainable Energy
Market structure: Medium
Institutions/policies: Small

An adequate legal and institutional framework for sustainable energy is in place. Energy pricing is cost reflective and encourages energy efficiency investments, although some cross subsidies exist. An Energy Efficiency Action Plan for 2008-2016 was adopted in 2008 with a target to decrease energy consumption by 1 per cent a year. The ESCO market is reasonably developed, with both commercial and residential energy efficiency projects. The legal framework is set out in the Energy Efficiency law. Renewable penetration is still lagging behind EU average. Installed wind capacity has increased to a level very close to the current license cap in the country (installed capacity was 295 MW as of Dec-2010 vs. current license cap of 330 MW). Although the Hungarian Energy Office launched a second wind capacity auction in 2010 that would have provided licenses for additional 410MW and allow the sector to grow further, this initiative was cancelled by the government. A Climate policy geared to achieve EU 20/20/20 targets is in place. Hungary has ratified the Kyoto protocol and as a new EU member is part of the Emissions Trading System (ETS). Hungary traded assigned amount units under International Emissions Trading mechanism, however green investment schemes are yet to be designed and implemented. Remaining challenges include the deployment of renewable projects to improve renewable penetration and further progress on CC. The incentive effects of EU grants will need to be reviewed to encourage faster implementation of commercially viable investments.

INFRASTRUCTURE

Urban Transport

Market structure: Small
Institutions/policies: Small

Urban transport companies are corporatised and largely under municipal control. There is substantial private sector participation and competition in the urban bus markets although municipal company BKV, which operates urban rail and bus services in Budapest, has kept its monopolistic position in the capital. The contractual framework for municipal transport services are generally adequate with good public service contracts established for most of the public transport companies. Remaining challenges include a better integrated and inter-modal planning and regulation of the urban transport sector in the larger cities and well as increased private sector involvement and competition in bus services in the capital. Moreover, adequate implementation of EU-compliant PSCs, out-sourced integrated e-ticketing in the capital and some secondary cities are needed.

Water and wastewater

Market structure: Small
Institutions/policies: Small

The majority of the utility companies are corporatised and under municipal or private control. There are several large-city or regional water operators with strong operational and financial performance, demand driven targets and high standards for wastewater treatment. However, operators in smaller municipalities need to further improve their operational efficiency and financial performance. The institutional framework for municipal finance is in place and tariffs have been adjusted to reflect costs for all consumer groups, but investment grants instead of revenue-based financing still prevail. Municipal authorities set the tariffs for water and district heating on an annualised cost-based formula. There is still some room for strengthening incentive-based pricing linked to implementation of a multi-year tariff methodology. Not all operators have public service contracts which can result in delays in tariff increases. There is no central regulator in the sector. Improving corporate governance and management standards in smaller utilities remains a challenge and disclosure of service performance against targets and public consultation can further improve.

Roads

Market structure: Small
Institutions/policies: Negligible

In roads, there have been a number of PPP projects but with a mixed track record (e.g. M1/M15 was eventually nationalised). The government abolished tolls and all new PPP projects are on an availability payments basis. Road construction and maintenance are contracted out to the private sector. Road sector finance has been in line with EU standards. The transition challenges are considered as small but the key challenge relates to the reduction of political fluctuations on PPP projects.

Railways
Market structure: Small
Institutions/policies: Small

Since 2005, the Hungarian government's efforts in railway restructuring and road PPP projects have been quite successful, however the main railway operator, MAV, remains state owned and the latest government reform package did not contain any details on its restructuring. Operating and policy setting functions have been fully separated and core railway functions have largely been separated into individual institutions. Freight operations were privatised. Competition in the freight market has increased but remains weak. Infrastructure access is granted *de jure*, but *de facto is* not fully operational. The government provides substantial subsides in the sector without significant restructuring efforts. The government has made the take-over of the substantial MAV debt (about 1 per cent of GDP) conditional on a comprehensive restructuring plan of the company, which in September 2011 had not been disclosed. Although the policies and institutions are considered to be at an advanced stage, there remain deep-rooted problems. Financial conditions remain weak while the government and railways effectively rely on EU grants and concessional loans. Significant corporate restructuring (including labour restructuring and line closures) and establishment of contractual arrangements (including PSO and access charge regime) are key. Development of new businesses, including commercial based property management, is also needed.

FINANCIAL INSTITUTIONS

Banking
Market structure: Small
Institutions/policies: Medium

Hungary's banking sector is reasonably deep, with bank credit to the private sector at approximately 65 per cent of GDP as of 2009. The sector is dominated by foreign institutions (81 per cent), however, OTP, the former state savings bank, remains the largest bank and still dominates the domestic retail market, while also playing an important role in neighbouring countries. Close to 60 per cent of the sector is controlled by the top five banks and there is a high reliance on external funding. NPLs have risen substantially from around 3 per cent before the crisis to over 10 per cent by 2009. At the end of 2009, the private sector credit to GDP ratio stood at 65 per cent. The single supervisor for the financial sector has recently tightened prudential standards, imposing higher capital requirements for loans denominated in JPY and loans with lower loan-to-value (May 2008) and for exchange rate risk (May 2009). The current government imposed a temporary ban on the registration of FX mortgages, though this was again lifted in May 2011, and EUR denominated mortgages will again be available to highly credit-worthy borrowers. Lending standards have overall tightened and Hungarian banks have restricted their lending to both enterprises and households due to lower profitability and increased risk aversion. The supervisor is closely collaborating with the authorities in the home countries of bank subsidiaries. The bank levy introduced in July 2010, aimed at supporting government's deficit reduction efforts, imposes a significant tax burden on the sector.

Micro, Small and Medium-sized enterprises
Market structure: Medium
Institutions/policies: Small

The value added created by MSMEs grew substantially in the past few years reaching about 52 per cent of the total value added of non-financial enterprises in 2008. Hungary's private financial sector is well developed, though following years of excessive growth it is in the process of reverting to more prudent lending, which depresses credit to MSMEs. Most commercial banks have dedicated MSME departments. However, lending to MSMEs is estimated to account for about 18 per cent of total domestic credit to the private sector in 2009. Credit constraints remain for some micro enterprises, innovative start-ups or SMEs with high growth potential. SMEs still find it difficult to mobilise long-term financing from commercial banks with only about 43 per cent of firms reporting to have access to a bank loan, according to the 2009 EBRD/World Bank BEEPS survey. Several parallel programmes have been set up by the government to improve the access to finance for MSMEs, including micro-credit programme, venture capital and credit guarantee schemes.

Insurance and other financial services
Market structure: Negligible
Institutions/policies: Small

Insurance legislation and regulation almost fully meet the IAIS standards, and the regulatory authority is adequately staffed with professional supervisors. The insurance sector has been growing rapidly in recent years, albeit from a base well below the OECD average, and reached a penetration level of 3.2 per cent of GDP. The sector is solely operated by the private sector, skills in the industry are good and there is adequate availability of non life products, although availability of life products still remains low. Privately managed funds operate both mandatory and voluntary pension schemes with Pillar II assets under management (AUM) amounting to 10 per cent of GDP in 2009. In November 2010, the Hungarian government approved measures to force Hungarians back into the state pension system, a policy aimed at reducing Government pension funding costs (and thus the fiscal deficit) and recapturing private pension funds to reduce government debt. Leasing and non-bank consumer finance markets have been largely developed. Leasing penetration is high at just below 10 per cent, even by EU standards, and legislation in this segment has reached good standards.

Capital markets
Market structure: Small
Institutions/policies: Small

Following the adoption of the EU *acquis communautaire* securities market legislation complies with high international standards, both with respect to quality and effectiveness.

Stock market capitalisation is reasonable at around 40 per cent of GDP. Hungary's government bond market is well developed, with regular and frequent issuance of securities via auctions as well as a well developed infrastructure in the secondary market. Liquidity of secondary trading has not yet caught up with more developed countries and in particular with CEB peer Poland. Hungary's money market shows benchmark indices in place and used; however, activity in forward as well as unsecured and secured markets again lags behind more advanced countries.

ANNEX 3 - LEGAL TRANSITION

Overall assessment

The Bank's recent assessments of commercial and financial laws in the region show that Hungary has an advanced set of commercial laws when compared to other transition countries.

Through its Legal Transition Programme, the EBRD helps create an investor-friendly, transparent and predictable legal environment in transition countries. Programme activities may include policy dialogue, assessment of legislation, and technical cooperation with the country's authorities. Below is a review of legal developments in sectors crucial to the Bank's investment strategy for Hungary. Given the scarcity of funding resources for legal technical assistance in EU member states, the Bank is not planning any specific technical cooperation activities in Hungary during the coming strategy period.[3]

Investment climate / private sector

Mortgage law

Hungary is a priority country for the EBRD's new mortgage lending strategy (covering primary mortgage market – in local currency only – and secondary mortgage market). The secured transactions regime in place since 1997, and due to be amended in 2010 (although the reform has been postponed by judicial decision), is generally speaking a modern and efficient one. There are however some bottlenecks to the system, in particular:

- the time required to register a mortgage, which is unduly long;
- the costs associated with the creation of a mortgage, again comparatively high for the region; and
- the inefficiency of the enforcement process, due to the enforcement costs (again, very high) and the fact that the property is rarely sold at market value.

With the country keen to re-assess its mortgage market (badly hit during the financial crisis because of significant foreign currency exposure) and strengthen the secondary mortgage market, these bottlenecks should be addressed.

Insolvency law

The 2009 EBRD Insolvency Law Assessment rated Hungary's general insolvency law[4] as being in "Medium Compliance" with international standards of best practice. Despite the

[3] Exceptions could be made if there was a highly compelling case for legal technical assistance in a specific area (e.g., in the context of the EBRD Local Capital Markets Initiative), coupled with available funding.
[4] Act on Bankruptcy and Liquidation Proceedings (49/991) (as amended)

sound rating overall, there are material gaps in the law. There remains scope for improvement in dealing with the assets of the estate and in particular the requirements for the debtor and third parties to maintain and deliver up assets of the insolvent estate. Further, EBRD has identified that the provisions dealing with the provision of information to creditors and the independent analysis of a reorganisation plan are weak and require improvement. The largest single issue is with respect to reorganisation proceedings. According to the World Bank (2010) less than 1 per cent of companies which enter into insolvency proceedings continue as a going concern – in other words, business rescues are very rare.

The World Bank visited Hungary in May 2010 to meet with officials to discuss the improvement of Hungary's insolvency regime. A number of recommendations were made, largely aimed to increase the number of rescues. To date, no follow up actions have been made by either side. In the context of insolvency legislation, EBRD would recommend that the Hungarian government take steps to improve the rate of business rescues. Such steps could include: allowing the law to permit expedited restructuring proceedings, introduce a comprehensive moratorium and provide for super-priority financing comprehensive stay on all creditor action upon the opening of bankruptcy proceedings.

EBRD's 2009 Insolvency Officer Assessment (part of the general insolvency law assessment) indicated "Very Low Compliance" with the Bank's Office Holder Principles. The World Bank's "Doing Business" survey notes that insolvency proceedings cost much more and recover much less than similar proceedings in OECD countries, although they appear to be completed within a reasonable time frame. With regard to insolvency administrators, the Bank recommends that Hungary introduce formal qualification requirements and a code of professional standards and ethics for the insolvency profession and enhance the insolvency administrator's powers to obtain information and company assets from third parties.

Local capital market legislation

Hungary is a priority country in the EBRD Local Currency / Local Capital Market Initiative.

The debt capital market of Hungary is not as developed as in more advanced EU countries due to the Hungarian market's size and relatively young age, but the regulatory and institutional framework is generally in line with the relevant European Union laws and standards, including those adopted in the wake of the global financial crisis. In addition, as part of a financial support programme for Hungary with the IMF and the European Union, Hungary adopted legislation to strengthen the stability of the financial intermediary system. While reforms to the existing framework have moved forward, areas in need of improvement remain. EBRD recommendations include:

- improving private placement rules by amending the requirement that the issuer and the distributor finalise all terms seven days before purchasing the securities;

- eliminating overlaps and gaps that have resulted from the implementation of EU directives;
- enacting a law governing securitisation;
- developing standardised documents to be used for derivative transactions between local counterparties;
- removing barriers to local debt issuance; and
- improving the enforcement of payment obligations.

Municipal Environment and Infrastructure

PPP legislation

The Bank's financing of municipal and transport investments would be facilitated by improvements to the Public Private Partnership (PPP) regulatory framework. The government in the spring of 2011 announced that would not adopt any further PPP projects, and with the exception of the motorway PPPs seeks to renegotiate those contracts already ongoing.

Hungarian legislation[5] does not provide a clear definition of concession. Since there is no formal definition of PPP either, several legal provisions may be relevant to PPP depending on the project's particulars. Arrangements are governed by a combination of the concessions law and sector specific legislation, references to which are contained in the former.

Overall, the concessions law appears somewhat superficial and inflexible. In addition to an unclear concession definition other deficiencies include the restricted assignment of concession rights to a third party, the absence of a stability clause, insufficient termination/compensation provisions and mechanism and an insufficient pre-qualification procedure. These have been addressed by an EBRD-sponsored technical cooperation project requested by the Ministry of Economy and Transport in 2006/7. A comprehensive, modern PPP Policy paper has also been drafted in consultation with the PPP Task Force for the Government to consider. However, neither the reviewed concessions law drafted under the project nor the PPP Policy paper has been approved since. The Government should take steps to act on the EBRD advice previously provided.

Public Procurement

Public investments in infrastructure and municipal sectors also require a solid public procurement framework. In the EBRD 2010 assessment Hungarian public procurement legislation scored high to very high compliance with international standards. The public procurement legislation[6] provides for modern, uniform, and comprehensive regulation, in

[5] Law XVI of 1991 on Concessions. Moreover, Act CXXIX of 2003 on public procurements (replacing Act XL of 1995) may be applicable to PPP projects other than concessions.
[6] Act CXXIX of 2003 on Public Procurement (amended on several occasions) and secondary legislation (Government Decrees and Ministry of Justice and Law Enforcement Decrees)

accordance with the EU PP Directives. In certain aspects however the legislative framework and the corresponding practice could be improved: for example communication rules are outdated and there is no general requirement to publish all tender documents and procurement reports on the contracting entity's website. These issues should be addressed by the Hungarian authorities.

ANNEX 4 - TC COMMITMENTS FOR HUNGARY

TC COMMITMENTS BY DONOR THROUGH EBRD, 2008-2010

Donor	TC Commitments (€)
Austria	120,000
EBRD Shareholder Special Fund	200,000
European Commission	847,410
Total	**1,167,410**

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2008-2010

Sector	TC Commitments (€)
Energy Efficiency and Climate Change	1,047,410
Municipal Environmental Infrastructure	120,000
Total	**1,167,410**

ANNEX 5 - SELECTED ECONOMIC INDICATORS

Hungary	2005	2006	2007	2008	2009	2010	2011
						Estimate	*Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.2	3.6	0.8	0.8	-6.7	1.2	2.7
Private consumption	3.3	1.9	0.2	0.4	-7.9	-2.1	na
Public consumption	2.2	3.7	-7.3	1.0	-0.1	-1.7	na
Gross fixed capital formation	6.5	-3.5	3.7	3.2	-9.2	-6.9	na
Exports of goods and services	11.3	18.6	16.2	5.7	-9.6	14.1	na
Imports of goods and services	7.1	14.8	13.3	5.8	-14.6	12.0	na
Industrial gross output	3.1	5.5	4.2	-1.5	-12.6	na	na
Agricultural gross output	-3.9	-6.7	-21.8	54.6	-15.2	na	na
Employment			*(Percentage change)*				
Labour force (annual average)	1.3	1.0	-0.2	-0.7	-0.1	1.3	na
Employment (annual average)[1]	0.0	0.7	-0.1	-1.4	-2.3	0.0	na
			(In per cent of labour force)				
Unemployment (end-year)	7.2	7.5	7.4	7.8	10.0	11.2	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	3.6	3.9	8.0	6.1	4.2	4.9	4.2
Consumer prices (end-year)	3.3	6.5	7.4	3.5	5.6	3.5	na
Producer prices (annual average)	4.3	6.5	0.2	5.3	4.9	na	na
Producer prices (end-year)	4.5	4.5	1.6	-0.8	0.1	na	na
Gross average monthly earnings in economy (annual average)	8.8	8.2	8.0	7.4	0.6	1.4	na
Government sector[2]			*(In per cent of GDP)*				
General government balance[3]	-7.9	-9.4	-5.0	-3.6	-4.5	-4.2	2.0
General government expenditure	50.2	52.0	50.0	48.8	50.5	48.9	na
General government debt	61.8	65.7	66.1	72.3	78.4	80.2	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	13.0	11.8	8.6	10.2	0.8	0.0	na
Domestic credit (end-year)	16.3	18.5	12.8	18.5	-3.5	4.0	na
			(In per cent of GDP)				
Broad money (M2, end-year)	48.5	50.2	51.1	53.3	55.1	52.9	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	6.0	8.0	7.5	10.0	6.3	5.8	na
Interbank interest rate (up to 30-day maturity)	6.1	8.1	7.6	10.1	6.7	4.5	na
Deposit rate weighted average (fixed for less than 1 year)	5.2	7.4	6.8	9.9	5.8	4.9	na
Lending rate weighted average (maturing within 1 year)	7.4	9.2	8.8	12.3	8.9	na	na
			(Forints per US dollar)				
Exchange rate (end-year)	213.6	191.6	172.6	187.9	188.1	208.7	na
Exchange rate (annual average)	199.6	210.4	183.6	172.1	202.3	207.9	na
External sector							
			(In millions of US dollars)				
Current account	-8,070	-8,424	-9,390	-11,134	345	1,304	1,800
Trade balance	-2,795	-2,576	260	-108	5,720	6,200	5,500
Merchandise exports	62,827	73,320	93,172	106,442	83,045	95,200	0
Merchandise imports	65,623	75,897	92,912	106,550	77,325	89,000	0
Foreign direct investment, net	5,502	3,117	1,800	4,021	-3	-2,500	0
Gross reserves, excluding gold (end-year)	19,531	20,529	22,382	35,290	42,620	44,544	na
External debt stock	83,554	102,835	135,475	180,870	181,993	119,148	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.0	2.8	2.5	3.4	5.5	5.1	na
			(In per cent of exports of goods and services)				
Debt service [4]	15.3	12.5	12.4	17.1	27.0	na	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	10.1	10.1	10.1	10.1	10.0	10.0	na
GDP (in billions of forints)	21,970.8	23,730.0	25,321.5	26,753.9	26,054.3	27,119.8	29,021.9
GDP per capita (in US dollars)	10,902.1	11,193.3	13,699.2	15,458.7	12,818.8	12,997.3	na
Share of industry in GDP (in per cent)	25.9	26.1	25.6	24.6	25.3	na	na
Share of agriculture in GDP (in per cent)	3.6	3.5	3.4	3.6	2.6	na	na
Current account/GDP (in per cent)	-7.3	-7.5	-6.8	-7.2	0.3	1.0	na
External debt - reserves (in US$ million)	64,022.1	82,305.9	113,092.9	145,579.9	139,372.2	74,604.6	na
External debt/GDP (in per cent)	75.9	91.2	98.2	116.4	141.3	91.4	na
External debt/exports of goods and services (in per cent)	110.1	118.2	122.8	143.0	179.8	104.2	na

[1] Data from labour force surveys.

[2] According to Eurostat

[3] Data are based on Eurostat methodology (ESA95), excluding part of the cost of pension reform.

[4] Excluding inter-company loans.

ANNEX 6 - GENDER EQUALITY

According to the UNDP's 2010 Human Development Index (HDI), Hungary is amongst the very high human development countries at 36th place. Between 1980 and 2010, Hungary's HDI value increased substantially – from 0.689 to 0.805, an increase of 17 per cent. The country ranks slightly better in terms of the Gender Inequality Index, designed to reveal if the national human development achievements are eroded by gender inequality, than for its HDI. Once reproductive health, education, political and labour dimensions of gender equality are examined, the country ranks 34th globally.

	Index/% (1.0 max)	Ranking (out of 169)	Year
Human Development Index	0.805	36	2010
Gender Inequality Index	0.382	34	2010

Source: UNDP Human Development Index 2010

Since reaching a peak in 1980 at 61.5 per cent, the labour force participation of women decreased steadily throughout the pre-transition period and continued falling until the mid 1990s, when it reached its lowest point in 1996 (48.7 per cent). Since then women's labour force participation began to grow steadily until 2006 (55.2 per cent) and has since stagnated, according to the ILO. The labour force participation of women between the ages of 25 and 34 has fallen much more significantly since 1980 than for women between the ages of 35 and 54. This may be explained by the fact that women in Hungary take significantly more time away from work following childbirth than in other EU countries and face greater challenges re-entering the labour market. The unemployment rate among women decreased from 10.4 per cent in 1993 to as low as 4.9 per cent in 2000, and has since been increasing steadily to 11.2 per cent in April 2011, only slightly lower than the average, according to eurostat. The crisis hence did not have a disproportionate impact on female unemployment or labour force participation.

	Female	Male	Year
Labour Force Participation (15-64)	54.7	68.5	2009
Unemployment Rates (15-74)	9.7	10.3	2009

Source: ILO Key Indicators of the Labour Market 2009

Occupational gender segregation has also been decreasing, although slowly. However, women still tend to be clustered in low paid, low status sectors, such as the service and public sector, including health, social services, and education. Vertical segregation is more common in the private sector, which employs fewer women, although it is also present in the public sector. The proportion of women in management and professions has grown, although men still tend to be more present in higher management. According to the European Commission, women occupy 30.2 per cent of positions as leaders of businesses, which is slightly below the European average of 32.6 per cent. Men dominate the top positions of limited companies and two thirds of large companies are run by men.

Gender discrimination is widespread, especially affecting women over the age of 50 and pregnant women. Roma women furthermore are particularly affected by discrimination in the labour market and experience higher unemployment rates than women in general.

The gender pay gap began to decline in 2003, but increased again and in 2008 was 17.5 per cent, in 2008 which is exactly at the EU average.[7]

The EU figures for 2009 show that 15.7 per cent of Hungarian men are entrepreneurs and 8.33 per cent of women are entrepreneurs. This, however, may be changing given that the overall number of self-employed women (including entrepreneurs), while half that of men, has remained steady over the last 10 years, whereas the number of self-employed men has declined. This may be related to the fewer opportunities available for women after childbirth and the long childcare leave.

Out of all businesses run by women, 94 per cent are micro enterprises and 28 per cent do not have any employees, according to the EU sources. The statistics are not very different for men: 92 per cent of male run businesses are micro-enterprises and 20 per cent do not employ staff, partly because of public dues and administration costs. According to a survey commissioned by the EU in 2008, only 15 per cent of female entrepreneurs believed their businesses to be growing, most made small profits, two thirds had never participated in any cooperation, and the majority only sold products locally. Only 15 per cent of these businesses had ever taken out a business loan, while 30 per cent of them relied on private and/or household loans to finance their operations. In 2008, less than 10 per cent of these businesses planned to expand the enterprise and more than half of them expanded only by reinvesting their past profits. Women entrepreneurs very rarely relied on professional services and lacked developed business plans.

[7] European Commission Employment, Social Affairs and Inclusion 2010