The proposed CAS for Hungary is concise, to the point, well organized, presents its main messages with clarity and appropriately links the Bank’s instruments to implementation, although there are some concerns which we will note.

Hungary continues its transformation into a democratic, free market society. As this process continues the Bank can be proud of the lengthy support and cooperation that has existed. While Hungary’s situation and the context of its efforts are perhaps somewhat sui generis, this does not diminish the satisfaction we feel for the progress that has been made.

One of the most important ingredients of this has been the broad societal support mobilized for reform measures. Over and over again the CAS refers to consultations with political parties, NGO’s, affected groups and organizations, and civil society in general. This transparency and the support it provides to a sometimes difficult reform process seems to us to be an important factor.

The progress made since introduction of the emergency stabilization package has indeed been impressive, as the CAS notes. Current account and budget deficits are declining. That the country’s risk rating is now investment grade confirms our views.

But, while the economy has been largely privatized, important public sector reforms remain to be accomplished. The private sector is reported to account for 70% or more of GDP. Hungary leads the rest of Central Europe in privatizing state-owned assets. The country has also benefited from foreign direct investment, broad support from government donors and large private foundation generosity.
We, therefore endorse the overall strategy with, however, some specific comments for consideration that we hope will improve the proposed strategy as well as the Public Sector Adjustment Loan (PSAL).

We will refer first to the overall strategy and then specifically to the need for further tightening the compromises reached in the PSAL. Second, we will discuss some transitional problems of macroeconomic time consistency related to the proposed reduction of inflation. Third, we will comment on some omissions in the proposed core reforms of the public sector. Finally, we will comment on the approach to reducing poverty, especially in a group not considered adequately in the safety net package, namely middle age males with second generation health problems.

Exit strategy?

The CAS clearly states that Hungary is a sophisticated, cost conscious borrower that already has investment grade ratings in the international financial markets, receiving terms similar to the Bank. It correctly points out that in this case the Bank’s comparative advantage is in policy design and the implementation experience accompanying its lending.

We were especially and favorably struck by the observation that for Hungary (and perhaps others) “...the attractiveness of Bank operations now depends significantly on the perception of non-financial benefits.” This reflects the World Bank Group’s perhaps unique mixture of comparative advantage; this is an opportunity to show how the knowledge bank can be put to work.

We fully agree with this approach and believe that the Bank has correctly focused its program in advancing pending reforms in the public sector and in particular, the reform of the social security system, where it has ample cross-country experience; and on environmental issues where it has recently acquired worldwide expertise and where Hungary has demonstrated keen interest, especially as this is a requisite for accession to the European Union.

We, therefore concur with the Bank’s country assistance strategy for Hungary. Its emphasis, helping to complete public sector reforms and support Hungary’s eventual accession to the European Union, is correct.

Nevertheless, we are concerned with the possible lack of leverage for enforcing the proposed key reforms. For example, the Pension Sector Adjustment Loan basically implements the proposed reforms over a number of years. On the other hand, it is a single tranche, front loaded fast disbursing loan. Moreover, the local government program does not have vehicles for monitoring and enforcing the implementation of the proposed reforms. This area will require adequate monitoring.
Time consistency of Macroeconomic projections and the reduction of inflation.

It also seems to us a little risky to use, as the main instrument to reduce inflation, just wage and exchange rate restraint, precisely at the beginning of a process of pension reform in which the fiscal deficit is temporarily increasing due to the additional cost of the second pillar. This suggests that in order to have a sounder strategy to reduce inflation, more emphasis should be given to monetary policy in the short run. Of course, this could bring some negative consequences on investment and growth projections, that should also be considered.

Pending reforms in the Public Sector

The CAS rightly focuses on pending reforms in the public sector. Most of the reforms in the private sector are already well advanced. Price and trade liberalization, privatization and financial sector reforms are almost finished. What is left is basically a top-heavy governmental apparatus which still needs to be reformed and placed in a market like type of operation. This is understandable for an economy that is coming out of socialism, but should not be delayed any further.

Specifically appropriate is the proposed PSAL’s focus on pension reforms. This has significant positive effects on medium term fiscal sustainability, on national savings, on creating instruments for term financing and on reducing distortions in the labor market. However, we are concerned over the potential difficulties for these positive effects to occur. The demographics of the exercise appear to make it difficult to produce the proposed increase in savings in the medium term. The population is shrinking, specifically at the middle age range where the proposed increase in retirement ages was supposed to generate the significant savings in the medium term. Could staff comment further on this point?

Nevertheless, the benefits expected from this proposed loan more than compensate for the risks if the compromises agreed to permit its full implementation. In the case of the proposed reform of sub national governments, all standard features of the reform are well explained, but the problem of lack of economies of scale at the municipality level to permit rational management and planning is not addressed. Some proposal for aggregation at the regional level should be put forward for these efforts to become more rounded and successful.

Other Observations:

Most poverty in Hungary is shallow. Recuperation of economic growth through the implementation of the proposed reforms together with the lock in on reforms with the proposed accession to the European Union augurs well for sustained growth in Hungary. This should contribute to eliminating most poverty. In addition, the proposed minimum pension scheme and the adjustment and better targeting of the disability pension of the proposed PSAL will address poverty problems of the poorest. However, we would also note there is still a segment of the population that clearly needs special and specialized attention, namely middle age males with
second generation health problems, like alcoholism, bad diet and so forth which show the highest death rates in the whole population. The proposed health strategies should address these issues.

We would have appreciated more information on the role of other partners and their programs and thus a better understanding of how Bank efforts support and contribute overall to the developmental program.

We would also support efforts to strengthen markets and market institutions. In that regard, and recognizing that the IFC and MIGA are to some extent dependent on others seeking them out, nevertheless we would urge increased activism in these areas, and perhaps especially in the use of financial intermediaries.

To summarize, the over-riding goal of Hungarian Government policy is to become a full European partner, a goal supported by the Bank as well as other participants, believing this provides for strong, sustainable development. Let me reiterate that the Bank’s program appropriately uses the Bank’s comparative advantages in policy design and implementation in key areas of specialized Bank expertise, such as the social sectors. It is also commendable that management is addressing the risks of program reversal and of implementation of complex reforms. This first type of risk is cushioned by the strong political commitment to obtain access to the European Union and the implementation risks are dealt with by unbinding and better pacing of the reforms. We therefore would expect positive results from implementation of this proposed strategy.

Finally, we would express our appreciation for the extensive work that has produced these well prepared documents. We also want to wish the Government of Hungary, success with the implementation of this CAS.