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LN 2965-HU

Report No. P-4796-HU

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED INDUSTRIAL SECTOR ADJUSTMENT LOAN

TO THE

HUNGARIAN PEOPLE'S REPUBLIC

IN AN AMOUNT EQUIVALENT TO US$200 MILLION

May 27, 1988

Industry and Energy Operations Division
Country Department IV
Europe, Middle East and North Africa Region

CURRENCY EQUIVALENTS

Currency Unit - Forint (Ft)

Average Exchange Rates
(Forints per US$)

	1983	1984	1985	1986	1987	1988 (Jan.)
US$1.00 =	Ft. 42.7	48.0	50.1	45.8	47.0	47.2

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS

CMEA	Council for Mutual Economic Assistance
DRC	Domestic Resource Cost
NBH	National Bank of Hungary
NPO	National Planning Office
R&D	Research and Development
TFP	Total Factor Productivity

FISCAL YEAR

January 1 - December 31

HUNGARY
INDUSTRIAL SECTOR ADJUSTMENT LOAN

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HUNGARY

INDUSTRIAL SECTOR ADJUSTMENT LOAN

LOAN SUMMARY

Borrower: Hungarian People's Republic.

Amount: US$200 million equivalent.

Term 15 years, including five years of grace at the Bank's standard variable interest rate.

Objectives and Description: The loan would support the Government's program of economic stabilization and structural reform with industrial sector policies being a central part of the policy reforms. The objective of the program is to increase the efficiency and international competitiveness of the industrial sector to enable increased Hungarian exports to the convertible currency markets. Policy objectives being supported by the loan cover:
(i) increasing domestic and external competition in the economy, (ii) tightening financial discipline in the enterprise sector, and (iii) facilitating the mobility of capital and labor to enable restructuring of industry. These reforms are an integral part of the 1988-90 economic program approved by the Government in September 1987 and being supported by a Standby Arrangement of SDR265 million with the IMF. The loan would provide US$200 million equivalent to finance general imports of goods.

Benefits and Risks: Industrial policy reforms are expected to lead to efficient restructuring and growth. While the focus of the reforms is on the industrial sector, many of the reforms are systemic in nature and would have an economy-wide impact. Successful implementation of the reform would lead the economy to a path of sustainable growth by improving the efficiency, flexibility and market-responsiveness of the structure of production. The main risk of the policy reform program is the possiblity of inadequate implementation of the macroeconomic stabilization policies which would provide the conditions for a strong supply response from industrial policy reforms. The strong commitment by the

Hungarian authorities to implement the stabilization program while accelerating the industrial restructuring program reduces the risk. The feasibility of the program is enhanced by the fact that a new leadership, committed to the reform, has been put in place for its implementation. Overall, while there are risks in the implementation of a reform program in a climate of austerity, the level of risk is acceptable. Nonetheless, implementation of the program will require intensive monitoring by Bank staff.

Estimated Disbursements: The loan will be disbursed in two tranches. The first tranche of $100 million would be available for disbursement at the time of loan effectiveness, and the second tranche is expected to be released in early 1989, on the basis of : (i) satisfactory progress in the implementation of the 1988 economic program, and the adoption of a 1989 Annual Plan and Central State budget, including a public investment plan, which would (a) reduce the budget deficit further and facilitate halting the growth of external debt by 1990; and (b) reduce producer and consumer subsidies and financial support by at least 10% annually from the 1988 level; and (ii) satisfactory progress in the implementation of critical measures which form part of the agreed industrial sector policy reform measures.

Economic Rate of Return: Not applicable.

Appraisal Report: None.

Map: IBRD 17361R1

REPORT AND RECOMMENDATION OF THE PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED
INDUSTRIAL SECTOR ADJUSTMENT LOAN
TO THE HUNGARIAN PEOPLE'S REPUBLIC

1. I submit the following report and recommendation on a proposed Industrial Sector Adjustment Loan of US$200 million equivalent to the Hungarian People's Republic. The Loan would be amortized over a period of 15 years, including a grace period of five years. The Loan would be at the Bank's standard variable interest rate.

PART I - THE ECONOMY

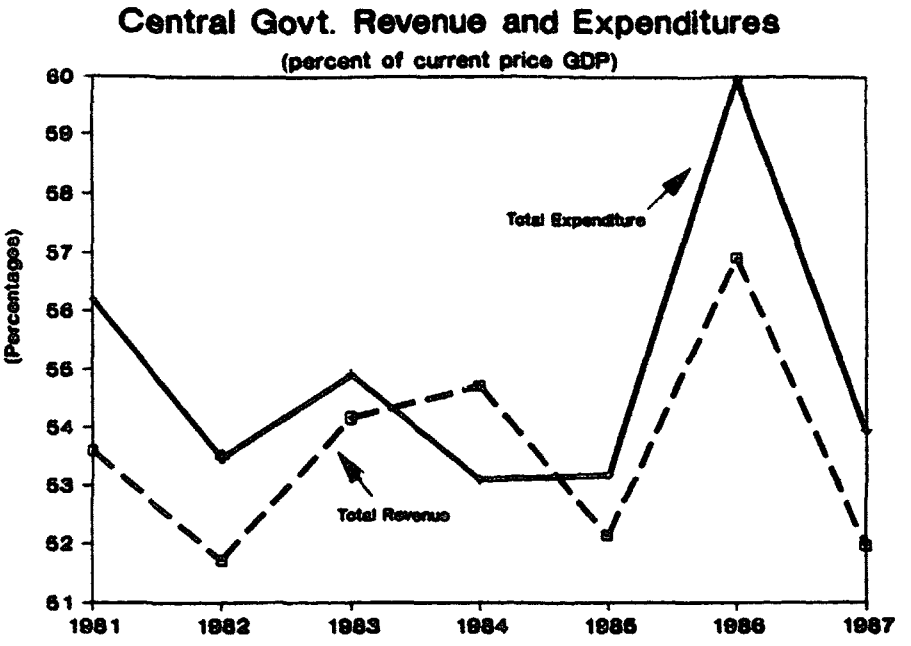
2. A Country Economic Memorandum (Report No. 5951-HU) was circulated to the Executive Directors in 1986. A mission to update the Country Economic Memorandum visited Hungary in July 1987. The findings of the mission were discussed with the Government in October 1987 and January 1988. The following assessment is based on the findings of the mission. The report of the mission is expected to be distributed to the Executive Directors shortly. Country data sheets are attached as Annex 1.

A. Recent Economic Developments

3. Following an economic crisis in the late 1970s and early 1980s, Hungary had stabilized its economy by the end of 1984 with the help of two IMF Standby Arrangements which enabled the country to avert a liquidity crisis. The current account was in surplus, as was the Central Government budget. The stabilization was mainly due to tight demand management, including administrative restrictions on imports, which however had created pent up demand. In 1985 the Government initiated a vigorous renewal of the economic reform program, which had been begun in 1968. Reforms to further the goals of decentralization and reliance on "indirect regulators", or market-based signals, to guide economic actions were instituted.

4. The macroeconomic environment in which the reforms were implemented was, however, not supportive. The authorities judged that, following the stabilization period, a more expansionary demand management policy was justified. This led to a rapid growth of monetary and credit aggregates due to the expansionary fiscal stance, which increased Government expenditures (Figure 1) and fiscal deficits. Part of the reason for the growing fiscal deficits was the increase in State financial support to enterprises. Increased support to enterprises reduced financial discipline and insulated enterprises from the effects of the reforms, and resulted in poor performance in the enterprise sector. Consequently, economic performance was poor: real GDP declined by 0.3% in 1985 and grew by only 1.5% in 1986. Nonruble exports fell by 6.6% and 3.8% respectively (Annex 2).

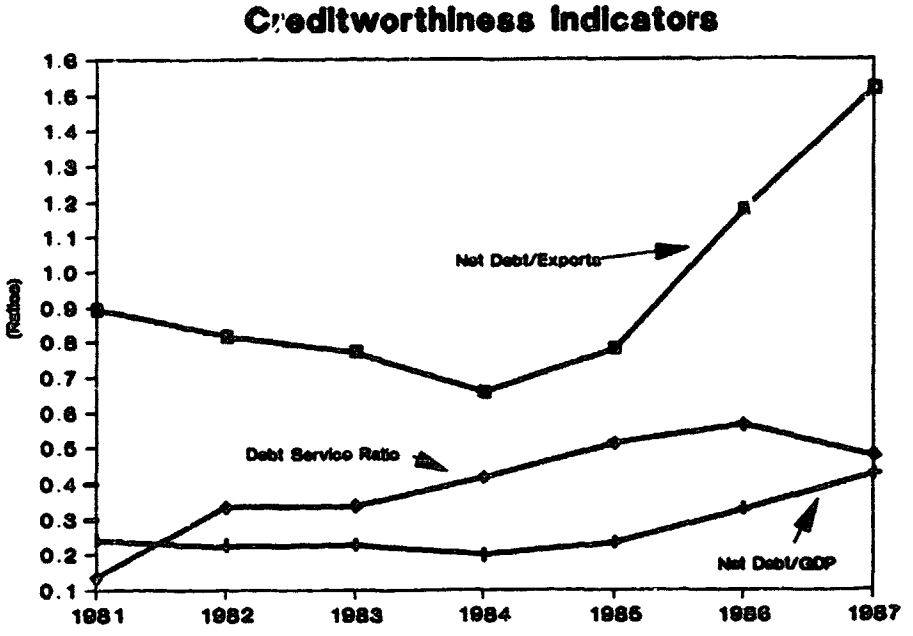
Figure 1



5. Nonruble exports suffered from the contraction of export markets in the Middle East and some developing country markets, and the effects of poor weather on agricultural production, especially of grain. In addition, the profitability of sales to the convertible currency area compared with the domestic market declined in 1985 and 1986. Nonruble import volume increased by an average of 1.7% per year in 1985-86. There was also a cumulative 8.2% deterioration in the terms of trade. The deterioration was due to the heavy concentration of raw materials and semi-finished goods and bulk agricultural products, where world prices were declining, in Hungary's exports. In addition, since a significantly higher proportion of Hungary's exports are denominated in US dollars compared with imports, the depreciation of the dollar against other major currencies worsened the deterioration. As a result of these forces, the trade and current account balances deteriorated sharply.

6. Starting from a surplus of US$329 million in 1984 (Annex 3), the convertible currency current account deficit reached US$1,419 million in 1986 (6.0% of GDP). The growing current account deficits were financed by higher foreign debt. In addition, however, the resulting increase in external indebtedness was exacerbated by the sharp movements in the cross-currency exchange rates that began in 1985 and the shift in the composition of new borrowings into currencies that subsequently appreciated against the US dollar. As a result of the increase in debt and the poor supply side performance, three key creditworthiness indicators - the net debt to GDP ratio, the net debt to exports ratio, and the debt service ratio - all deteriorated in 1985-86 (Figure 2).

Figure 2



7. A major part of the problem in 1985-86 was the unsatisfactory supply response in the industrial sector. Industrial value added fell by 1.3% per year in those years, and relatively strong growth was recorded only in the service sectors, partly because of the continued dynamism of the private sector. The poor overall performance, especially of industry, may be related to the protracted decline in fixed investment, which began in 1979. That decline exposed deficiencies in the composition of investment, which were less noticeable when investment was growing more rapidly. Inefficient investments, particularly those in the coal mining and heavy engineering industries, have been a burden on the economy in the 1980s.

8. Corrective Measures. Throughout the 1985-86 period, the authorities attempted to improve macroeconomic management and implement the economic reform. The maintenance of a sound macroeconomic environment was emphasized in the first Industrial Restructuring Project (Loan No. 2700-HU), which became effective in mid-1986. As the seriousness of the macroeconomic situation became evident by mid-1987, the authorities decided, with Bank advice, on a quantitative target for reducing the fiscal deficit in conjunction with the second Industrial Restructuring Project (Loan No. 2834-HU). Corrective measures were taken in mid-1987 to reduce the budget deficit to Ft35 billion (2.9% of GDP) from the planned level of Ft44 billion, to tighten financial conditions for enterprises, to reduce domestic demand and thus improve the convertible currency current account balance. In March 1987, consumer price subsidies were reduced to contain the fiscal deficit, and the Forint was

devalued by 8%. Punitive taxation of wage increases in excess of productivity gains was applied. Further reductions in consumer subsidies were implemented in July 1987 and the Forint was devalued by a further 5% in November. These measures were effective in reversing the deterioration in internal and external balance, though the extent of the improvement was somewhat less than the authorities' expectations, partly due to a continued increase in household consumption.

9. Real household consumption in 1987 grew by 2.8% compared to the planned reduction of 0.5-1.0%. Part of the reason for the unplanned increase in consumption was anticipatory buying before the introduction of a value-added tax in January 1988 which, when announced in mid-1987, was expected to raise consumer prices by an average of 15% in 1988. In sharp contrast to 1985-86, however, strong domestic demand did not result in a decrease in nonruble exports, which are estimated to have grown by 5% in 1987 as compared to a fall of 6.6% and 3.8% in 1985 and 1986. A major reason for the better export performance was an improvement in the profitability of nonruble exports. The active exchange rate policy that began in 1986, and the change in the domestic pricing system in March 1987 to permit nominal devaluations to increase the profitability of nonruble exports compared with domestic sales, contributed to the improvement in export performance.

10. The turnaround in the performance of nonruble exports was a principal cause of the improvement in the convertible currency trade balance from a deficit of US$539 million in 1986 to a US$3 million surplus in 1987. The trend has continued in 1988. The improvement in the trade balance led to an almost equal improvement in the convertible currency current account, which ended the year with a deficit of US$847 million - a reduction of US$572 million (40%) from the 1986 level. Despite these improvements, there was a further large increase in gross and net external indebtedness, mainly arising from continued valuation losses caused by the depreciation of the US dollar.

11. The supply side of the economy also improved in 1987 as GDP growth accelerated to 3.4%. Industrial production grew by 4.1%, reversing the trend of the previous two years. In addition, the service sectors continued to grow faster than the economy-wide average for the same reasons as in 1985-86. Wheat production was again adversely affected by the third consecutive year of drought, but higher meat production kept value-added in the agriculture sector as a whole from falling.

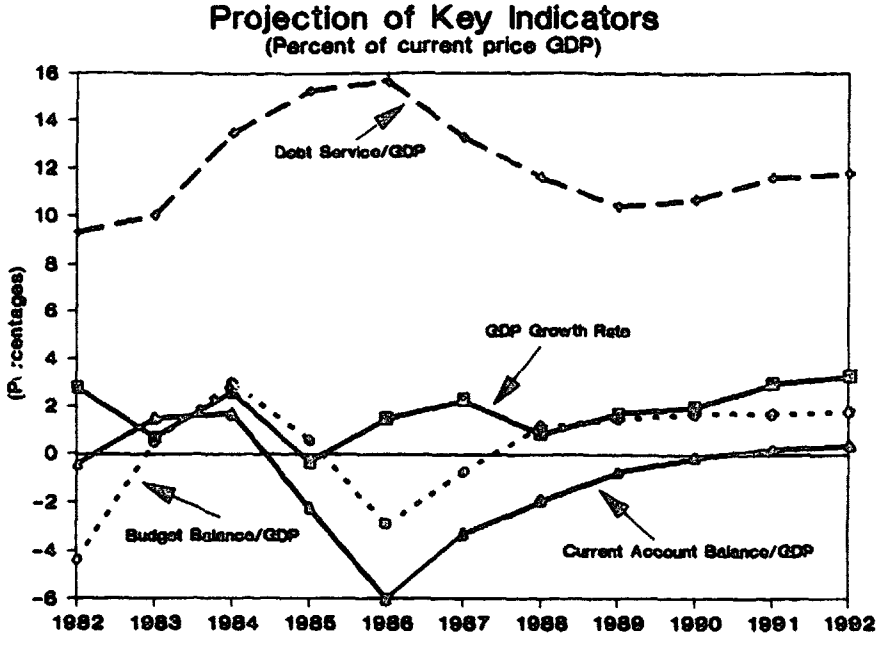
B. Prospects for 1988 and Beyond

12. In order to strengthen and sustain the turnaround in economic performance in 1987, the Government developed a medium term Economic Stabilization and Structural Reform Program for the 1988-90 period described below (paras. 36-38). The main goal of the program is to stop the growth of external debt by the end of 1990. The central feature of the program is a sharp contraction in domestic demand in order to bring about a significant improvement in the convertible currency current account. The main instruments for achieving the objectives of the program are: a strict limit on nominal

wage increases, further reduction of the budget deficit, ceilings on the growth of credit aggregates, an active exchange rate policy, and an active interest rate policy to raise household and enterprise savings rates.

13. Medium term macroeconomic projections on the basis of the implementation of the medium term program are attached as Annex 2. Projected changes in key macroeconomic indicators are depicted in Figure 3, showing the turnaround achieved by the economy in 1987, and the targeted stabilization in 1988. The program is expected to lead to a steady improvement in the current account balance until a near balance is reached in 1990. The Government's net financial position is expected to continue to improve, due partly to reductions in support to enterprises. The continued improvement would support the stabilization of the economy, and improve its responsiveness to the reforms. Gross capital inflows are projected to average US$2.0 billion annually in 1988-90, down sharply form the 1985-87 levels. Lower capital inflows and the improved supply side performance are expected to lead to improvements in the creditworthiness indicators. Overall, the implementation of the economic reform, including measures to improve the efficiency of investment (see below) is expected to lead to a sustainable growth path.

Figure 3



14. The Public Investment Program. The public investment program for 1988-90 calls for increased allocation of investment favoring the manufacturing industries where Hungary is potentially competitive. In 1986 there was a shift in investment composition toward the manufacturing industries and away from the basic materials and electric energy subsectors.

Estimated 1987 results indicate that the favorable trends observed in 1986 continued. Fixed investment increased by 5.5%. The share of mining continued to decline, but the share of electric energy, reflecting the large expenditure on the construction of the Paks nuclear power plant, grew.

15. The Government has agreed to carry out a review of the 1989-90 public investment plan, under terms of reference agreed with the Bank by the end of 1988. The result of the review will be reflected in the public investment plan for 1989. The authorities' efforts to improve the structure of investment include reducing investments financed by the Central Government budget from 44% in 1981 to 31% in 1988 and increasing the share of investment financed by enterprises, which should result in better investment choices as a consequence of tightened financial discipline. In 1987 there were 8 large Central Government projects each exceeding Ft500 million, down from 13 in 1984. The authorities envision no new large projects for the remainder of the Plan, and have reduced and stretched out expenditures on some of the existing projects. In 1988, expenditure on large projects is projected to fall by 15 percent in nominal terms, which would imply a cut of nearly 50 percent since 1983. Expenditure on Central Target investments, which are mainly for coal mining, development of the electricity network, rail and road transport, and the communications system has fallen slightly since 1983. The Plan for 1988 shows total target investment spending rising slightly. A third group of public investments are concentrated in services such as public health, social services, education, culture and others. Spending on this group has also fallen sharply since the early part of the decade.

PART II - BANK GROUP OPERATIONS IN HUNGARY

A. Bank Lending Strategy

16. Since lending to Hungary began in 1983, the Bank's strategy of assistance has focussed on supporting Hungary's program of structural adjustment in the economy to make it more efficient, flexible, market responsive and competitive in external markets, particularly in the convertible currency area. Until 1985, this strategy was reflected in lending operations focussed on selected sectors, i.e. agriculture, industry, energy and transport. Institution building measures, such as the establishment of project analysis capacity, studies and analysis of road user charges, strengthening of capacity to analyze relative efficiency of industrial subsectors, relative prices in agriculture, development of least cost investment programs and application of long-term marginal cost pricing in the power subsector were implemented.

17. Extensive economic and sector work in the agriculture, energy industry, financial and transportation sectors provided the analytical basis for the Bank's policy dialogue with the Government. Apart from such sector specific reviews, a review of public investment[1/] and the 1984/86 Country

1/ Hungary - Investment Issues and Options (Report No. 5585-HU, dated August 25, 1986).

Economic Reports and memoranda have focussed on economic policy issues. These studies have been the basis for the gradual deepening of the Bank's dialogue on management of the economy and the design of the economic and industrial policy reforms. A study[1/] of the policies, performance and constraints in the industrial sector carried out jointly with the Government was particularly instrumental in this respect.

18. The 1985-90 industrial policy reforms, which form the cornerstone of the Bank's lending to Hungary, were designed in close collaboration with the Bank. The main vehicle of Bank support to the reform has been the two industrial restructuring projects, with a "hybrid" design which combined subsector and enterprise restructuring with support to policy changes to encourage competition, tighten financial discipline and enhance resource mobility in the economy. As the economy deteriorated during 1985-86, the Bank advised the Government to accelerate the reform process while further strengthening the macroeconomic and sector policy content of lending operations. The proposed loan with its explicit coupling of the economic stabilization and structural reform objectives is an evolution of this process in response to the current economic situation.

19. The close collaboration between Hungary and the Bank in the design of the economic reform program has resulted in close correspondence between Hungary's development strategy and the Bank's program of assistance. Future lending operations will support the goals of the economic reform. During 1988-90, the Bank's program of assistance will focus on adjustment, particularly in industry but also of broader aspects of the economy such as the incentive system and the regulatory framework for trade. There is a strong complementarity between adjustment lending and investment lending in Hungary. Investment operations in the industry sector are planned to: promote needed restructuring of enterprises and subsectors toward improved international competitiveness; foster growth of small and medium enterprises as well as feeder industries required to deepen Hungary's industrial structure; strengthen technological development capacities; and more important, support development of the evolving financial institutions. Systemic reform supported by adjustment operations will provide a supportive policy and institutional environment and increase the likelihood of success of investment operations.

20. Investment operations in agriculture, energy and infrastructure have been designed to further restructuring in those sectors, while the knowledge and experience gained from the implementation of investment lending operations has been an important input into the development of the reform program and the proposed loan. Improvements in the capital stock resulting from the investment operations in the productive sectors of the economy are also needed to establish a sustainable supply response.

21. The Bank also plays a role through the catalytic effect of its assistance program on other international lenders. This will be a particularly crucial role in 1988-90 when Hungary needs access to international capital markets. Successful stabilization combined with the

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1/ Hungary - Industrial Policy, Performance and Prospects for Adjustment (Report No. 6124-HU, dated September 30, 1986.)

vigorous and consistent implementation of the economic reform will improve Hungary's creditworthiness and its standing among international lenders. The Bank s role as a catalyst for other lenders will gradually decrease, and after 1990 the overall level of lending to Hungary is expected to be at a level consistent with continued support for economic reform and structuring, which is a medium-term process. The Bank's exposure in Hungary is relatively modest. The Bank's share of the disbursed and outstanding debt of Hungary is projected to be 10.7% in 1990, and its share in debt service will reach 8.7%. Measured by the exposure indicators, the risk to the Bank will remain manageable.

B. Status of Bank Group Operations

22. The Bank, as of March 31, 1988, had provided 19 loans for a total of US$1,312.5 million (Annex 4). These include six B-loans with a Bank share of US$136 million. Of the total Bank commitment, 43% was in the industrial sector, 32% in the agricultural sector, 16% in the energy sector, and 8% in the transport sector.

23. The Bank was successful in mobilizing six commercial cofinancing syndications for the Bank-assisted operations in FY83 to FY85. They helped to mobilize nearly US$1.2 billion, including the Bank's contribution of US$136 million. In all these cofinancing operations, the Bank was able to improve the terms over the most recent Hungarian borrowings and to introduce the country to commercial banks from which it had not borrowed previously. The Bank's participation in B-loans was discontinued in 1985 after Hungary had regained adequate access to financial markets on favorable terms.

24. Project implementation in general has been satisfactory. Disbursement performance has been good. Total disbursements at the end of March 1988 amounted to US$820.4 million. The disbursement ratio (calculated as total disbursements in a fiscal year divided by the undisbursed amount at the end of the previous fiscal year) has been good at about 40%.

25. Since Hungary joined IFC in April 1985, IFC's activities focussed on promotion of direct foreign investment through joint ventures and in the cooperative sector. IFC participated in the establishment of a private joint venture bank and in financing two industrial ventures. IFC's total commitment in these operations amounts to US$19.3 million. It is actively seeking to participate in other projects, especially those requiring technical collaboration with foreign partners. IFC's participation would also help develop new financial instruments and activities such as leasing.

PART III - THE FRAMEWORK FOR INDUSTRIAL POLICY REFORM

A. Structure and Performance of Industry

26. Industry is the largest sector in the economy. It accounts for about one third of GDP, employment, and fixed investment and for about 75% of

total exports (Table below). The sector can be divided into the energy (coal, gas and oil) and basic materials subsectors, which represent 20-25% of industrial value added, and the manufacturing subsectors. The former group includes the "smokestack" industries of Hungary, coal-mining and ferrous metallurgy. The poor performance of these industries has been a drain on the economy. The authorities have recognized the need for restructuring these subsectors, and a restructuring plan for metallurgy that will eliminate the need for Government subsidies after 1990 is being implemented. Restructuring the coal-mining subsector is more difficult, principally because of the larger number of workers involved and the potential localized area impact. Nevertheless, the authorities recognize the need to close unprofitable pits and are developing a restructuring plan for the coal-mining subsector which will be finalized by the end of 1988 (para. 49).

Selected Data on the Industrial Sector (1986)

(Ft billion and Percentages)

	GDP		Investment		Nonruble Exports	
	Amount	%	Amount	%	Amount	%
Mining	49.1	15.5	16.6	22.9	1.2	0.8
Electric Energy	28.5	9.0	13.6	18.8	0.0	0.0
Metallurgy	9.8	3.1	4.1	5.6	20.7	13.2
Engineering	110.2	34.9	8.7	12.0	40.9	26.0
Building Materials	46.2	14.6	2.2	3.0	24.0	15.3
Chemicals	42.5	13.4	12.5	17.3	36.3	23.1
Light Industry	14.8	4.7	5.7	7.9	2.8	1.8
Food Processing	10.3	3.3	8.8	12.2	30.5	19.4
Other	4.6	1.5	0.2	0.3	0.7	0.4
Total	316.0	100.0	72.4	100.0	157.1	100.0

27. A study of the policies, performance and constraints affecting the industrial sector was carried out collaboratively by the Government and the Bank (para. 49) to analyze the international competitiveness of Hungarian industry. Most of the manufacturing industries were found to be potentially competitive as measured by a domestic resource cost (DRC) below 1.1. Hungary is also competitive in construction materials, chemicals and light industry. Total factor productivity growth during 1980-85 was positive in these subsectors, a marked contrast to the energy and basic materials subsectors. The study also concluded, however, that growth in productivity in the manufacturing subsectors, especially in capital productivity, was below international norms.

28. Industrial production grew by 4.1% in 1987, a marked improvement over 1985-86. Within the industrial sector, the chemicals, electric energy, engineering and machinery, and construction materials subsectors recorded better than average growth. Part of the improvement is attributable to the

estimated 6.0% growth in nonruble exports by units in these subsectors, with a particularly strong growth in the chemical and light industry subsectors. This export performance indicates improvements in the competitiveness of the sector.

29. Improved performance of the industrial sector is a key to the success of the program in the medium term. There is evidence that performance of industry is improving following two disappointing years in 1985-86. While some of the improvement was due to strong domestic demand, nonruble exports also increased by an estimated 5%, a change from earlier years when domestic demand had the effect of crowding-out nonruble exports. The improvement in incentives for nonruble exports compared with either domestic sales or ruble exports accounts for some of the improvement. The Government intends to maintain the incentives for nonruble exports through an active exchange rate policy.

B. Strategic Issues in the Industrial Sector

30. One of the primary reasons for the poor performance of industry has been the policy environment within which the sector has operated. The economic reform replaced the physical planning system with a new system of economic planning and management linked to markets. While this important achievement enhanced economic efficiency in industry, some strategic issues remain. These are: (a) limited domestic and international competition, (b) limited resource mobility, and (c) the lack of financial discipline and weak autonomy of enterprises. These issues are discussed below.

31. Competition. Limited domestic and international competition has sharply curtailed incentives for improved performance and productivity resulting in an adverse impact on technological, quality and cost competitiveness. The regulatory, financial, and other barriers to free entry and exit of enterprises created a highly concentrated industrial structure and limited the degree of domestic competition and resource mobility. Legal forms of enterprises acceptable to social ownership were limited. Credit allocation preference was given to large state enterprises, crowding out small and medium enterprises. Liquidation of state enterprises was traditionally considered to be incompatible with the principle of the indivisibility of social property and with the guarantee of full employment. Failing enterprises were either subsidized or merged with other enterprises.

32. The most important instrument that limited international competition, both at home and abroad, was the state regulation of international trade until 1986. Competition among the state foreign trade organizations was weak. Regulatory barriers to entry included restrictions on product categories of the trading organizations, and severely limited trading rights granted to other enterprises. Increased competition in international trade activity was therefore one of the earliest reform measures under which producing enterprises were given the right to engage in export trade without going through a foreign trade organization. Quantitative restrictions on imports, which severely limited import competition, were reversed in 1985.

33. Resource Mobility. Structural adjustment in industry has been impeded by institutional and policy constraints on the reallocation of

resources away from uneconomic activities and towards activities where Hungary has a dynamic comparative advantage and the potential for increased convertible currency exports. The capital market as such had not existed during most of the post-war period and securities as instruments for resource mobilization and investment were introduced only recently. Competition in banking began to develop with the banking reform of 1987, when independent commercial banks were set up to take over credit activities of the National Bank of Hungary (NBH) but is still modest. These conditions have in general limited efficient mobility of capital in the economy. Among important factors that limited resource mobility, particularly out of uneconomic activities, were the barriers to exit of enterprises.

34. Since 1981, most industrial products have been placed under pricing rules designed to align them with world market prices, reflecting the actual or potential import or export prices of the convertible currency area. From 1987, the only pricing rule that exists is the limitation that domestic prices should not exceed the cost of comparable imports plus tariffs. These pricing rules represent a major departure from the preceding regime, where most prices were set administratively on the basis of production costs. Wage policy, implemented historically through wage level guidelines and heavy taxation on wage increases, resulted in small wage differentials which reduced labor mobility.

35. Enterprise Discipline and Autonomy. The above constraints combined with the framework in which state enterprises were managed, including no bankruptcy risk until 1986 and limited managerial autonomy, molded enterprise behavior away from attention to market demand, profits, and cost and quality performance. Instead, enterprises focussed on bargaining with the State, which was reflected in their organization, planning, marketing and financial management capability. A high tax incidence on profits further reduced the profit orientation of industrial enterprises. This past environment resulted in little premium being attached to profitability, financial prudence, innovation and productivity improvement.

C. The Economic Stabilization and Structural Reform Program

36. The Government has recognized that an industrial policy reform could proceed and result in the required supply response only under the framework of supportive macroeconomic policies. It was evident from the disappointing performance of the industrial sector during 1985-86 that the macroeconomic policies needed to be tightened to support industrial policy reform. Recognizing the shortcomings of past macroeconomic policies and the need to contain and eventually halt the increase in convertible currency debt, the authorities developed an Economic Stabilization and Structural Reform Program in mid-1987 that shifted the focus of the Seventh Five Year Plan (1986-90) toward a greater emphasis on stabilization and acceleration of structural reform. The main goal of the program, which is summarized in Annex 5, is to stop the growth of external debt by the end of 1990. The central feature of the program is a sharp contraction in domestic demand to bring about a significant improvement in the convertible currency current account. The authorities acknowledge that past stabilization efforts have set back the economic reform and are determined to avoid a repetition of a similar occurrence by pursuing accelerated implementation of structural reforms in parallel with the economic stabilization program.

37. The Macroeconomic Program. The Parliament approved the Government's program in September 1987. The program for 1988 requires a reduction in domestic absorption of 1.25%. Real wages are to decline by 9%, and household consumption by 2.0-2.5%. The program's acceptance of real cuts in household consumption is a major policy shift, as household consumption has not fallen in over thirty years. There is political consensus that these developments are unavoidable if economic stabilization and recovery is to be achieved.

38. In September 1987, the Government requested IMF support to its program. Agreement was reached in January 1988 on a one year Standby Arrangement of SDR265.35 million (about US$365 million), which was approved by the IMF board on May 16, 1988. The Government has agreed to implement (a) a reduction in real wages, household consumption, and domestic absorption to bring down the budgetary and current account deficits to Ft10.4 billion (0.8% of GDP) and US$500 million (1.9% of GDP) respectively in 1988; (b) strict limits on credit expansion; and (c) use of an active exchange policy. In addition to these macroeconomic stabilization features, the agreement supports a number of broader medium term structural reform measures. These include: a ceiling on support to loss-making enterprises; tax, wage and price reforms; liberalization of export trade; a flexible interest rate policy, banking reform, and capital market and corporate legislation reform.

D. Industrial Policy Reforms

39. Within the overall economic stabilization and structural reform program, the three issues of strategic importance for the industrial sector (paras. 31-35) have been formulated into comprehensive industrial policy reforms by addressing them through both the factor and product markets in which industrial enterprises operate. This approach has been supplemented by strengthening the basic building blocks of competitive and efficient markets -- liberal entry, free exit, and freedom of production and exchange by autonomous economic entities. The industrial policy reform consists of the following eleven components which are central to the reform of the Hungarian economic system: entry of enterprises; liquidation; international trade; pricing; taxation; wage differentiation and worker mobility; capital market development; the banking system; enterprise management system; direct foreign investment; and technology development.

40. The objectives, major elements and the medium term timetable for industrial policy reforms were developed by the Government jointly with the Bank and are outlined in the Letters of Intent submitted to the Bank by the Hungarian authorities in May 1986 and 1987, which formed the basis for the first two industrial restructuring projects. Details were presented in the Staff Appraisal Report for the First Industrial Restructuring Project (Report No. 6069-HU, dated May 7, 1986), and updated in the Staff Appraisal Report for the Second Industrial Restructuring Project (Report No. 6643-HU, dated May 15, 1987).

41. Progress since 1985. The industrial policy reforms across all the 11 areas form an integrated package of structural changes in the industrial sector. While coordinated action on all areas is essential for the reform to produce its full effect, the emphasis given to individual areas has changed

from year to year according to evolving circumstances. During 1985-87, the highest priority was given to: (a) reform of the enterprise management system, (b) enactment of the liquidation framework, (c) increased competition in international trade activity, (d) setting up a two tier banking system, (e) reform of the system of enterprise accounting and information disclosure practices, and (f) preparation of the tax reform. A Restructuring Council headed by the Deputy President of NPO and including representatives of various Government agencies and NBH was set up under the First Industrial Restructuring Project to monitor the timely introduction of the agreed reform measures. The Council is supported by a Policy Task Force. Since 1985, measures have been implemented in all of these areas according to the commitments agreed under the first two projects.

42. Assessment of the Reforms. The reforms as reflected in the Government's Letters of Intent are intrinsically sound and remain adequate in the current economic environment. The implementation of the reforms, and consequently, their results have clearly fallen short especially during 1985-86. However, the Hungarian reform process has surmounted, in the last two years, some major ideological and political barriers that appeared insurmountable only a short time ago, and which remain serious obstacles to reform in some neighboring socialist countries. These include the resistance to recognizing the possibility of open unemployment and of liquidation of state enterprises; existence of wage differentials; legalizing private entrepreneurship and ownership of means of production; taxation of private incomes; and even to considering mixed ownership of enterprises. Widespread systemic reforms such as those underway in Hungary will take several years to produce the desired changes in managerial attitudes and behavior, and ultimately, stronger economic growth. The focus of the proposed operation is to ensure that the necessary framework of incentives and supportive measures is put in place in an accelerated and consistent manner to increase the prospect of success.

43. The 1988-90 Industrial Policy Reforms. As in the earlier operations, the industrial policy reforms to be implemented during 1988-90 will address all 11 policy areas. The objectives continue to be to tighten financial discipline in the enterprise sector, increase competition and improve resource mobility. Unlike in the 1985-86 period, industrial policy reforms will proceed under a much more supportive macroeconomic policy framework. The highest priority will be accorded to those areas which are likely to have immediate impact on Hungary's macroeconomic problems. These are: (a) further reduction in budgetary support to inefficient enterprises and subsectors and stringent application of the liquidation framework; (b) strengthened incentives for convertible currency exports, with necessary changes in regulations; (c) facilitation of entry of new enterprises and private entrepreneurship; (d) further reform of taxation, pricing and wage systems; and (e) reduction in producer and consumer subsidies. The policy industrial reforms for 1988-90 agreed with the Government are contained in the Government's Letter of Sector Development Policies, dated May 26, 1988 attached as Annex 6 and discussed below.

1. Entry of Enterprises

44. Increased competition is one of the most important facets of the reform. The Government will therefore liberalize regulations to facilitate

the establishment of different forms of economic associations and conversion to other forms. Currently, legislation is being finalized permitting: (i) state enterprises to convert themselves into joint-stock companies, (ii) individuals to own negotiable, and transferable shares in joint-stock companies, and (iii) individuals to form limited liability and joint-stock companies. The draft legislation will be approved by the Council of Ministers in mid-1988, and the Law of Association introduced in Parliament in its autumn session. Following Parliament's approval, the legislation is expected to become effective from January 1, 1989.

45. The Government will continue to encourage the small scale, essentially private, sector which has proved to be dynamic. The maximum number of employees permitted in private businesses has been doubled from 15 to 30. Amendments have been made to the current legislation to permit individuals to form limited liability associations together with legal entities. Incentives are being continued for enterprises to set up subsidiaries or autonomous profit centers, and to promote small and medium enterprises. Building on significant past progress in this direction, a further 24 new enterprises have been established by breaking up State enterprises. This process is planned to continue during 1988-90.

2. Liquidation and Restructuring of Inefficient Enterprises

46. The Government has recognized the critical importance of tightening financial discipline among enterprises to bring about greater efficiency and market orientation. Accordingly, bankruptcy legislation was given high priority and enacted in 1986. The legislation has generally deterred companies from taking imprudent financial decisions, though the number of actual liquidations of State enterprises has been limited. The Government will implement the bankruptcy legislation more forcefully in 1988, including initiation by the State of liquidation proceedings against enterprises in arrears of Government dues. Commercial banks are now required to set up additional provisions for doubtful debts in addition to normal risk reserves. These provisions will be equivalent to 20% of those debts classified as non-performing according to the criteria established by the Bank Supervisory Board. This, together with strict credit policies, will tighten financial discipline in the economy.

47. Along with the enactment of the bankruptcy legislation, a Refloatation Organization was set up to coordinate and monitor financial workouts of enterprises in financial difficulty. The Government has decided to limit enterprise and subsector specific financial support designed to alleviate financial difficulties of enterprises to that provided under the liquidation/refloatation framework, with the exception of coal mining (para. 49), and of a Ft600 million Government guarantee for bank loans to enterprises that are unable to "gross up" their wage bills in 1988 following the tax reform. To prevent excessive recourse to the Refloatation Organization, the 1988 budget allocation to the Refloatation Fund was reduced to Ft1.5 billion, 25% below 1987 nominal levels. State guarantees for the issue of bonds to finance the Refloatation Fund have been eliminated. Further, the Government is developing programs for the resolution of problems in crisis subsectors (coal mining and ferrous metallurgy), and some major

enterprises known to be in chronic financial difficulties. Major among these is Ganz-Mavag, one of the largest engineering units in Hungary. Some of these programs are now being implemented, while the others are being reviewed prior to a final decision. The programs aim at restructuring of enterprises in these subsectors, closure of non-viable units, reductions in labor force, and shifting production to more profitable and competitive activities permitting the reduction and elimination of Government support.

48. In the ferrous metallurgy subsector, current subsidies other than CMEA Price Equalization (Ft5 billion in 1988), have been eliminated. Plans to reduce capacity and rationalize the product mix across two of the three steel plants, which are loss-making, to enable the units to become financially self-sufficient have been approved. As part of these plans, Government investment support will be limited to restructuring existing capacities and will not exceed Ft2.0 billion during 1988-90.

49. In the coal mining subsector, the Government is developing a restructuring plan, which will be reviewed by the Bank and then finalized by the end of 1988. The plan will include: a substantial reduction in the level of coal production from underground mines; review of the feasibility of import of energy to substitute coal from underground mines; identification of pits whose coal production cost are higher than those for comparable energy source imports, a timetable for closure of uneconomic pits and implementing concurrent reductions in labor, especially administrative staff. The plan will be implemented from 1989 to progressively reduce subsidies to coal mining starting with a substantial reduction from the 1988 budget allocation of Ft10.6 billion.

3. International Trade

50. The Government recognizes that external competition and a liberal import policy is an essential ingredient of the policy to increase competitive pressure on domestic enterprises to improve efficiency. The Government intends to maintain the incentives currently provided to investments for export to convertible currency areas under the export promotion program introduced in 1986. The Government is taking steps to increase the relative profitability of exports to convertible currency markets by eliminating the guaranteed profitability of exports to CMEA. The Government is streamlining the procedures for import licensing to ensure that licenses are issued to exporters in an expeditious way to avoid export constraints.

51. To achieve the needed improvement in the convertible currency trade balance, the Government will rely on market based instruments and tight demand management. The Government will maintain the import regime free of quantitative restrictions in line with Hungary's protocol with the GATT. The average level of import tariffs was reduced from 23% in 1980 to 16% in 1987 in eight annual steps as agreed by the Government with the GATT in 1980. To foster greater import competition, the Government will encourage more widespread use of international competitive bidding for goods and services in investments financed from the Government budget or from the commercial banks.

52. The Government has already liberalized access to foreign trading rights, thus promoting a closer link between production and trade, and

increased competition in foreign trading activities. As of January 1, 1988 all legal entities may register automatically to conduct foreign trade in convertible currencies subject only to prescribed criteria of staff capability and financial viability. 350 enterprises have already been registered, while a further 83 applications are being processed.

53. Finally, with the establishment of the new Ministry of Trade, the Government has reorganized the responsibilities related to foreign trade. In this context, the Government has agreed to review the regulatory framework influencing convertible currency foreign trade, particularly imports, under terms of reference agreed with the Bank, by the end of 1988. In light of the outcome of the review, the Government will identify necessary changes to make the framework more efficient in line with the Government's policy objectives. Thereafter the Government will develop a timetable for implementing the necessary changes beginning in 1989.

4. Pricing

54. The Government recognizes that prices should respond to demand and supply and changes in the structure of relative prices are crucial for efficient resource allocation. The Government will increasingly replace administrative price determination by market mechanisms which will help develop a flexible and dynamic economy integrated more effectively into world markets. For inflation control, the Government will rely on appropriate monetary and fiscal policies. The system of price determination has been very considerably simplified and liberalized since 1985. In 1986, the Export Pricing Rule, which set prices for domestic sales in line with those of export sales was abolished. The basic limitation of prices in the domestic market is now the remaining rule that such prices should not exceed the landed cost of comparable imports (The Import Pricing Rule). In order to monitor expected price developments, the Government can require advance reporting of price increases by producers. In cases where markets are dominated by a small number of firms or where other major market imperfections exist, there is a mechanism for the price authorities to arrange consultations regarding price levels between producers and consumers. This is supplemented by the provisions of the Law of Unfair Economic Practices, which is basically legislation designed to prevent speculative and exploitative behavior by producers operating in imperfect markets.

55. In the context of the introduction of the VAT, the Government found it necessary to impose temporary administrative control of price movements from August 1987, requiring prior reporting of all intended price increases to the Government. This requirement was abolished on April 1, 1988, after which enterprises are free to change most prices.

56. Since January 1, 1988, administratively determined consumer prices are limited mainly to energy, passenger and city transport, milk and some items of basic foods and pharmaceuticals, which amount to no more than 20% of consumer goods. Prices of the remaining 80% of consumer goods are classified as belonging to the free pricing category, of which 22% are subject to advance reporting of price increases to the Government, 5% to procedures under which producers and buyers can be brought together for consultations, and the

remaining 53% are subject only to the Import Pricing Rule and the Law of Unfair Economic Practices. The Government has agreed to increase the last proportion to at least 62.5% by January 1, 1989.

57. Prices of 25% of the value of producer goods turnover remain administratively set, mainly for energy, transport, some agricultural products and chemicals. Out of the remaining 75%, price increases have to be reported in advance to the Government in respect of 15% of turnover, and consultations can be required in respect of another 3%. Prices of the remaining 57% of the value of producer goods turnover are subject only to the general pricing rule.

58. The Government has agreed to carry out a study, by end of 1988, under terms of reference agreed with the Bank, of the scope of administrative price setting, advance reporting requirements and consultation procedures with a view to limiting their coverage and improving the effectiveness of market forces in the economy. The Government plans to review the level of administratively determined consumer and producer prices and the process for setting them to identify possible improvements and reductions in their scope. The Government intends to implement the results of the review during 1989 after consultations with the Bank. In 1989 and 1990 The Government intends to reduce the number of goods covered by advance reporting requirements. Where advance reporting requirements are designed to enable monitoring of expected price developments, the Government will replace them by ex-post reporting of price levels.

59. The Government is taking steps to develop legislation to prevent monopolistic behavior for enactment in 1989. Meanwhile, the pricing authorities will limit their consultations with producers and consumers to markets dominated by a small number of firms or where other major market imperfections exist. The Government will review the experience with these consultations, and also consider the use of imports to enforce market discipline in cases of unfair market practices, or other market imperfections. Based on such reviews, the Government expects to be able to increase the share of consumer prices subject only to the Import Pricing Rule and the Law of Unfair Economic Practices to about 70% by January 1, 1990, with this percentage being determined finally after the reviews have been completed.

5. Taxation and Subsidies

60. A major achievement of the Government in 1987 was the enactment of the tax reform, comprising the introduction of a value added tax and personal income tax, and the elimination of a large number of existing taxes on enterprises. The tax reform was implemented effective from January 1, 1988. The tax reform eliminated many distortions to enterprise decision-making and will enable efficient enterprises to retain a greater proportion of their profits which should lead to long-run efficiency gains. Aggregate corporate profit taxes are projected to decrease by Ft44 billion and indirect taxes to increase by Ft110 billion (8% of GDP).

61. The Government intends to make further reforms in the tax system to make it neutral with respect to form of association. By January 1, 1989, the Countervalue Tax (which is a tax applied to turnover of private enterprises)

will be eliminated and the Entrepreneurial Tax (which is a tax equal to 20% of the profit of a private entrepreneur) will be integrated into the personal and corporate profit taxes including a provision for the deduction of the cost of he entrepreneur's labor income for tax purposes. The Government will undertake a further streamlining of the legal framework of enterprise taxation and introduce a new unified law for the taxation of business profits not later than January 1, 1990.

62. In view of the need for strict demand management in 1988, the Government will initially rebate only 20% of the value added tax paid on goods used for investment. The proportion will increase to 40% from 1989, 60% from 1990, 80% from 1991, and 100% from 1992.

63. In addition to the tax reform, a subsidy reduction program will further restructure the role of the Government budget in the economy. In 1988 total current producer and consumer subsidies from the State budget, the budget of the Local Councils and Extrabudgetary Funds were reduced by about 15%, i.e. by Ft37.1 billion to Ft204.9 billion. This represents a reduction of about 25-30% in real terms as the inflation rate is expected to be about 15% in 1988. The Government is committed to continue reducing subsidies and financial support. The Government will develop a program by October 1988 to reduce these subsidies and financial support from the 1988 Plan level of Ft204.9 billion by at least 10% per year in 1989 and 1990, which will be a much larger reduction in real terms, given the expected inflation rate.

6. Wage Differentiation and Worker Mobility

64. The Government supports the principle of free determination of individual earnings based on performance. However, given the necessity of very tight demand management policies in 1988, the Government found it necessary to enforce a general ceiling on increases in enterprises' wage bill. During 1988, enterprises will be subject to a 2.5% nominal ceiling on the growth of their total wage bill. Within the aggregate ceiling, enterprises could generate savings by releasing excess labor and apply such savings to increase wages for the remaining work force by more than 2.5%. The mandatory upper limits of wage scales have been removed from 1988 to enlarge the scope for such wage differentiation. The only exception to the general ceiling on wage increases will be in respect of a small group of enterprises (employing at present 6% of the labor force) meeting stringent objective criteria of profitability, creditworthiness, and non-reliance on budgetary subsidies.

65. The Government intends to elaborate a reform of the wage system during 1988, to be implemented beginning from January 1, 1989. The reform will enable enterprises in the productive sectors (i.e., only excluding services) to determine individual worker's earnings freely, subject to an overall ceiling on the wage bill of the enterprise related to performance, permitting sufficient scope for wage differentiation. This is designed to address the need for major shifts in employment patterns likely to arise over the next few years as a result of industrial restructuring.

66. A significant step has been taken in 1988 with the establishment of the Employment Fund with a budget of Ft1.2 billion to strengthen measures for

retraining and facilitate labor mobility. The Government will continue to modify the conditions for use of the Fund based on experience.

7. Capital Markets

67. Further development of the capital markets for efficient mobilization and allocation of capital will continue. The new Law of Association, the conversion of some state enterprises into joint-stock companies, and proposals for establishment of securities market regulation, will help to develop the capital market. As a first step, the Government has already enabled introduction of "capital tickets", which are a redeemable, non-voting, profit sharing instrument to be issued to employees by their enterprises in 1988. The enterprise and household bond markets have been integrated with the removal of the requirement of a State guarantee for bonds sold to the population. The Government will further modify the regulatory environment to promote development of insurance, and develop plans to operate the social security system on a self-sustaining basis. These measures should also help to strengthen the development of the capital market.

68. To ensure adequate recognition of profits and equity capital as well as the availability of timely and reliable information about the financial position of enterprises and potential borrowers to the banks and investors, new accounting standards, auditing and disclosure requirements were introduced in January 1988.

69. During 1987, several financial institutions, including insurance companies, commercial and specialized banks, joined together to develop a credit information system and to share information on bond issues and trading. The Government will support this initiative to develop a stock exchange that can serve the needs of an active and diversified financial market.

8. Banking System

70. In 1987, credit functions of NBH were separated from its central banking functions and entrusted to competitive, full service domestic commercial banks set up for the purpose. As a further step to promote competition among banks, enterprises will be permitted to open current accounts with more than one commercial bank of their choice from January 1, 1989. A study of the policies and measures needed for the development and reform of the financial sector was carried out collaboratively by the Bank and the Government in 1987. The study concluded that the most important step to be taken is to integrate the interest rates for enterprises and households in order to unify the flow of savings among all sources and uses through the banking system. The main obstacle to this integration has been the system of subsidized housing loans financed out of low interest rate household deposits. To rectify this situation, the Government has agreed to develop comprehensive proposals for a new housing finance system and review the proposals with the Bank by the end of 1988.

71. As a preliminary step towards the integration of banking services, commercial banks have been permitted during 1988 to issue bonds to households to mobilize resources and to provide banking services to entrepreneurs.

Concurrently with the development and introduction of the new system of housing finance, the Government would be able to gradually integrate interest rates in the two banking systems and integrate the banking system fully. By January 1, 1989 the Government will initiate implementation of the integration of banking services for households and enterprises and continue the process, with full integration planned in 1989-90.

72. New instruments such as treasury bills were introduced in 1988 to strengthen the effectiveness of monetary policy. Graduated interest rates have been introduced to improve the refinancing mechanism to reduce excess liquidity in the banking system and facilitate better management of monetary policy. The Government will continue to review the interest rate structure, refinancing criteria and reserve requirements to improve the effectiveness of monetary policy, resource mobilization and allocation.

73. By June 1988, the newly established commercial banks will carry out a portfolio review by independent auditors to determine the extent of non-performing loans and set up provisions as necessary in accordance with the regulations issued by the State Bank Supervision Board. Steps will be taken to strengthen and systematize the inter-bank market. A clearing center for checks and payments is being established with Bank funding and technical assistance.

74. The Government intends to introduce foreign exchange operations by commercial banks gradually, commencing in 1988. For the time being, borrowing in international financial markets will be carried out exclusively by NBH in view of the need for very careful management of the country's external debt.

9. Enterprise Management System

75. The Government intends to extend the system of autonomous enterprise management, which is currently based on management by partly elected enterprise councils or by enterprise assemblies. While the experience with the present system is too short to draw any definite conclusions at present, modifications will be made as required in the light of experience in the next two years, especially as deregulation of prices and wages is progressively implemented.

76. As mentioned earlier (para. 44), the new Law of Association will permit State enterprises to convert themselves into joint stock companies. The Government believes that the decision for such conversion should be taken at the initiative of the enterprise managements themselves. To encourage the conversion process, the Government will identify an initial group of enterprises and facilitate their conversion commencing in 1989.

10. Direct Foreign Investment

77. The Government recognizes the contribution direct foreign investment could make to improving the structure and performance of the Hungarian economy by enabling infusion of foreign capital, technology and management know-how. Besides intensifying promotional campaigns to attract foreign capital and continuing to enter into investment protection agreements with other countries, the Government will continue to assess the effectiveness of the incentives framework, rules, regulations and operating environment for direct

foreign investment and implement modifications as necessary in the context of the newly introduced tax reform and the proposed law of association. Hungary deposited its instruments of ratification of the Convention establishing the Multilateral Investment Guarantee Agency on April 21, 1988.

11. Technology Development

78. Technology development is one of the major objectives of the program. The reform of the tax system and other policy areas radically improves the prospects for technology development. The Government also introduced measures for improving the accounting treatment of intangible assets such as intellectual property, e.g. patents and copyrights, and is continuing to develop measures for the accounting treatment of disembodied technology, which will provide necessary incentives for R&D. The Government intends to review the 12 national R&D programs with a view to concentrating resources on a few selected priority areas, instead of diffusing them thinly and widely. The Government will streamline the procedure for approval of licensing, leading to a registration mechanism instead of individual approvals by January 1, 1989. Finally, the Government will continue the effort to make R&D by enterprises more market oriented, and increase the proportion of R&D resources available to enterprises for market oriented R&D activities.

PART IV - THE PROPOSED LOAN

A. Loan Features and Implementation

79. Loan Design. The proposed sector adjustment loan would support the Government's Economic Stabilization and Structural Reform Program. The program will ensure a supportive macroeconomic environment for consistent implementation of industrial policy reforms. The industrial reforms will address all the eleven industrial policy reform areas (para. 39). However, at the present stage, the highest priority must be accorded to those areas which are most likely to have an immediate macroeconomic impact and on the realization of the main reform objectives (financial discipline, enhancement of competition, and resource mobility). The agreed program, as well as conditionality for the release of the second tranche of the loan, is designed to address these areas in particular.

80. Loan Amount and Borrower. The loan in the amount of US$200 million will be made to the Government of Hungary, which will make the proceeds available to NBH, which will administer and disburse the funds. NBH will: (a) maintain separate accounts to record and monitor disbursements and repayments; and (b) arrange for an audit of such accounts by auditors acceptable to the Bank and submit certified copies of the relevant accounts to the Bank within six months of the loan's effectiveness and then on an annual basis. The auditor's report will include an opinion on whether satisfactory procedures are in operation at NBH regarding the use of Statements of Expenditure (SOE).

81. Utilization. The proposed loan would finance about 5% of Hungary's convertible currency imports over the disbursement period (July 1988-June 1989). The proposed loan would finance all goods to be imported into Hungary

except those financed by other sources and a specific list of excluded goods such as military or para-military items, luxury goods, nuclear reactors and parts, and uranium. The foreign exchange made available would be finally used mostly by enterprises. They would raise the local currency equivalent of their foreign currency needs either out of their own resources, or by borrowing from commercial banks. The banks would certify the availability of local currency to NBH after satisfying themselves of the financial viability of the enterprises in cases where the local currency resources are being provided through additional credits. NBH would then open the letter of credit, and on delivery of the imported goods, make the necessary payment in foreign currency and debit the enterprise's account.

82. Procurement. Procurement of goods costing more than US$5 million will be through international competitive bidding in accordance with the Bank's Guidelines for Procurement. Certain commonly traded commodities may be purchased through price quotations from organized international commodity markets. All contracts of lesser value would be awarded through normal channels on the basis of normal procurement procedures of the agencies concerned, which are judged to be satisfactory.

83. Disbursement. The loan will be disbursed in two equal tranches. The first tranche of US$100 million will be available on effectiveness, while the second tranche of US$100 million will be released on fulfillment of tranche release conditions (para. 86). To simplify disbursement, only invoices with a minimum value of US$50,000 will be eligible for disbursement. The loan would be disbursed only against foreign expenditures. In order to ensure that Hungary will have ready access to foreign exchange, a special account would be established in NBH to which the Bank would make an initial deposit of up to US$40 million, which would approximately equal estimated disbursements for three months. Payment requests would be made against full documentation except for contracts valued up to US$3 million equivalent, where SOEs would be authorized. The special account would be replenished against withdrawal requests at monthly intervals or as appropriate when the undisbursed balance of the account falls below US$25 million and until only US$40 million of the loan remains undisbursed. The closing date for disbursements will be June 30, 1990.

84. Implementation. Implementation arrangements set up during the two industrial restructuring projects will remain in force. The Restructuring Council set up to monitor the implementation of the reform actions will continue to be responsible for the development and implementation of the industrial policy reforms. NBH and NPO will be responsible for monitoring and overall coordination.

B. Monitoring and Tranche Release

85. Monitoring of performance involves essentially three complementary activities. The first is the monitoring of the implementation of the Government's macroeconomic program which is an ongoing activity as part of the Bank's economic dialogue and reporting arrangements to be agreed during loan negotiations. The second activity is monitoring of the implementation of agreed industrial policy reform actions on a semiannual basis by the Bank. Progress in carrying out agreed studies of (a) the investment program (para. 15), (b) the regulatory framework of convertible currency foreign trade

(para. 53) and (c) the price setting system (para. 58) under agreed terms of reference will be reviewed. The third activity will be monitoring of progress on specific reform actions and meeting macroeconomic targets as a condition for the release of the second tranche of the loan.

86. Conditions for Tranche Release. The release of the second tranche of the loan will be based on completion, in a manner satisfactory to the Bank, of the following actions:

(i) Adoption of the 1989 Annual Plan and Central State Budget, including a public investment plan, which: (a) further reduces the Central State Budget deficit and results in halting the growth of Hungary's external debt in convertible currency by the end of 1990 (para. 36); and, (b) further reduces the total producer and consumer subsidies and other financial support from the 1988 plan level of Ft204.9 billion by at least 10% (para. 63).

(ii) Enactment of a Law of Association and related legislation which would permit: (a) State enterprises to convert themselves into joint stock companies; (b) individuals to hold negotiable shares in joint stock companies; and (c) individuals to form limited liability and joint stock companies (para. 44).

(iii) Adoption and commencement of implementation of programs to restructure the ferrous metallurgy and coal mining subsectors (para. 48-49).

(iv) Enactment of legislation which would eliminate the Countervalue Tax and integrate the Entrepreneurial Tax as part of the corporate profit and personal income taxes (para. 61).

(v) Enactment of legislation which would allow enterprises to determine independently the level and scope of compensation for individual workers, within overall ceilings on the wage bill of the enterprise based on performance (para. 65).

(vi) Integration of banking services for enterprises and households, with full integration of the two banking systems planned for 1990 (para. 71).

C. Coordination with the IMF

87. The Hungarian authorities reached agreement on most issues regarding the Standby Arrangement, as mentioned earlier, with the IMF in January 1988. The appraisal of the proposed loan was underway at about the same time. Bank staff assigned to the proposed loan have coordinated their work with that of IMF staff, and the two institutions have taken mutually consistent positions on the 1988 plan and on critical areas of the program. Bank and IMF staff will continue to work together in providing advice to the Government in managing the stabilization/reform effort. The staffs of the two institutions will coordinate actions and recommendations during the period of the loan.

D. Social Costs

88. There will be social costs to implementation of the program. The most significant will be the appearance of open unemployment, previously unseen in Hungary. Most of the displaced workers are expected to be able to find new jobs within a short period. Unemployment compensation is available for one year (up to six months at full pay, followed by three months at 75% pay and another three months at 60% pay). Retraining programs are being expanded, a nationwide network of more than 400 employment offices has been set up, and a program of public works has been launched to give temporary employment to workers while they wait for other prospective jobs. An Employment Policy Fund, with an initial allocation of Ft1.2 billion (US$25 million) has been included in the 1988 fiscal budget to finance employment related central assistance in a coordinated manner. In addition to covering the costs for unemployment compensation and the retraining program, the fund will provide grants to help finance employment-creating investments and relocation assistance (mainly for housing), and will provide seed capital to unemployed workers wishing to start their own small businesses. To date, instances of labor redundancy as a result of enterprise restructuring have been readily resolved in most cases by the transfer of workers to other firms, by retraining within the original firm, or by early retirement.

89. The condition of pensioners and families with small children also is a matter of concern, particularly because of the price increases that will accompany the introduction of the Value Added Tax. A Social Benefits Package has been introduced in January 1988 to compensate partially for the planned reduction in real wages, while simultaneously decreasing the budget deficit. The package aims at shifting from price subsidies to targetted assistance which should have a net positive resource allocation effect. The package includes a 10% increase in pensions (Ft12.1 billion). To compensate families partially for the removal of price subsidies on food, children's clothing, and construction materials used in housing construction, the Social Benefit Package also includes a 40% increase in family allowances, an increase in the size and duration of child support payments, and an increase in family grants for housing purchase estimated to amount to Ft14 billion.

E. Risks

90. The principal risk associated with the loan and the program it supports is its far reaching nature, and the difficult economic environment in which it is being implemented. Despite the turnaround in the economy in 1987, the high level of debt has left Hungary with little potential for further borrowing. In this situation, tight financial discipline will have to be enforced on the enterprise sector, which has not always acted with sufficient financial prudence in its investment choices. The Government would need to implement its macroeconomic program, which calls for severe austerity after thirty years of rising consumption, with determination until a supply response emerges, necessarily after a time-lag. Finally, Hungary, being a highly trade-dependent country, is subject to adverse external changes.

91. On the other hand, there is a broad consensus in Hungary that adjustment in the domestic economy can no longer be postponed by resort to continued external borrowing, even if it means a decline in living standards

in the short term, to return to a sustainable growth path. The need for the proposed steps has been openly debated in the media. Trade unions were consulted before the stabilization program was presented to the Parliament. The maintenance of the consensus during the implementation of the program, which does change the existing social compact, will be a challenge, but the risk is reduced by the fact that a new leadership, committed to the reform, has been put in place.

92. Finally, Bank support coupled with an agreement with the IMF would reduce the overall risk, as it would ease the country's access to international financial markets to roll over maturing debt until at least 1990, when Hungary is expected to reach current account balance. Overall, the assessment is that while the risks are considerable, the Government's commitment, the openness of its approach, and the relatively open conditions of Hungarian society make the risks manageable.

PART V - RECOMMENDATION

93. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank and recommend that the Executive Directors approve the loan.

Barber B. Conable
President

Attachments

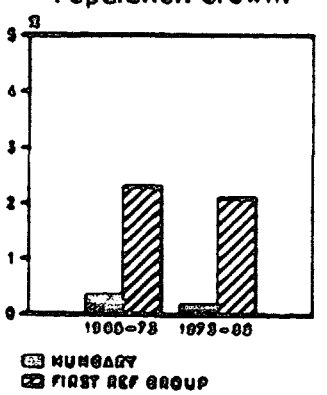
Washington, D.C.
May 27, 1988

1987 SOCIAL INDICATOR DATA SHEET

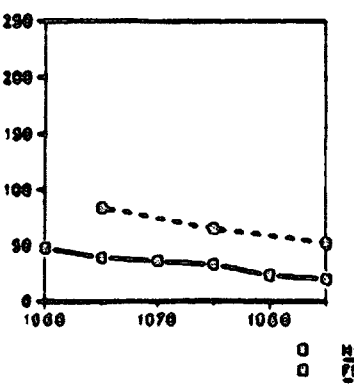
HUNGARY

	1965	1973	Most Recent Estimate	Reference Groups (MRE) Upper mid income	Industrial mkt econ
AREA					
Total land area (thou sq km)	93.0	93.0	93.0		
Agricultural (% of total)	74.8	73.9	70.9		
GNP PER CAPITA (current US$)	.	..	2,020	1,830	11,920
POPULATION AND VITAL STATISTICS					
Total population (thou)	10,153	10,436	10,633		
Urban pop. (% of total)	43	49	55	65	75
Population growth rate(%)					
Total		0.3	0.2	2.1	0.7
Urban		2.2	1.5	3.6	1.5
Life expect. at birth (yrs)	70	70	71	66	76
Population projections:					
Pop. in 2000 (thou)			10,508		
Stationary pop. (thou)			12,000		
Population density per sq km of agricultural land	148	193	182	239	534
Per. age structure (%):					
0-14 yrs	23	21	22	36	21
15-64 yrs	66	67	65	59	67
65 and above	10	12	13	5	12
Crude birth rate (per thou)	13	15	12	28	13
Crude death rate (per thou)	11	12	14	8	9
Total fertility rate	1.8	2.0	1.7	3.7	1.8
Infant mort. rate (per thou)	39	34	20	52	9
Child death rate (per thou)	3	2	1	4	0
Family planning:					
Acceptors, annual (thou)	..	149	712	..	..
Users (% of married women)	67	74	..	..	..
FOOD, HEALTH AND NUTRITION					
Index of food production per capita (1979-81 = 100)	..	90	104	106	102
Per capita supply of:					
Calories (per day)	3,186	3,371	3,544	2,987	3,417
Proteins (grams per day)	86	91	94	75	92
Pop. per physician (thou)	..	0.5	0.4	2.4	1.5
Pop. per nurse (thou)	0.3	0.2	0.2	0.7	0.2
Pop. per hospital bed (thou)	..	0.1	0.1	0.4	0.1
Access to safe water (% of population): Total	..	37	..	..	..
Urban	..	65	84	..	..
Rural	..	11	43	..	..

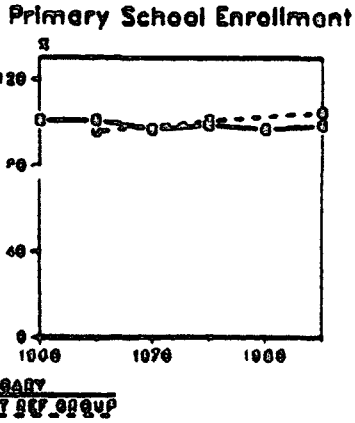
Population Growth



Infant Mortality



Primary School Enrollment



1987 SOCIAL INDICATOR DATA SHEET

HUNGARY

	1965	1973	Most Recent Estimate	Reference Groups (MRE) Upper mid income	Industrial mkt econ.
LABOR FORCE					
Total Labor Force (thou)	5,138	5,464	5,227		
Female (%)	38	41	44	34	37
Agriculture (%)	32	23	18	29	7
Industry (%)	40	44	44	31	35
Participation rate (%):					
Total	51	52	49	38	47
Male	65	62	56	50	60
Female	37	42	42	26	35
Age dependency ratio	0.5	0.5	0.5	0.7	0.5
HOUSING					
Average size of household:					
Total	..	3	3	..	..
Urban	..	3	3	..	..
Rural	..	3	3	..	..
Percentage of dwellings with electricity:					
Total	..	94	98	..	..
Urban	..	98	99	..	..
Rural	..	91	97	..	..
EDUCATION					
Enrollment rates:					
Primary: Total	101	99	99	105	102
Male	102	99	98	108	102
Female	100	99	99	101	101
Secondary: Total	..	63	73	63	90
Male	..	67	73	64	89
Female	..	58	73	61	91
Pupil-Teacher ratio:					
Primary	23	18	15	28	20
Secondary	21	20	..	19	14
Pupils reaching grade 6 (%)	..	92	96	85	99
INCOME, CONSUMPTION, AND POVERTY					
Energy consumption per cap. (kg of oil equivalent)	1,825	2,259	2,974	1,960	4,883
Percentage of private income received by:					
Highest 10% of households	..	..	..	..	..
Highest 20%	33	34	32 a	..	..
Lowest 20%	10	10	11 a	..	..
Lowest 40%	25	25	26 a	..	..
Est. absolute poverty income level (US$ per capita):					
Urban	..	..	..	..	..
Rural	..	..	..	..	..
Est. pop. below absolute poverty income level (%)					
Urban	..	..	..	..	..
Rural	..	..	..	..	..
Passenger cars/thou pop.	10.0	39.1	107.2	50.4	323.7
Newspaper circulation (per thousand population)	178.2	225.7	249.8	88.0	300.0

IECSE August 1987

Not available. Note: Most recent estimates of population and GNP per capita are for 1986 unless otherwise noted. Group averages are population weighted. Country coverage depends on data availability and is not uniform. Unless otherwise noted, 1965 refers to any year between 1962 and 1969, 1973 between 1970 and 1976, and most recent estimate between 1980 and 1986.
a 1977

Definitions of Social Indicators

The definition of a particular social indicator may vary among countries or within one country over time. For instance, different countries define "urban area" or "safe water" in different ways. For more detailed definitions, see the technical notes to the World Development Indicators.

AREA (thousand square kilometers)
Total - Total surface area comprising land area and inland waters.
Agricultural (percentage of total) - Estimate of agricultural area used for crops, pastures, market and kitchen gardens or lying fallow, as a percentage of total.

GNP PER CAPITA (US$) - 1986 GNP per capita estimates at current market prices, calculated by the conversion method used for the *World Bank Atlas*.

POPULATION AND VITAL STATISTICS
Total population - mid-year (millions), 1986 data.
Urban population (percentage of total) - Different countries follow different definitions of urban population which may affect comparability of data among countries.
Population growth rate (percent) - total and urban - Annual growth rates of total and of urban populations.
Life expectancy at birth (years) - Number of years a newborn infant would live if prevailing patterns of mortality at the time of its birth were to stay the same throughout its life.
Population projections
Population in 2000 - Projections of population given total population by age and sex, fertility and the demographic parameters of mortality rates, and migration in the base year 1980.
Stationary population - Projected population level when zero population growth is achieved: i.e., the birth rate is constant and is equal to the death rate, the age structure is stable, and the growth rate is zero.
Population density, agricultural land - Population per square kilometer (100 hectares) of agricultural area.
Population age structure (percent) - Children 0–14 years, working age group 15–64 years, and people of 65 years and over as percentages of population.
Crude birth rate - Annual live births per thousand population.
Crude death rate - Annual deaths per thousand population.
Total fertility rate - Average number of children that would be born alive to a woman during her lifetime, if during her childbearing years she were to bear children at each age in accordance with prevailing age-specific fertility rates.
Infant (aged 0–1) mortality rate - Number of infants per thousand live births, in a given year, who die before reaching one year of age.
Child (aged 1–4) mortality rate - Number of deaths of children, aged 1–4, per thousand children in the same age group, in a given year.
Family planning - acceptors, (thousands) - Annual number of acceptors of birth-control measures received under the auspices of a national family planning program.
Family planning - users (percentage of married women) - Percentage of married women of child-bearing age who are practicing, or whose husbands are practicing, any form of contraception. Child-bearing age is generally 15 to 44, although for some countries contraceptive usage is measured for other age groups.

FOOD, HEALTH AND NUTRITION
Index of food production per capita (1979–81 = 100) - Index of per capita annual production of all food commodities. *Production* excludes animal feed and seed for agriculture. *Food commodities* include primary commodities (for example, sugarcane instead of sugar) which are edible and which contain nutrients (for example, tea and coffee are excluded). They include nuts, fruits, pulses, cereals, vegetables, oil seeds, sugarcane and sugar beets, livestock, and livestock products. Aggregate production of each country is based on national average producer price weights.
Per capita supply of calories - Computed from energy equivalent of net food supplies available in a country, per capita, per day. Available supplies comprise domestic production, imports less exports, and changes in stock. Net supplies exclude animal feed, seeds for use in agriculture, quantities used in food processing, and losses in distribution.
Per capita supply of protein (grams per day) - Protein content of per capita net supply of food per day. Net supply of food is defined as above. Requirements for all countries, established by United States Department of Agriculture, provide for minimum allowances of 60 grams of total protein per day and 20 grams of animal or pulse protein.
Population per physician - Population divided by the

number of practicing physicians qualified from a medical school at university level.

Population per nursing person - Population divided by the number of practicing graduate nurses, assistant nurses, practical nurses and nursing auxiliaries.

Population per hospital bed - Population divided by the number of hospital beds available in public and private, general and specialized hospitals, and rehabilitation centers. Hospitals are establishments permanently staffed by at least one physician.

Access to safe water (percentage of population) - total, urban, and rural - People (total, urban, and rural) with reasonable access to safe water supply (includes treated surface waters or untreated but uncontaminated water such as that from springs, sanitary wells, and protected boreholes). In an urban area this may be a public fountain or standpost located not more than 200 meters away. In rural areas this implies that members of the household do not have to spend a disproportionate part of the day fetching water.

LABOR FORCE

Total labor force (millions) - Economically active, including armed forces and unemployed but excluding housewives and students.

Female (percent) - Female labor force as a percentage of total labor force.

Agriculture (percent) - Labor force in farming, forestry, hunting and fishing as a percentage of total labor force.

Industry (percent) - Labor force in mining, construction, manufacturing and electricity, water and gas as a percentage of total labor force.

Participation rate (percent) - total, male, and female - Participation rates are the percentage of population of all ages in the labor force. These are based on ILO data on the age-sex structure of the population.

Age dependency ratio - Ratio of population under 15, and 65 and over, to the working age population (age 15–64).

HOUSING

Average size of household (persons per household) - total, urban, and rural - A household consists of a group of individuals who share living quarters and main meals.

Percentage of dwellings with electricity - total, urban, and rural - Conventional dwellings with electricity in living quarters, as a percentage of all dwellings.

EDUCATION

Enrollment rates

Primary school enrollment - total, male and female - Gross enrollment of all ages at primary level as a percentage of school-age children as defined by each country, and reported to Unesco. While many countries consider primary school age to be 6–11 years, others use different age groups. For some countries with universal education, gross enrollment may exceed 100 percent since some pupils are younger or older than the country's own standard primary school age.

Secondary school enrollment - total, male and female - Computed in a similar manner, but including pupils enrolled in vocational, or teacher training secondary schools. The age group is usually 12 to 17.

Pupil-teacher ratio - primary, and secondary - Total students enrolled in school divided by the total number of teachers.

Percentage pupils reaching grade six - The percentage of children starting primary school, that continue until grade six.

INCOME, CONSUMPTION, AND POVERTY

Energy consumption per capita (kilograms of oil equivalent) - Annual consumption of commercial primary energy (coal, lignite, petroleum, natural gas, and hydro, nuclear and geothermal electricity).

Income distribution - Income (both in cash and kind) accruing to percentile groups of households ranked by total household income.

Passenger cars (per thousand population) - Includes motor cars seating fewer than eight persons.

Newspaper circulation (per thousand population) - Average circulation of a "daily, general interest newspaper," defined as a news periodical published at least four times a week.

Estimated absolute poverty income level (US$ per capita) - urban and rural - Absolute poverty income level is that below which a minimal nutritionally adequate diet plus essential nonfood requirements are not affordable.

Estimated population below absolute poverty income level (percent) - Percentage of urban and rural populations who live in "absolute poverty."

ANNEX 2

HUNGARY

INDUSTRIAL SECTOR ADJUSTMENT LOAN

KEY MACROECONOMIC INDICATORS

	1982	1983	1984	1985	1986	1987/p	1988	1989	1990	1991	1992	1993	1994	1995
							Projected							
GDP Growth Rate	2.8%	0.7%	2.6%	-0.3%	1.5%	3.4%	1.3%	1.7%	2.7%	3.1%	3.3%	3.4%	3.5%	3.5%
GDY Growth Rate	1.8%	-0.5%	1.6%	-0.7%	0.1%	3.9%	1.6%	1.6%	2.7%	3.1%	3.3%	3.4%	3.5%	3.5%
GDY/Capita Growth Rate	1.8%	-0.5%	1.6%	-0.7%	0.1%	3.9%	1.6%	1.6%	2.7%	3.1%	3.3%	3.4%	3.5%	3.5%
Private Consumption/Capita Growth Rate	1.3%	0.5%	1.2%	1.4%	2.0%	2.8%	-2.3%	1.0%	2.1%	3.0%	3.3%	3.4%	3.4%	3.5%
Total DOD (in mill. US$) 1/	7715	8250	8836	11760	15086	17739	17878	18250	18369	18342	18483	18704	18920	19075
IBRD/DOD 1/	0.0%	0.0%	0.0%	2.9%	3.5%	4.2%	6.6%	8.6%	10.7%	12.6%	13.7%	14.5%	15.0%	15.5%
DOD/XGS 1/	120.0%	132.8%	143.1%	191.4%	227.7%	246.9%	237.0%	228.8%	217.6%	206.1%	196.6%	188.5%	180.6%	172.5%
DOD/GDP 1/	33.3%	39.3%	43.4%	57.0%	63.5%	68.0%	65.7%	63.8%	60.5%	56.6%	53.4%	50.3%	47.7%	44.9%
Debt Service (in mill. US$) 1/ 3/	1995	1990	2580	3155	3735	3416	3107	2949	3210	3705	4066	4258	4140	4438
Debt Service/XGS 1/ 2/ 3/	31.0%	32.0%	41.8%	51.3%	56.4%	47.5%	41.2%	37.0%	38.0%	41.6%	43.2%	42.9%	39.5%	40.1%
Debt Service GDP 1/ 3/	8.6%	9.5%	12.7%	15.3%	15.7%	13.1%	11.4%	10.3%	10.6%	11.4%	11.7%	11.5%	10.4%	10.5%
IBRD Debt Service/Debt Service 1/ 3/	0.0%	0.0%	0.0%	0.7%	1.1%	2.2%	3.8%	6.3%	8.7%	9.0%	9.4%	9.8%	11.1%	11.0%
Gross Investment/GDP	28.5%	26.5%	25.7%	25.0%	26.9%	26.8%	26.8%	26.3%	26.5%	26.8%	26.9%	27.1%	27.1%	27.2%
Domestic Savings/GDP	27.7%	26.7%	26.7%	24.9%	22.9%	23.9%	26.5%	26.8%	27.2%	27.2%	27.3%	27.4%	27.4%	27.5%
National Savings/GDP	27.2%	26.6%	27.1%	24.7%	21.5%	24.6%	26.1%	26.6%	27.3%	27.4%	27.8%	27.9%	28.0%	28.3%
Marginal National Savings Rate	38.0%	17.4%	31.8%	-17.3%	-38.9%	49.9%	35.6%	30.8%	34.0%	29.2%	32.5%	29.4%	30.0%	31.4%
Public Investment/GDP 4/	25.2%	22.9%	22.0%	21.3%	21.9%	22.2%	22.2%	21.8%	21.9%	21.9%	21.8%	21.7%	21.6%	21.5%
Household Savings/GDP	3.5%	4.0%	4.3%	4.3%	4.6%	3.7%	3.2%	3.5%	4.1%	4.7%	5.2%	5.6%	5.9%	6.1%
Ratio of Public/Household Savings 4/	6.8	5.7	5.3	4.7	3.7	5.7	7.2	6.6	5.7	4.8	4.3	4.0	3.8	3.6
Government Revenue/GDP 5/	63.5%	65.2%	65.6%	64.9%	71.3%	65.9%	64.2%	64.0%	61.7%	61.4%	61.0%	60.7%	60.3%	60.0%
Government Expenditure/GDP 5/	67.5%	68.9%	66.4%	67.6%	74.4%	68.2%	64.2%	63.1%	60.9%	60.6%	60.2%	59.9%	59.6%	59.3%
Deficit (-) or Surplus (+) 5/	-4.0%	-3.6%	-0.8%	-2.8%	-3.1%	-2.3%	0.1%	0.8%	0.9%	0.8%	0.7%	0.8%	0.7%	0.7%
Export Volume Growth Rate	7.6%	9.6%	5.9%	-0.8%	-0.8%	3.5%	3.9%	2.9%	2.8%	2.8%	3.1%	3.1%	3.1%	3.1%
Ruble	3.3%	7.7%	7.0%	8.3%	-0.1%	2.5%	2.0%	0.4%	0.5%	1.6%	2.5%	2.5%	2.5%	2.5%
Nonruble	10.6%	10.8%	4.7%	-6.6%	-3.8%	5.0%	5.5%	5.0%	4.6%	3.7%	3.6%	3.5%	3.5%	3.5%
Exports/GDP	37.9%	40.2%	41.1%	42.2%	39.6%	37.9%	37.4%	38.0%	38.1%	38.0%	38.0%	37.8%	37.7%	37.6%
Import Volume Growth Rate	0.6%	5.6%	1.1%	1.8%	1.5%	4.0%	-1.6%	1.6%	2.4%	3.3%	3.5%	3.3%	3.3%	3.3%
Ruble	2.8%	1.5%	-0.5%	-0.4%	3.7%	3.7%	3.8%	2.3%	3.4%	3.5%	3.5%	3.0%	3.0%	3.0%
Nonruble	-2.3%	6.4%	0.4%	2.6%	0.8%	2.6%	-6.0%	1.0%	1.5%	3.2%	3.5%	3.5%	3.5%	3.5%
Imports/GDP	37.1%	38.3%	37.9%	40.1%	41.1%	38.4%	35.6%	35.7%	35.6%	35.7%	35.8%	35.7%	35.7%	35.6%
Current Account (in mill. US$)	-313	37	270	-56	-1286	-573	-166	89	229	209	290	312	355	438
of which, Convertible Currency	-92	297	329	-457	-1419	-847	-504	-252	-32	38	78	87	122	198
Conv. Currency Current Account/GDP	-0.4%	1.4%	1.6%	-2.2%	-6.0%	-3.2%	-1.9%	-0.9%	-0.1%	0.1%	0.2%	0.2%	0.3%	0.5%

p Preliminary

Sources: Central Statistical Office, National Bank of Hungary, National Planning Office, Government Financial Statistics (various issues), and World Bank staff estimates.

1/ Convertible currency.

2/ Exports of goods and services are adjusted to include ruble exports corresponding to ruble imports of energy and raw materials, and to exclude estimated re-exports.

3/ Amortization includes prepayment of medium- and long-term debt. The amounts were $457 million in 1985, $523 million in 1986, and approximately $420 million in 1987. No further prepayments are projected. If prepayments are excluded, the Debt Service Ratio in those years becomes 43.9%, 48.5%, and 42.4%.

4/ Public sector includes the socialist enterprise sector.

5/ Data on the Public Sector refer to the Consolidated Central and Local Governments. References in the text are to the Central Government in the State Budget format.

ANNEX 3

HUNGARY

INDUSTRIAL SECTOR ADJUSTMENT LOAN

BALANCE OF PAYMENTS IN CONVERTIBLE CURRENCIES
(US$ millions at current prices)

	1982	1983	1984	1985	1986	1987/p	1988	1989	1990	1991	1992	1993	1994	1995
							Projected							
A. Exports of Goods & NFS	5169	5145	5297	4833	4553	5692	5997	6454	6929	7376	7829	8320	8854	9429
1. Merchandise (FOB)	4876	4847	4965	4475	4136	5078	5379	5803	6243	6654	7079	7522	8014	8537
2. Non-Factor Services	293	298	332	359	416	614	618	651	686	722	759	798	840	884
B. Imports of Goods & NFS	4447	4278	4053	4547	5130	5629	5447	5630	5881	6233	6654	7131	7622	8145
1. Merchandise (FOB)	4110	3970	3729	4180	4676	5075	4874	5013	5212	5503	5855	6236	6669	7107
2. Non-Factor Services	337	308	324	367	454	554	572	617	669	730	799	874	953	1037
C. Resource Balance	722	867	1244	288	-577	63	551	824	1048	1142	1175	1189	1231	1276
D. Net Factor Income	-976	-662	-744	-725	-829	-924	-1072	-1095	-1104	-1131	-1128	-1138	-1150	-1124
1. Factor Receipts	125	112	153	220	256	206	224	226	226	222	229	241	255	269
2. Factor Payments	1101	774	899	945	1085	1130	1296	1321	1330	1353	1357	1379	1405	1393
E. Net Current Transfers	162	92	-171	-20	-13	14	17	20	23	27	31	36	41	46
1. Current Receipts	550	492	449	443	644	722	758	795	833	872	912	953	995	1039
2. Current Payments	388	400	620	463	657	708	741	775	810	845	881	917	954	993
F. Current Account Balance	-92	297	329	-457	-1419	-847	-504	-252	-32	38	78	87	122	198
G. Long-Term Capital Inflow	174	60	964	1909	1152	822	139	372	119	-27	140	222	215	153
1. Net LT Loans	174	60	964	1909	1152	822	139	372	119	-27	140	222	215	153
a. Disbursements	1068	1276	2645	4119	3802	3108	1950	2000	2000	2325	2850	3100	2950	3200
b. Repayments	894	1216	1681	2210	2650	2286	1811	1628	1881	2352	2710	2878	2735	3045
H. Total Other Items (net)	-1236	89	-989	-531	121	-1253	-200	-170	-170	-170	-170	-170	-170	-170
1. Net Short-Term Capital	-1044	154	-864	-267	432	-1156	-150	-120	-120	-120	-120	-120	-120	-120
2. Capital Flows MEI	-192	-65	-125	-284	-311	-97	-50	-50	-50	-50	-50	-50	-50	-50
I. Changes in Net Reserves	-1154	446	304	901	-146	-1278	-566	-49	-82	-158	49	138	167	183
1. Net Credit from the IMF	237	336	380	18	60	-300	5	179	268	-50	-300	-300	-300	-120
2. Other Reserve Changes	-1391	110	-76	883	-206	-978	-571	-228	-350	-108	349	438	467	303
Shares of GDP														
1. Resource Balance	3.1%	4.1%	6.1%	1.4%	-2.4%	0.2%	2.0%	2.9%	3.5%	3.5%	3.4%	3.2%	3.1%	3.0%
2. Total Interest Payments	4.8%	3.7%	4.4%	4.6%	4.6%	4.3%	4.8%	4.6%	4.4%	4.2%	3.9%	3.7%	3.5%	3.3%
3. Current Account Balance	-0.4%	1.4%	1.6%	-2.2%	-6.0%	-3.2%	-1.9%	-0.9%	-0.1%	0.1%	0.2%	0.2%	0.3%	0.5%
4. LT Capital Inflow	4.6%	6.1%	13.0%	20.0%	16.0%	11.9%	7.2%	7.0%	6.6%	7.2%	8.2%	8.4%	7.4%	7.5%
5. Net Credit from the IMF	1.0%	1.6%	1.9%	0.1%	0.3%	-1.2%	0.0%	0.6%	0.9%	-0.2%	-0.9%	-0.8%	-0.8%	-0.3%
Memorandum Items:														
GDP (millions of current US$)	23159	21005	20365	20625	23757	26085	27227	28603	30370	32379	34617	37042	39638	42461
Foreign Exchange Reserves (US$ mill.)														
1. Int'l. Reserves	767	1222	1805	2792	2888	1953	1387	1338	1255	1097	1146	1284	1451	1634
2. Gold	466	640	751	751	751	525	525	525	525	525	525	525	525	525
3. Gross Reserves incl. Gold	1233	1862	2556	3543	3639	2478	1912	1863	1780	1622	1671	1809	1976	2159
Gr. Reserves in Months Imports	3.3	5.2	7.6	9.4	8.5	5.3	4.2	4.0	3.6	3.1	3.0	3.0	3.1	3.2
Exchange Rates														
1. Nom. Eff. X-Rate	36.6	42.7	48.0	50.1	45.8	47.0	52.3	55.5	57.4	58.2	58.5	58.8	59.0	59.3
2. Real Eff. X-Rate Base 1980 1/	78.7	84.7	84.0	85.6	101.2	121.2	135.0	143.2	148.1	150.2	151.0	151.7	152.4	153.1

P Preliminary

Sources: Central Statistical Office, National Bank of Hungary, National Planning Office and World Bank staff estimates.

1/ A rise indicates a depreciation.

HUNGARY
INDUSTRIAL SECTOR ADJUSTMENT LOAN

Status of Bank Group Operations in Hungary

A. STATEMENT OF BANK LOANS /a

(As of March 31, 1988)

Loan No.	Fiscal Year	Borrower	Purpose	US$ Million (Less Cancellations) Loan	Undisbursed
	One loan and six B-loans loans fully disbursed			266.5	-
2317	1983	HPR /b	Industrial Energy Conservation	109.0	20.3
2397	1984	NBH /c	Indus. Exports & Restructuring	110.0	16.2
2398	1984	OKGT /d	Petroleum	90.0	7.8
2510	1985	NBH	Integrated Livestock	80.0	60.5
2511	1985	NBH	Fine Chemicals	73.0	25.9
2557	1985	HPR	Transport (Rail/Road)	75.0	27.2
2697	1986	HPR	Power	64.0	58.5
2700	1986	NBH	Industrial Restructuring	100.0	50.0
2709	1986	NBH	Industrial Energy Conservation II	25.0	18.9
2738	1987	NBH	Crop Production Improvement	100.0	43.6
2834	1987	NBH	Industrial Restructuring II	150.0	99.8
2847	1987	NBH	Telecommunications	70.0	63.4
			Total	1,312.5	
			Of which Repaid	28.3	
			Total Now Held by the Bank	1,284.2	
			Total Undisbursed		492.1

/a The status of these projects is described in a separate report on all Bank/IDA-financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.
/b Hungarian People's Republic.
/c National Bank of Hungary.
/d National Oil and Gas Trust.

B. STATEMENT OF IFC INVESTMENTS

(as of March 31, 1988)

Fiscal Year	Obligor	Type of Business	US$ Million Loan	Equity	Total
1988	Salgotarjan Glass Wool	Glasswool	3.44	1.39	4.83
1987	UNIC Bank	Banking	-	3.21	3.21
1987	Huni Fermentation Limited	Lysine Manufacturing	8.55	2.70	11.25
	Total Gross Commitments		11.99	7.30	19.29
	Less cancellations, terminations, repayments and sales		-	-	-
	Total Commitments now held by IFC		11.99	7.30	19.29
	Total Undisbursed		11.29	0.33	11.62

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ANNEX 5

HUNGARY

Macro-Economic Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
1. Fiscal Deficit			
Adopt 1988 Central State Budget with deficit not exceeding FT10.4 billion.	Formulate 1989 Central State budget to further reduce budget deficit in order to reduce current account deficit and reach current account balance in 1990.	Implement 1990 State budget in accordance with agreed targets. Formulate 1990 Central State budget to further reduce budget deficit in order to reduce current account deficit and achieve near balance in the current account in 1990.	Implement 1989 State budget in accordance with agreed targets.
2. Current Account Deficit			
Adopt demand management measures to limit current account deficit in convertible currencies to $500 million	Develop current account deficit target consistent with budget deficit.	Develop current account deficit target consistent with budget deficit. Adopt demand management measures to limit current account deficit to target.	Achieve near balance in the current Account balance in convertible currencies.
3. Expansion of Credit			
Adopt measures to restrict expansion of credit of monetary institutions to the State and the State Development Institute to Ft390.6 billion.	Develop credit expansion target consistent with the budget deficit, subsidy reduction program and maintenance of macro-economic equilibrium.	Continue to implement monetary program consistent with maintenance of macroeconomic equilibrium.	Continue to implement monetary program consistent with maintenance of macroeconomic equilibrium.
4. Household Savings			
Implement flexible interest rate policy to stimulate savings and prevent disintermediation. Raise interest rates on long term savings to positive levels in real terms.	Review household interest rates in light of developments in the savings rate in 1988. Formulate interest rate changes necessary.	Implement interest rate changes as necessary. Review household interest rates in light of developments in the savings rate in 1989. Formulate interest rate changes as necessary.	Implement interest rate changes as necessary. Review household interest rates in light of developments in the savings rate in 1990. Formulate interest rate changes as necessary.
5. Exchange Rate Policy			
Continue active exchange rate policy to promote external equilibrium, curb domestic demand, and increase relative profitability of convertible currency exports to promote such exports.			
6. Public Investment Program			
Reduce [illegible] State investm[illegible] by 15% from plan 1987 level. Reduce financial support from SDI for preferred activities of enterprises from Ft16.4 billion to Ft15.4 billion in 1988.	Review 1989-90 public investment to plan to improve efficiency of investment. Assess the role and scope of SDI to improve its efficiency and its integration into the financial system.	Implement revised public investment plan.	

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ANNEX 6

HUNGARY
INDUSTRIAL SECTOR ADJUSTMENT LOAN
Letter of Sector Development Policies

Budapest, Dated,
May 26, 1983.

Mr. Barber B. Conable,
President,
The World Bank
Washington D.C.

Dear Mr. Conable,

I am writing this letter in reference to the proposed Industrial Sector Adjustment Loan. This letter and its attachment update the Hungarian Government's Letters of Intent on the Development of Economic Conditions Concerning Industrial Restructuring in Hungary of May 6, 1986, and May 8, 1987 submitted in connection with the First and Second Industrial Restructuring Projects, respectively.

Background

As you are aware, Hungary has a highly trade dependent economy with over 40 percent of GDP being internationally traded. Such high trade dependence requires continuous increases in the efficiency and international competitiveness of Hungary's industry, especially as over half of our trade is with convertible currency markets. Accordingly, it has been the Government's endeavour to reform the economy and to make it more efficient and internationally competitive. The Government is continuously taking steps to enlarge the role of market forces in the economy, introduce entrepreneurial attitudes in enterprises, and expand the role of market-based instruments for macro-economic management. The Government has already taken a number of actions to advance the reform supported by the two World Bank-financed Industrial Restructuring Projects. These include among others: (i) reform of the enterprise management system in 1985; (ii) enactment of a bankruptcy law in 1986; (iii) the liberalization of international trading activity, following the removal of quantitative import restrictions in 1984; (iv) introduction of a two-tier competitive banking system in 1987; and (v) a comprehensive tax reform, comprising the introduction of a personal income tax and a value added tax from January 1, 1988.

The supply response to these actions is beginning to emerge, but has not met our expectations, partly because of external factors, and also because the full range of reform measures has not yet been introduced. In addition, during the last two years, the macroeconomic environment created more domestic

demand than anticipated, reducing incentives for enterprises to increase efficiency and compete more effectively in export markets. Even when all the reform elements are introduced, it will take considerable time for the structural change in the economy to produce the changes in attitudes and behavior necessary for the full impact to be felt.

After a particularly disappointing performance in 1985-86, the economy continued to deteriorate at the beginning of 1987. The Government therefore took corrective measures to reduce the budget deficit by reducing subsidies and increasing administered prices of some commodities. The Forint was devalued by 5% in November 1987 in addition to a devaluation of 8% in March 1987. The budget deficit was reduced from Ft46.9 billion in 1986 to Ft34.8 billion, and the current account deficit in convertible currency decreased from US$1.4 billion in 1986 to US$846 million in 1987. At the same time, there was evidence of the initial emergence of a supply response to the policy measures introduced in 1985-87. In 1987, industrial growth reached 3.7%, and the volume of nonruble exports rose by 5%. Exports to the highly competitive western markets grew much faster (12%). In 1987, GDP grew by 3.4%.

The economy achieved a partial turnaround in 1987, establishing that the design of the reform program remains fundamentally sound, and will produce the desired results if implemented consistently and forcefully within a sufficiently tight macroeconomic environment.

The Government's Medium Term Program

The Government is aware that the recovery has to be strengthened and sustained. Accordingly, we have prepared a three year (1988-90) program of economic stabilization and structural reform, which incorporates the ongoing industrial sector policy reform program. The overriding objective of the program is initially to restrain, and then to halt the growth of external debt by the end of 1990 by progressively reducing the convertible currency current account deficit. Through the program, we expect to restore sustainable growth of the economy allowing long term improvement in the living standards of the people. The program promotes structural change through accelerated systemic reforms, along with stabilization, to raise productivity and international competitiveness.

The Government intends to implement the program in a consistent manner over the 1988-90 period. The targets for 1988 are outlined below.

The current account deficit in convertible currencies will not be allowed to exceed US$500 million. The targeted reduction in the current account deficit will be achieved by implementing a restrictive demand management policy, including a reduction in the budget deficit and tight credit policy; an active exchange rate policy; and measures to enhance supply, especially exports.

The budget deficit will not be allowed to exceed Ft10.4 billion. The reduction in the deficit will occur, despite a lower overall tax burden in

relation to GDP, largely through a substantial reduction in producer and consumer subsidies. Household consumption will be reduced by 2-2.5% in real terms through a 9-10% reduction in real wages.

Credit of monetary institutions to the State budget and the refinancing of the State Development Institute will together be limited to Ft390.6 billion. Credit expansion will be restrained through higher interest rates and lower limits on the refinancing of commercial banks by the National Bank of Hungary. Besides the increase in interest rates on short-term refinancing credits from 11% to 16% at the beginning of the year, the interest rate on installment credit, which was raised by three percentage points in November, were raised further by one percentage point to reach 14% by April 30, 1988. Use of such credit has been restricted and interest rates on personal loans have been raised by an additional two percentage points to 15-17%. Interest charges on nonpreferential bank loans for housing have also been raised to 12-15%.

Further significant measures to stimulate household savings and to prevent disintermediation have been decided. Interest rates on term deposits of households will be raised to 13.5-15% from June 1, 1988. Interest rates on long term savings notes will also be raised to 14.0-16.5% from the same date. With these increases, interest rates on long term household savings are expected to be positive in real terms. The Government will continue to monitor household savings and take measures to maintain the attractiveness of savings instruments if necessary to generate the required volume of savings. Net domestic assets of monetary institutions will not be allowed to increase beyond Ft1,284.8 billion.

We will continue to pursue an active exchange rate policy to promote external equilibrium. The cumulative devaluation of the forint by 25% between 1986-1987 has had some impact in promoting exports and reducing the trade deficit. The stabilization program should provide a significant incentive to increase exports by curbing domestic demand. We will continue to take actions to increase the relative profitability of exports to convertible currency markets, and continue to provide incentives to stimulate exports. External borrowings in 1988 will be limited to ensure that the total external liabilities in convertible currencies will not exceed US$16 billion, (excluding net purchases from IMF), including short-term liabilities of no more than US$2.3 billion during 1988.

Over the past 3 years, we have attempted to improve the effectiveness of the investment program by encouraging a shift of investment resources out of energy and basic materials into the manufacturing subsectors. Tight resource constraints anticipated during the program period have led us to intensify this effort. As a result of an intensive review of Plan priorities undertaken last year, expenditures on large State investments will be reduced by 15% in 1988. In 1988, no new large central projects will be started, and resources will be concentrated on completing ongoing projects.

We intend to reduce investment in coal mining, electric energy and metallurgy, and increase investment in manufacturing industry. Investments by Local Councils, which had exceeded planned levels in recent years, will be reduced by at least 20% to a level that permits them to provide for essential health and education investments. Equity allocations (a form of low-cost credit) and other forms of financial support from the State Development Institute (SDI) for preferred investment activities of enterprises will be reduced from Ft16.4 billion in 1987 to Ft15.4 billion in 1988. Most of the structural measures outlined below, combined with tight monetary policy, will increase enterprise financial discipline and improve the quality of enterprise investment, which forms the largest single share of socialist sector investment (62%) as well as of investment in industry (78%). We are also taking steps to facilitate investment financing for the rapidly growing small business sector, which we expect will expand vigorously following the implementation of the new Law of Association in January 1989. Finally, before the end of 1988, we will undertake a further review of the investment plans for 1989-90 in an effort to ensure the greatest possible returns from the scarce resources available. We will also assess the role and size of the SDI to determine the scope for improving its efficiency and its integration into the financial system.

The reduction in household real incomes which the program implies will have social costs. The Government has taken steps to protect the vulnerable sections of the society. The budget for 1988 includes a Ft26.1 billion social benefits package containing increases in pensions and family allowances to compensate partially for the removal of subsidies on food, children's clothing, and construction materials used in housing. Increases in the size and duration of child support payments, and an increase in family grants for housing purchase are also included. Unemployment compensation and retraining opportunities are being expanded for those who might be temporarily displaced as a result of the closing down of inefficient productive activities. Measures to promote growth of new small businesses will provide increased opportunities to such workers. An Employment Fund has been established with an initial allocation of Ft1.2 billion to finance and coordinate employment-related assistance. These additional programs have been funded out of savings in Government expenditure, while reducing the budget deficit at the same time.

We will monitor the performance of the economy closely, and if it appears that the actions already taken are inadequate to reach the targets, the Government will undertake additional measures promptly.

The Government also reached agreement with the IMF on a Standby Arrangement for SDR265 million to support the implementation of the economic stabilization and structrual reform program.

Structural Reforms

We are strongly committed to accelerate systemic reform and promote the needed structural changes in the economy. While implementation of reforms and achievement of structural change is difficult at any time, it is more so

during a stabilization period. The high level of Hungary's convertible currency debt and the high proportion of debt service to exports limits the room for resorting to further commercial borrowing in support of the reform program. Our problem is further compounded by the uncertain prospects for world economic growth and trade. We are nevertheless determined to press ahead with the policy reform program, as we firmly believe it is the only way to achieve sustainable growth and the longer-term goal of improved living standards.

Industry is the single largest sector in the Hungarian economy, contributing about a third of GDP, employment and gross domestic fixed investment. It accounts for 75-80% of the total imports and exports. Industrial sector policy reform is therefore the centerpiece of our economic reform. In 1985, the Government undertook, jointly with the Bank, an extensive analysis of the structure, performance, constraints and potential of the industrial sector and of the sector policy and institutional framework. The principal constraints on improved industrial performance were identified as the lack of financial discipline and weak autonomy of enterprises, the lack of domestic and international competition, and the low mobility of resources.

Drawing upon this analysis, the Government launched a five-year industrial sector restructuring program in 1985 to address these constraints. The program aims at increasing reliance on competitive market mechanisms and signals in order to promote efficiency, innovation, and financial discipline at the enterprise level. The program consists of reform actions covering eleven policy areas, which are central to the objectives of the reform. These areas are: entry of enterprises; liquidation and restructuring of inefficient enterprises; international trade; pricing; taxation and subsidies; wage differentiation and worker mobility; capital markets; the banking system; the enterprise management system; direct foreign investment; and technology development. As mentioned above, between 1985-87 we have taken a number of significant actions in support of the program, fully in line with our earlier agreements. The policy actions the Government is committed to take during 1988-90 in respect of the eleven policy areas are elaborated in the following paragraphs. A policy matrix is annexed indicating the specific actions recently taken and those planned to be taken. We recognize the importance of providing a stable environment for enterprise decision-making as quickly as possible. We will therefore accelerate the implementation of the program so that all major systemic changes are implemented during 1988-89.

1. Entry of Enterprises

Increase in competition is one of the most important facets of the reform. The Government will therefore liberalize regulations to facilitate the establishment of different forms of economic associations and conversion to other forms.

We are currently drafting legislation permitting: (i) State enterprises to convert themselves into joint-stock companies, (ii) individuals to own negotiable and transferable shares in joint-stock companies, (iii) individuals to form limited liability companies and joint-stock companies. The draft legislation will be approved by the Council of Ministers in mid-1988, and the Law of Association introduced in Parliament in its autumn session. Following Parliament's approval, the legislation will be implemented from January 1, 1989.

The Government will continue to encourage the small scale, essentially private, sector which has proved to be dynamic. The maximum number of employees permitted in private businesses has been doubled from 15 to 30. Amendments have been made to the current legislation to permit individuals to form limited liability associations together with legal entities.

We have already designed incentives for enterprises to set up subsidiaries or autonomous profit centers, and to promote small and medium enterprises. During the last year 24 new enterprises have been established by breaking up large State enterprises. We expect this process to continue during 1988-90.

2. Liquidation and Restructuring of Inefficient Enterprises.

The Government has recognized the critical importance of tightening financial discipline among enterprises to bring about greater efficiency and market orientation. Accordingly, bankruptcy legislation was given high priority and enacted in 1986. The legislation has generally deterred companies from taking imprudent financial decisions, though the number of actual liquidations of State enterprises has been limited. The Government will implement the bankruptcy legislation more forcefully in 1988. It has been decided that the State itself will initiate liquidation proceedings against enterprises in arrears of Government dues. Commercial banks are now required to set up additional provisions for doubtful debts in addition to normal risk reserves. These provisions will be equivalent to 20% of those debts classified as non-performing according to the criteria established by the Bank Supervisory Board. This, together with tight credit monetary policies, will tighten financial discipline in the economy.

We will limit enterprise and subsector specific financial support designed to alleviate financial difficulties of enterprises to that provided under the liquidation/refloatation framework, with the exception of coal mining (discussed below), and a Ft600 million Government guarantee for bank loans to enterprises that are unable to gross up their wage bills in 1988 following the tax reform. The 1988 budget allocation to the Refloatation Fund was reduced to Ft1.5 billion, 25% below 1987 nominal levels. State guarantees for issue of bonds to finance the Refloatation Fund have been eliminated. Further, the Government has elaborated programs for the resolution of problems in crisis sub-sectors, and some major enterprises known to be in chronic

financial difficulties. Some of these programs are now being implemented, while the others are being reviewed. The programs aim at restructuring of enterprises in these subsectors, closure of non-viable units, reductions in labor force, and shifting production to more profitable and competitive activities permitting the reduction and elimination of governmental support.

In the ferrous metallurgy subsector, we have eliminated current subsidies other than CMEA Price Equalization (Ft5 billion in 1988), and intend to continue this limitation. We have developed plans to restructure capacity to enable the units to operate with financial self-sufficiency. As part of these plans, further investments are limited to those for restructuring existing capacities, support to which during 1988-90, will not exceed Ft2.0 billion.

We are currently developing a restructuring plan for the coal mining subsector. The plan, which we will review with the Bank and finalize by November 1988, will include: a substantial reduction in the level of coal production from underground mines; a review of the feasibility of import of energy to substitute coal from underground mines; the identification of uneconomic pits (pits whose coal production costs are higher than those for comparable energy source imports) and a timetable for taking necessary measures, including closure of the uneconomic pits and a concurrent reduction in the labor force, especially administrative staff. We will implement the plan from 1989 and progressively reduce subsidies to coal mining commencing with a substantial reduction from the 1988 budget allocation of Ft10.6 billion (including those for grossing-up of wage bills of coal mining enterprises which were provided in 1988).

3. International Trade

The Government recognizes that external competition through export promotion and a liberal import policy is an essential ingredient of our policy to increase the pressure on domestic enterprises to improve efficiency. We intend to maintain the incentives currently provided to export related investments under the export promotion program introduced in 1986. We are continuously taking steps to increase the relative profitability of exports to convertible currency markets. We are streamlining the procedures for import licensing to ensure licenses are issued to exporters in an expeditious way to avoid export constraints.

To achieve the needed improvement in the convertible currency trade balance, the Government will rely on market based instruments and tight demand management. The Government will maintain the import regime free of quantitative restrictions in line with Hungary's protocol with the GATT. We recognize the need to foster greater import competition. Toward this end, we will encourage more widespread use of international competitive bidding for goods and services in investments financed from the Government budget. We will also encourage the commercial banks to promote the increased use of international competitive bidding by their borrowers.

We have already liberalized access to foreign trading rights, thus promoting greater links between production and trade, and increased competition in foreign trading activities. As of January 1, 1988 all legal entities may register automatically to conduct foreign trade in convertible currencies subject only to prescribed criteria of staff capability and financial viability.

Finally, with the establishment of the new Ministry of Trade, we have reorganized the responsibilities related to foreign trade. In this context, we will review the regulatory framework influencing convertible currency foreign trade. In light of the outcome of the review, we will identify necessary changes to make the framework more efficient in line with the Government's policy objectives. Thereafter, by the end of 1988, we will develop a timetable for implementing necessary changes and implement them beginning in 1989.

4. Pricing

The Government recognizes that prices should respond to demand and supply, and changes in the structure of relative prices are crucial to efficient resource allocation. We will increasingly replace administrative price determination by market mechanisms which will help develop a flexible and dynamic economy integrated more effectively into world markets. For inflation control, the Government will rely on appropriate monetary and fiscal policies.

In the context of the introduction of the VAT, we found it necessary to impose a temporary administrative control of price movements from August 1987, requiring prior reporting of all intended price increases to the Government. This requirement was abolished on April 1, 1988. Enterprises are now free to change most prices. Prices of 25% of the value of producer goods turnover remain administratively set, mainly for energy, transport, some agricultural products and chemicals.

Since January 1, 1988, price of at least 80% of consumer goods are classified as belonging to the free pricing category. Of this, 22% are subject to advance reporting, 5% to price consultation procedures, and the remaining 53% are subject only to the Import Pricing Rule and the Law of Unfair Economic Practices. This proportion will be increased to at least 62.5% by January 1, 1989. Beginning April 1, 1988, administratively determined maximum consumer prices have been limited mainly to energy, passenger and city transport, milk and some items of basic foods, pharmaceuticals, amounting to no more than 20% of consumer goods.

We will examine the scope of administrative price setting, consultations and advance reporting by the end of 1988 with a view to limiting their coverage and improving the effectiveness of market forces in the economy. We plan to review the level of administratively determined maximum consumer and producer prices and the process for setting them to identify possible improvements and reductions in their scope. We intend to implement the results of the review during 1989. In 1989 and 1990 we intend to reduce

the number of goods covered by advance reporting. Where advance reporting is designed to permit monitoring of expected price developments, we will replace it by by ex-post reporting.

We are taking steps to develop legislation to prevent monopolistic behavior for enactment in 1989. Meanwhile, the pricing authorities will limit their consultations with producers and consumers to markets dominated by a small number of firms or where other major market imperfections exist. We will continuously review our experience with these consultations, and we will also consider the use of imports to enforce market discipline in cases of unfair market practices, or other market imperfections. Based on such reviews, we expect to be able to increase the share of consumer prices subject only to the Import Pricing Rule and the Law of Unfair Economic Practices to about 70% by January 1, 1990, though this percentage can only be determined finally after the reviews have been completed.

5. Taxation and Subsidies

A major achievement of the Government in 1987 was the enactment of the tax reform, comprising the introduction of a value added tax and personal income-tax, and the elimination of a large number of the existing taxes on enterprise. The tax reform has been implemented effective from January 1, 1988. The tax reform eliminated a great many distortions to enterprise decision-making and will enable efficient enterprises to retain a greater proportion of their profits which will lead to long-run efficiency gains. Aggregate corporate profit taxes are projected to decrease by Ft44 billion and indirect taxes to increase by Ft110 billion (8% of GDP).

By January 1, 1989, the Countervalue Tax will be eliminated and the Entrepreneurial Tax will be integrated into the personal and corporate profit taxes including a provision for the deduction of the cost of the entrepreneur's labor income for tax purposes.

We will undertake a further streamlining of the legal framework of enterprise taxation and introduce a new unified law for the taxation of business profits not later than January 1, 1990. The new system will aim to make the tax system neutral with reference to form of association.

In view of the need for strict demand management in 1988, the Government will rebate only 20% of the value added tax paid on goods used for investment. This is a purely transitory measure: 40% will be rebated from 1989, 60% from 1990, 80% from 1991, and full rebates are planned from 1992.

In addition to the tax reform, a subsidy reduction program will further restructure the role of the State budget in the economy. The 1988 annual plan contains a reduction in the total current producer and consumer support from the State budget, the budget of Local Councils, and Extrabudgetary Funds of Ft37.1 billion to Ft204.9 billion. The Government is strongly committed to taking the needed measures to meet the 1988 plan target

for reducing subsidies. We will endeavor to continue the phase-out of subsidies as rapidly as possible to improve fiscal balance, tighten financial discipline and promote structural adjustment at both the macroeconomic and enterprise levels. Toward this end, by October 1988 we will develop and thereafter review with the Bank, a program to reduce subsidies and financial support from the 1988 Plan level of Ft204.9 billion by at least 10% per year in 1989 and 1990.

6. Wage Differentiation and Worker Mobility

The Government supports the principle of free determination of individual earnings based on performance. However, given the necessity of very strict demand management policies in 1988, the Government has been obliged to enforce a general ceiling on increases in enterprises wage bill. During 1988, enterprises will be subject to a 2.5% ceiling on the growth of their total earnings bill. Within the aggregate ceiling, enterprises could generate savings by releasing excess labor and apply such savings to increase wages for the remaining work force by more than 2.5%. The mandatory upper limits of wage scales have been removed from 1988 to enlarge the scope for such wage differentiation. The only exception to the general ceiling on wage increases will be made in respect of a small group of enterprises (employing at present 6% of the labor force) meeting objective criteria of profitability, creditworthiness, and non-reliance on budgetary subsidies.

The Government intends to elaborate a reform of the wage system during 1988, to be implemented beginning from January 1, 1989. The reform will enable productive enterprises freely to determine individual earnings, subject to an overall ceiling on their wage bill related to performance, permitting sufficient scope for wage differentiation. This will address the need for major shifts in employment patterns likely to arise over the next few years as a result of industrial restructuring.

A significant step has been taken in 1988 with the establishment of the Employment Fund with a budget of Ft1.2 billion, to strengthen measures for retraining and facilitate labor mobility. We will continue to modify the conditions for use of the Fund based on experience.

7. Capital Markets

Further development of the capital markets for efficient mobilization and allocation of capital will be continued. The new Law of Association, the conversion of some state enterprises into joint-stock companies, and proposals for establishment of securities market regulation, will help to develop the capital market. As a first step, we have already introduced "capital tickets", which are a redeemable, non-voting profit sharing instrument to be issued to employees by their enterprises in 1988. The enterprise and household bond markets have been integrated with the removal of requirement of a State guarantee for bonds sold to the population. We will further modify the regulatory environment to promote development of insurance, and develop plans to operate the social security system on a self-sustaining basis. These measures will also help to strengthen the development of the capital market.

To ensure the availability of timely and reliable information about the financial position of enterprises and potential borrowers to the banks and investors, new accounting standards, auditing and disclosure requirements have been introduced in January 1988.

From mid-1987, several financial institutions, including insurance companies, commercial and specialized banks, have joined together to develop a credit information system and to share information on bond issues and trading. The Government will support an initiative to develop a stock exchange that can serve the needs of an active and diversified financial market.

8. Banking System

The most important step to be taken is to integrate the interest rates for enterprises and households in order to unify the flow of savings among all sources and uses through the banking system. The main obstacle to this integration has been the system of subsidized housing loans financed out of low interest rate household deposits. During 1988, we will develop comprehensive proposals for a new housing finance system.

As a preliminary step towards the integration of banking services, commercial banks have been permitted during 1988 to issue bonds to households to mobilize resources and to provide banking services to entrepreneurs. By January 1, 1989 we will implement the integration of banking services for households and enterprises and continue the process, with full integration planned in 1989-90.

New instruments such as treasury bills have been introduced in 1988 to strengthen the effectiveness of monetary policy. Graduated interest rates have been introduced to improve the refinancing mechanism to reduce excess liquidity in the banking system and facilitate better management of monetary policy. We will continue to review the interest rate structure, refinancing criteria and reserve requirements to improve the effectiveness of monetary policy, resource mobilization and allocation.

By June 1988, the newly established commercial banks will carry out a portfolio review by independent auditors to determine the extent of non-performing loans, set up provisions as necessary in accordance with the regulations issued by the State Bank Supervision Board. Steps will be taken to strengthen and systematize the inter-bank market and to establish a clearing center for checks and payments.

The Government intends to introduce foreign exchange operations by commercial banks gradually, commencing in 1988. For the time being, borrowing in foreign currencies will be carried out exclusively by the National Bank in view of the need for very careful management of the country's external debt.

9. Enterprise Management System

The Government intends to extend the system of autonomous enterprise management, at present based on management by partly elected enterprise councils or by enterprise assemblies. While the experience with the present system is too short to draw any definite conclusions at present, modifications will be made as required in the light of experiences in the next two years, especially as deregulation of prices and wages is progressively implemented.

As mentioned earlier, the new Law of Association will permit State enterprises to convert themselves into joint stock companies. The Government believes that the decision for such conversion should be taken at the initiative of the enterprise managements themselves. To encourage the conversion process, we will identify an initial group of enterprises and facilitate their conversion commencing from 1989.

10. Direct Foreign Investment

The Government recognizes the contribution direct foreign investment could make to improving the structure and performance of the Hungarian economy. Besides intensifying promotional campaigns to attract foreign capital and continuing to enter into investment protection agreements with other countries, we will continue to assess the effectiveness of the incentives framework, rules, regulations and operating environment for direct foreign investment and implement modifications as necessary in the context of the newly introduced tax reform and the proposed law of association.

11. Technology Development

Technology development is one of the major objectives of our current program. The reform of the tax system and other policy areas radically improves the preconditions for technology development.

We have introduced measures for accounting treatment of intangible assets such as intellectual property, e.g., patents and copyrights, and are continuing to develop measures for the accounting treatment of intangible assets and disembodied technology, which will provide necessary incentives for R&D. We intend to review the twelve national R&D programs with a view to concentrating resources on a few selected priority areas, instead of diffusing them thinly and widely. We are continuously developing measures to promote the acquisition of foreign know-how through licensing for indigenous manufacture and for encouraging its assimilation. We will streamline the procedure for approval of licensing, leading to a registration mechanism instead of individual approvals by January 1, 1989. We will continue our effort to make R&D by enterprises more market oriented, and increase the proportion of R&D resources available to enterprises for market oriented R & D activities.

Conclusion

We believe that these actions will contribute to meeting the objectives of industrial restructuring and policy reform as set out in our earlier letters of intent. As in the past, we will continue to consider the reforms as an ongoing process because the specific steps and targets needed to achieve structural adjustment in the industrial sector will change and evolve over time, depending on economic trends and on the results of the reform measures already taken. Accordingly, we will, in consultation with the Bank, continue to deepen the reform process and develop further measures to be taken in succeeding years until the objective of establishing a flexible and efficient structure of production is established.

We have always been in mutual agreement that the economic stabilization and structural reform program - of which the industrial sector policy reform program forms the core - both need to be implemented in a consistent and coordinated manner to obtain the necessary supply response, and lead to sustained economic growth. I would like to reconfirm that the Government is committed to implement the program. We appreciate the assistance the World Bank has provided us in this endeavor under the first two industrial restructuring projects. In continuation of this collaboration, I request the World Bank to extend an industrial sector adjustment loan to Hungary in support of the program. This assistance, together with that of the IMF, would help us in restoring equilibrium in the economy and achieving structural changes. It would also strengthen our access to the financial markets during the period of economic stabilization and structural reform.

With best regards,

Yours sincerely,

Joszef Marjai
Deputy Chairman of the Council of Ministers of the
Hungarian People's Republic

HUNGARY

Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
1. Entry of Enterprise			
Enact decree permitting individuals to form limited liability associations jointly with a legal entity.			
Finalization by Council of Ministers of new draft legislation (Law of Association) permitting (i)State enterprises to convert themselves into joint stock companies. (ii)individuals to own negotiable and transferable shares in joint stock companies, and (iii) individuals to form limited liability companies among themselves, and joint stock companies.	Submit draft law(s) to Parliament. Following Parliamentary approval, amend related laws and regulations.	Implement law(s) and related regulations from January 1, 1989	Continue implementation
	Prepare new legislation to unify financial environment facing different forms of associations (e.g. taxation, payment of dividends etc.) and to facilitate mobility among forms.	Enact and implement legislation.	Continue implementation
Take further measures to promote foundation and growth of entrepreneurship (e.g., immediate rebate of VAT on investment for entrepreneurs)		Remove 20% Countervalue Tax. Integrate Entrepreneurial Tax into personal and corporate profit taxes and eliminate other anomalies.	
Increase in maximum number of employees permitted per entrepreneurship from 15 to 30		Assess impact of new tax system on entrepreneurs and implement further necessary modifications.	
Maintain tax benefits for establishment of new companies and subsidiaries and related incentives for decentralization of enterprises.		Review and modify tax benefits in light of Law of Association and unified tax for taxation of business profits.	
Establish schedule for breaking up of some large enterprises under State management, and begin to implement program.	Continue implementation of program.	Complete the program	
2. Liquidation and restructuring of inefficient enterprises			
Eliminate enterprise and subsector specific financial assistance designed to alleviate financial difficulties of enterprises including (i) tax and loan forgiveness, (ii) State equity allocations, (iii) guarantees of bank loans, and (iv) grants, to individual enterprises outside the Liquidation/Refloatation framework.		Continue implementation of policy	Continue implementation of policy

HUNGARY

Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
Eliminate Govt. guarantees of loans and bond issues for Refloatation Organization		Continue implementation of policy	Continue implementation of policy
Reduce budgetary allocations to Refloatation Organization from Ft2.0 billion in 1987 to Ft1.5 billion in 1988.		Maintain budgetary allocation to Refloatation Organization at less than previous year's nominal level	Maintain budgetary allocation to Refloatation Organization at less than previous year's nominal level
Continue to monitor and enforce adherence to existing refloatation agreements by already refloated enterprises.			
Require banks to make provisions for non-performing loans and take measures to encourage banks, tax authorities, and enterprises to collect debts promptly in order to promote financial discipline.	Continue to implement the measures	Continue implementation	Continue implementation
Begin implementation of action plans for quick and efficient resolution of problems of Ganz Mavag, Lang Machinery Works, Soroksar Eng. Works and Pet Fertilizer.	Decide restructuring plan for coach plant of Ganz Mavag Soroksar Eng. Works and Pet Fertilizer	Implement plans	
	Implement restructuring plans for other enterprises in the liquidation/refloatation process		
Begin revising program for restructuring of coal mining industry to increase efficiency and reduce subsidies.	Finalize restructuring program.	Begin implementation	Continue implementation
Develop the restructuring program for ferrous metallurgy including limiting current subsidies except for CMEA Price Equalization and limiting investment support during 1988-1990 to a total of Ft2 billion.	Begin implementation	Continue the implementation. Eliminate current subsidies except for CMEA price Equalization from the 1988 level and limit investment support to Ft2 billion for restructuring investment.	

3. International Trade

Maintain the import regime free of quantitative restrictions in accordance with the GATT rules and rely increasingly on overall macroeconomic policy and flexible use of market-based instruments, such as an active exchange rate policy, for BOP management.

Continue to expand foreign trading rights by introducing automatic registration for legal entities.

HUNGARY

Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
Continue to encourage establishment of foreign trading houses, offices of foreign companies in Hungary, and offices of Hungarian companies abroad.			
Review procedures and implement changes to ensure issue of import licenses to exporters expeditiously.	Continue application of streamlined procedures.		
	Review the regulatory framework influencing convertible currency trade.	Implement necessary improvements to make framework more efficient.	
Ensure favorable conditions to create customs free zones.		Continue the process	Continue the process
Review and rationalize export promotion incentives including regulations for rebate of VAT on investment goods, in light of tax reform.		Implement necessary changes	Continue implementation
Review implementation of Export Promotion Program, to identify measures for monitoring performance of eligible units.		Implement necessary changes changes.	Carry out further review of modified export promotion program.
Conclude study of export marketing		Implement recommendations of study	Complete implementation
Continue to lower nominal tariffs in line with GATT		Complete ERP study in the first half of 1989. Take actions accordingly to further rationalize tariffs taking into account the results of the ERP study and results of the Uruguay round.	
Take measures to improve relative profitability of sales to convertible currency markets in relation to sales to other markets.	Maintain appropriate relative profitability of sales to convertible currency markets in relation to sales to other markets.		
Continuously monitor and take steps to increase effectiveness of the import competition program and broaden its scope, and reduce constraints.			
4. Pricing			
Implement restructuring of relative prices in context of tax reform.			
Implement plan to move from price regulation towards market regulation. Redefine main role of price authorities to monitoring enterprise compliance with Law of Unfair Economic Practices and regulation of imperfect markets.			

HUNGARY

Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
Increase proportion of consumer goods under general pricing rules to 53%	Review coverage, level and methods of price setting, advance reporting and consultation precedure in producer and consumer pricing by end-1988 to limit their scope and improve effectiveness of market forces.	Implement results of study, including increasing proportion of consumer goods prices subject only to the Import Pricing Rule and the law of Unfair Economic Practices to at least 62.5% by January 1, 1989.	Further increase the proportion of consumer goods prices subject only to the Import Pricing Rule and the law of Unfair Economic Practices in line with the review with the expectation that the proportion can reach about 70% by January 1, 1990.
End current universal requirement for firms to report price increases (April 1, 1988).			
Examine scope for use of selective imports of consumer goods to enforce market discipline in cases of unfair market practices.			
	Elaborate legislative framework to prevent monopolistic behavior and enact the framework.		Implement the legal framework.
5. Taxation and Subsidies			
Implement tax reform (introduction of VAT and PIT and removal of other taxes). to reduce tax burden on enterprise profits (1/88).		Review/assess infrastructure for tax administration, and modify as needed.	Review tax system and propose modifications (e.g. in rates, brackets etc.) as necessary.
	Prepare further improvements in tax legislation	Eliminate Countervalue tax.	
		Integrate Entrepreneurial tax into personal and corporate profit taxation.	
		Prepare unified law for taxation of business profits	Subject to parliamentary approval, implement the law
Rebate 20% of VAT on investment goods.		Increase rebate of VAT on investment goods to 40%	Increase rebate of VAT on investment goods to 60%
Eliminate tax incentives for categories of investment other than export promotion (e.g., energy conservation, waste recycling, raw materials, savings, etc.)			

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Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
Reduce total consumer and producer subsidies from FT242 billion in 1987 by 15% to Ft205 billion in 1988	Develop plan to reduce progressively total consumer and producer subsidies by at least 10% per year in 1989-90.	Implement producer and consumer subsidy reduction plan	
6. Wage Differentiation and Labor Mobility			
Introduce wage club to exempt enterprises meeting defined criteria from earnings regulation.	Review experience and evaluate results		
Prepare reform of the wage system	Submit proposals for approval	Permit enterprises to determine individual earnings freely, subject to an overall ceiling on their wage bill related to enterprise performance.	Continue implementation of wage reform
Eliminate mandatory application of wage scale ceilings.			
Introduce unified Employment Fund in 1988 Budget		Review operations of Fund to identify and implement possible improvements.	Implement improvements
Modify conditions for use of retraining benefits to facilitate labor mobility.	Develop further proposals to facilitate worker mobility.	Review effectiveness and make modifications as needed.	Review effectiveness and make modifications as needed.
7. Capital Market			
Enact decree to liberalize and integrate household and enterprise bond market (including removal of required state guarantee)			
Introduce non-voting, redeemable, profit sharing instruments for issue by enterprises to their employees (Capital tickets).			
Take further measures to develop securities information system based on initiatives by participating institutions		Evaluate effectiveness of system and implement	Complete implementation
Implement new accounting/auditing/information disclosure requirements for enterprises.		Evaluate effectiveness and implement appropriate modifications	Implement improvements

Review and modify, as necessary, the regulatory environment to promote development of insurance business.

Review and develop, as necessary, the measures to encourage wider use of instruments to supplementary pensions.

Review and develop, as necessary, the plan to operate social security system on a self-sufficient basis over a period.

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Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
8. Banking System			
Permit commercial banks to engage in household transactions		Integrate household and enterprise banking services.	Continue implementation
Develop proposals for new housing finance system and submit for approval		Begin implementation	Continue implementation
Require commercial banks to carry out portfolio review to determine extent of non-performing loans		Monitor compliance	
Require banks to set up provisions for nonperforming loans and increase capital as necessary.	Apply regulations for providing for nonperforming loans.	Continue to apply regulations	Continue application
Establish institutional arrangements for annual independent audits of commercial banks	Prepare and publish audits	Prepare and publish audits	Prepare and publish audits
Introduce issue of treasury bills		Evaluate effectiveness and introduce modifications as necessary	Continue to implement modifications as necessary
Develop methods and action plans for commercial banks to conduct foreign exchange operations (excluding borrowing in international markets) and to make adequate provisions for associated risks.	Implement system	Continue implementation	Continue implementation
Facilitate institutional arrangements for interbank market	Assess operations of market and initiate improvements as needed	Implement improvements.	Implement improvements.
Finalize proposals for setting-up of bank clearing center.	Begin to implement proposals	Continue implementation	Complete establishment of clearing center
Take further measures to develop credit information system based on initiatives by financial institutions.		Implement credit information system.	Evaluate effectiveness of system and implement needed improvements.
		Permit enterprises to open current accounts in more than one bank.	
Reassess interest rate structure, refinancing criteria, and reserve requirements and implement modifications as needed to improve efficiency of financial system.			
Complete design of program for bankers training school.	Begin to implement the program	Implement program.	Complete implementation

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Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
9. Enterprise Management System			
Decide on and begin implementation of enterprise management system in group of enterprises remaining under State and council management, inter alia, in coordination with decentralization program.	Continue implementation	Complete implementation	
Complete study to assess effectiveness of the enterprise management system.	Continue to implement modifications as needed		
Establish and begin to implement management development and training program.	Continue implementation.	Continue implementation	
Develop and implement proposals to reduce statistical reporting requirements for enterprises in line with reforms in accounting and taxation.	Continue implementation	Continue implementation	
Identify enterprises for conversion into share companies		Facilitate conversion of selected companies	Complete conversion of selected companies
10. Direct Foreign Investment			
Continue to assess effectiveness of incentives framework, and implement modifications as necessary in context of tax reform and preparation of law of association.		Implement measures in context of Law of Association	
Intensify promotional campaign to attract foreign capital/technology to Hungary.		Continue promotional campaign	
Continue to expand number of countries with whom investor protection agreements in place.			
11. Technology Development			
Implement new tax incentives for R&D under tax reform		Conduct a review of economic incentives for R&D and prepare proposals for implementation	Begin implementation
Implement national R&D programs in priority areas.	Conduct a midyear review of R&D programs and modify them to improve effectiveness and greater concentration on the more promising areas if necessary.	Continue implementation	Continue implementation Based on the evaluation of present R&D plan, develop R&D strategy for the 1991-95 period
Abolish regulations for compulsory establishment of tech. dev. funds by enterprises.		Design and introduce measures to strengthen R&D facilities of universities with the aim to upgrade the level of education and R&D capabilities	Evaluate the impact of measures implemented and policy followed.

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Summary of Industrial Policy Reform Program, 1988-1990

Policy area/Actions Pre-Board Presentations	Mid 1988 - end 1988	1989	1990
		Increase share of allocation from central funds for market oriented R&D activities.	
	Prepare measures to streamline procedures for the approval of acquisition of foreign licenses including the substitution of present approval procedure with registration mechanism in specific areas for introduction by January 1, 1989.	Introduce measures	
Implement accounting rules to capitalize intangible assets acquired commercially	Study measures to extend accounting rules to capitalize other types of intangible assets, e.g. proprietory technology developed within the company for implementation.	Introduce measures identified as a result of study.	
Implement modernization program for R&D infrastructure.	Continue implementation of the program		Based on evaluation of the ongoing program, prepare a long term strategy to upgrade the infrastructure for R&D over the period 1991 -2000. Design medium term program for 1991 95, including implementation plan.

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HUNGARY

INDUSTRIAL SECTOR ADJUSTMENT LOAN
SUPPLEMENTARY LOAN DATA SHEET

Section I: Timetable for Key Events

(a)	Time taken to prepare project:	8 months
(b)	Departure of Appraisal Mission:	March 4, 1988
(c)	Completion of Negotiations:	May 13, 1988
(d)	Planned Date of Effectiveness;	July 15, 1988

Section II: Special Bank Implementation Actions

None

Section III: Special Conditions

(1) Conditions of Loan Effectiveness

None

(2) Conditions for Release of the Second Tranche

(i) Adoption of the 1989 Annual Plan and State Budget, including a public investment plan, which: (a) further reduces the State Budget balance and is designed to lead to a halting in the growth of Hungary's external debt in convertible currency by the end of 1990; and (b) further reduces the total producer and consumer subsidies and other financial support from the 1988 Annual Plan level of Ft204.9 billion by at least 10%.

(ii) Enactment of a law of associations and related legislation which would permit: (a) State enterprises to convert themselves into joint stock companies; (b) individuals to hold negotiable shares in joint stock companies; and (c) individuals to form limited liability and joint stock companies.

(iii) Adoption and commencement of implementation of programs, satisfactory to the Bank, to restructure the ferrous metallurgy and coal mining subsectors.

(iv) Enactment of legislation which would eliminate the Countervalue Tax and integrate the Entrepreneurial Tax as part of the corporate profit and personal income taxes.

(v) Enactment of legislation which would allow enterprises to determine freely individual earnings subject to an overall ceiling on the enterprise's wage bill related to its performance.

(vi) Integration of banking services for enterprises and households.

MAP SECTION

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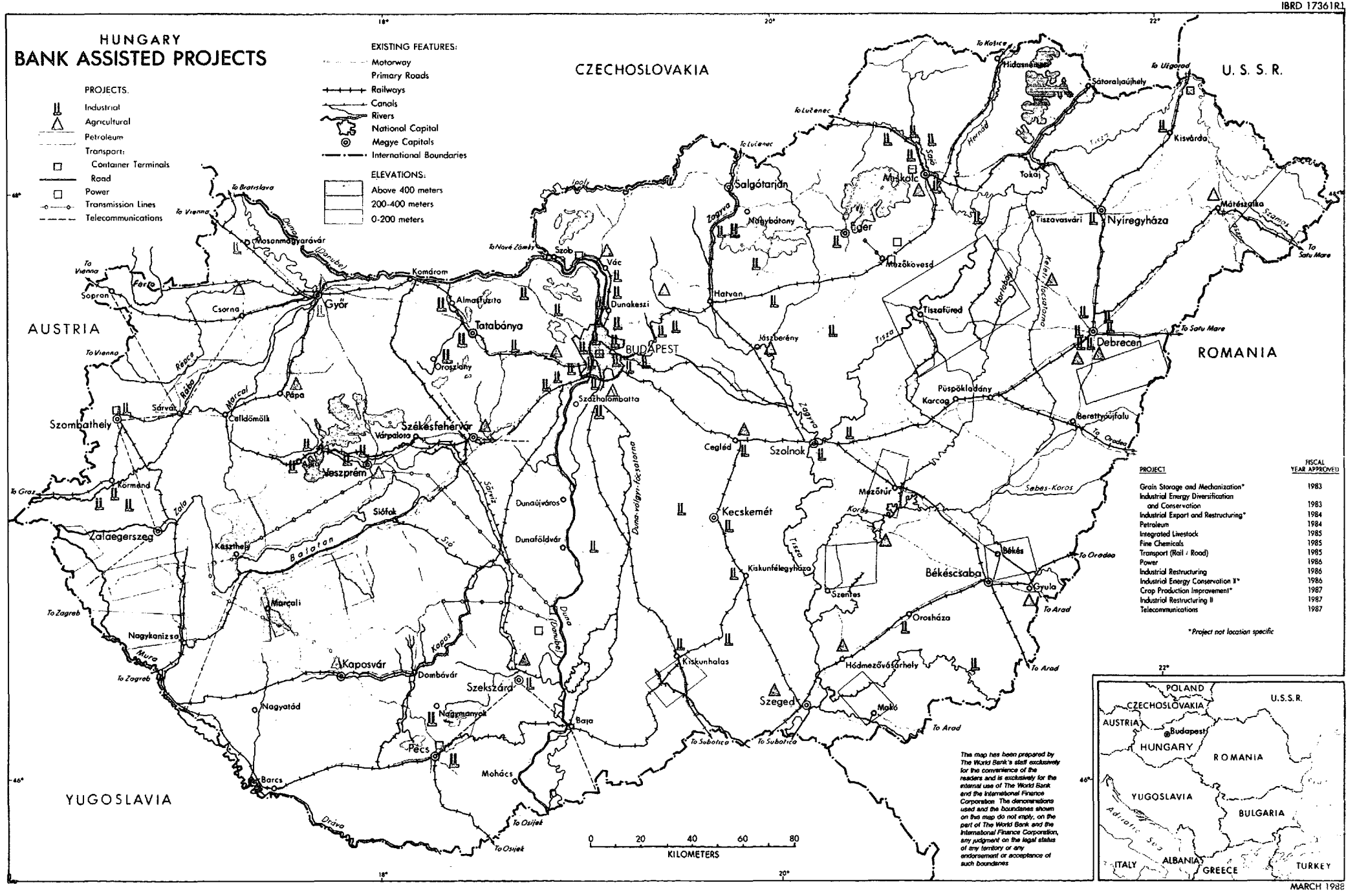
HUNGARY
BANK ASSISTED PROJECTS

PROJECTS:
- Industrial
- Agricultural
- Petroleum
- Transport:
  - Container Terminals
  - Road
- Power
- Transmission Lines
- Telecommunications

EXISTING FEATURES:
- Motorway
- Primary Roads
- Railways
- Canals
- Rivers
- National Capital
- Megye Capitals
- International Boundaries

ELEVATIONS:
- Above 400 meters
- 200-400 meters
- 0-200 meters



PROJECT	FISCAL YEAR APPROVED
Grain Storage and Mechanization*	1983
Industrial Energy Diversification and Conservation	1983
Industrial Export and Restructuring*	1984
Petroleum	1984
Integrated Livestock	1985
Fine Chemicals	1985
Transport (Rail / Road)	1985
Power	1986
Industrial Restructuring	1986
Industrial Energy Conservation II*	1986
Crop Production Improvement*	1987
Industrial Restructuring II	1987
Telecommunications	1987

*Project not location specific

MARCH 1988