WIIW Analytical Forecasts
HUNGARY

Sándor Richter

HUNGARY:
Medium-term
Forecast and
Risk Assessment

WIIW ANALYTICAL FORECASTS

In this series, The Vienna Institute for International Economic Studies (WIIW) attempts to assess the medium- and long-term outlook for economic developments of countries in transition.

We are fully aware of the risks inherent to this task and the reader should also be informed about limits to forecasting for transition countries. In addition to common uncertainties adherent to any forecast, these economies are still highly fragile and volatile, statistics are incomplete and changing, and the politics may – more than in an established market economy – affect economic developments, especially in the longer-run perspective.

We present alternative development scenarios and our forecasts are based on the in-depth analysis of recent economic and political trends. We hope that the WIIW Analytical Forecasts series may serve as a useful tool for providing an evaluation of countries' future prospects and represents a realistic and unbiased assessment of the future economic and political development of the respective country.

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Executive summary

Following the successful 1995 stabilization, the Hungarian economy entered a growth path that is characterized by strong export and investment growth and a much less dynamic increase of consumption. The growth acceleration has not resulted in external imbalances as was invariably the case in the last decades. Growth was coupled with an exceptionally rapid pace of modernization in industry which dramatically changed the composition of industrial output and exports. The driving force of these changes has been the foreign-owned sector.

The elections in 2002 and the intensified preparations for accession to the EU (assumed to take place in 2005) are the issues which may decisively influence the medium-term prospects of the Hungarian economy.

In this paper two scenarios for Hungary's economic performance in the period 2001-2004 are presented. According to the baseline scenario there will be a moderate political business cycle in 2001-2002 with a somewhat higher increase of domestic use than GDP growth. Following the necessary corrective measures to put a brake on household consumption growth, assumed to be introduced in late 2002 or early 2003, no further menace to the external equilibrium will be in sight until the end of the period in question. It will be possible to maintain an about 5% annual average GDP growth over the years concerned.

In scenario B it is assumed that household consumption is getting out of control in 2001 and 2002. The resulting deterioration of the external equilibrium will necessitate resolute and painful corrective measures which reduce household consumption growth to a marginal pace in 2003. GDP growth will be less dynamic from 2002 on, only 3-4% annually. Foreign debt of the country will start to grow again.

The realization of the baseline scenario is thought to be twice as likely as that of scenario B.

In the last two pre-accession years, 2003 and 2004, investments are expected to increase rapidly due to the obligations related to the acquis compliance. As the ratification of the Accession Treaty by the 15 EU members is thought to take place in these years, the strict observance of the obligations undertaken in the Accession Treaty seems unavoidable, setting thus the hardest constraint to the selection of economic policy priorities. The impact of the accelerated investment activities on the current account will be negative, but this is assumed to be overcompensated by stepped-up FDI and portfolio investments typically having occurred to countries immediately before their accession to the European Union.

Keywords: *Hungary, medium-term forecast, risk assessment*

JEL classification: *O11, O19, O40, O52*

HUNGARY: Medium-term Forecast and Risk Assessment

1 The Hungarian economy in international comparison

In 1999 Hungary's GDP amounted to 11.439 billion forint (HUF) or about USD 49 billion calculated at the official exchange rate; this corresponded to USD 4880 GDP per capita. This level of income lags considerably behind that of the highly developed industrial countries. Calculation based on purchasing power parity, however, inflates the Hungarian GDP to about USD 114 billion (USD 11,350 per capita). This corresponds to about 53% of the EU(15) average. Hungary's present level of development relative to the EU corresponds to that of Portugal in 1986, the year of its accession to the EU, and is only 5 percentage points lower than that of Ireland in 1973, the year of Ireland's accession to the EU.[1]

There are strong, and recently even growing regional disparities behind the nationwide average. Per capita GDP is highest in Budapest, attaining 89.5% of the EU average in 1998 and surpassing the national average by 86%.[2] The three most developed counties (two along the Austrian border, Györ-Moson-Sopron and Vas, and one in middle Trans-Danubia, Fejér) are 17% to 24% above the national average, while the least developed three counties (Szabolcs-Szatmár-Bereg, Borsod-Abaúj-Zemplén and Nógrád in the north-eastern part of Hungary) have a per capita GDP ranging from 57% to 69% of the national average. Per capita GDP in the poorest county, Nógrád, corresponds to 30% of the respective figure for Budapest and 27% of the EU average. (Map 1)

2 'Flying start' of transition

Deviation from the classical model of the centrally planned economy began in Hungary in fact long before the fall of the communist system in 1990. As early as 1968, economic reforms brought about limited freedom for the enterprises (then all of them were still in state ownership) in their decisions on production, investment, prices, etc. In 1982 the legal framework for small-scale private entrepreneurship was established. Some of the most important steps towards a market economy, such as establishment of a two-tier banking system, introduction of a modern taxation system and re-establishment of the legal framework for limited liability and stock holding companies, were taken in 1987-1989,

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[1] OECD. For more details see Richter (2000), pp. 11-12.

[2] Source of data cited in this paper (unless otherwise indicated): annual, monthly and online publications of the Central Statistical Office of Hungary.

Map 1

Hungary: GDP per capita, 1998
1000 HUF

GDP per capita, 1000 HUF

- 500 to 699
- 699 to 849
- 849 to 1000
- 1000 to 1499
- 1499 to 1858
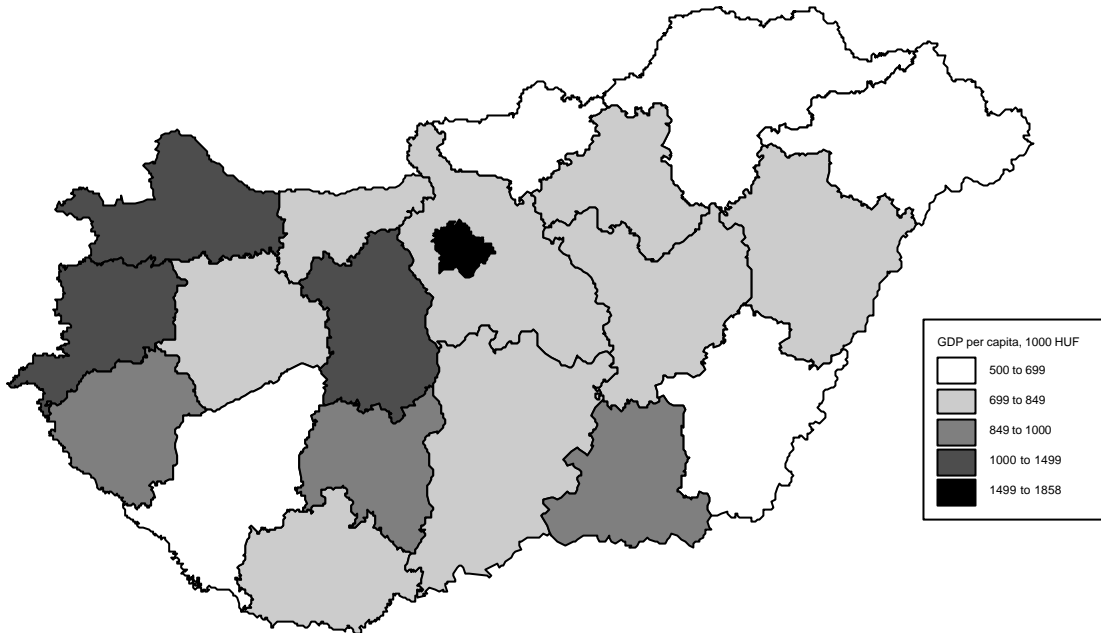
Hungary: GDP per capita, 1998
as a percentage of the EU average

GDP per capita, EU average = 100

- 27.20 to 34.90
- 34.90 to 39.90
- 39.90 to 50.00
- 50.00 to 59.90
- 59.90 to 89.50
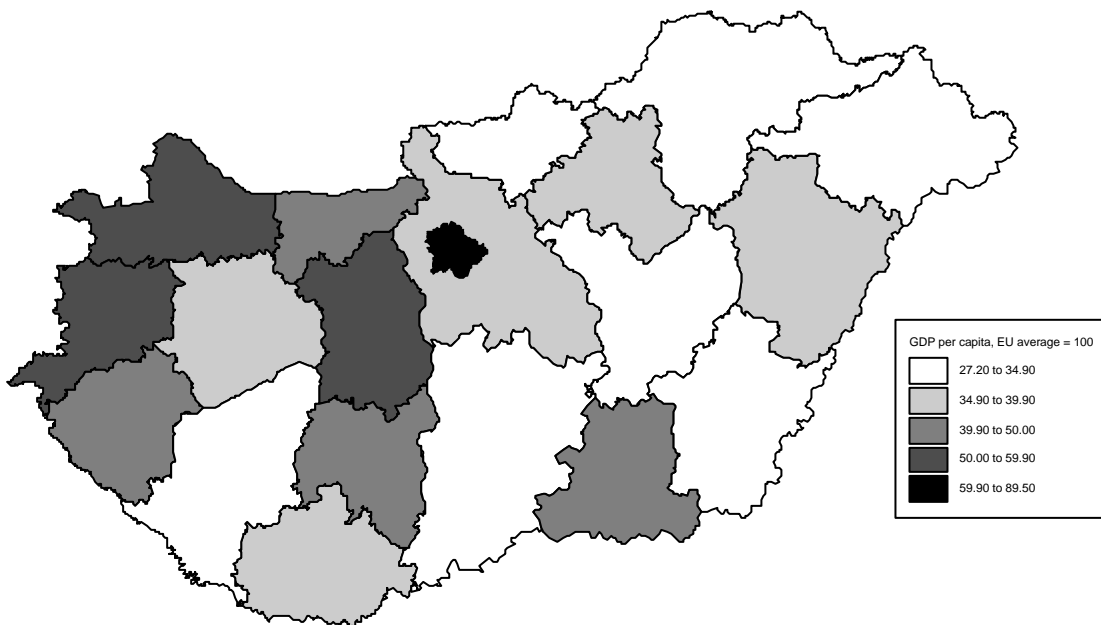
i.e. still under the ancien régime. Although many of the institutional reforms started still under communist rule, privatization was taboo up to the beginning of the political changes in 1989. Nevertheless, this early reform experience turned out to be of major importance during the 1990s.

The Hungarian way of privatization has relied primarily on direct sales, although vouchers were distributed to compensate victims of the totalitarian regimes in Hungary before and after the Second World War and persons deprived of their land or landed property. Preferential credit lines were opened as well to allow for the participation of Hungarian citizens in the privatization process. An important way of privatization was that through liquidation. Hundreds of mainly small and medium-sized state-owned companies went bankrupt, especially in 1993-1994, and their parts were sold, often to earlier managers or employees, at a bargain.

After many heated political debates and continuous reshuffling of the organizational system for privatization, the first major deal was signed in December 1993 when one third of MATÁV, the Hungarian telecom company, was sold to an American-German consortium. From 1995 on the privatization of strategic public utility companies gained momentum. Foreign investors acquired shares in gas and electricity distributors, in power plants and in the largest Hungarian company, MOL Rt. (Hungarian Oil and Gas Company). The privatization of the banking sector accelerated in 1995-1996, and was nearly completed by late 1997.

In January 1990, at the beginning of the privatization, close to 2000 enterprises had been owned by the state. By the end of 1999, only 207 companies were left in state ownership under the supervision of the state privatization agency. In 134 of them the state had a majority stake, in the rest only a share below 50%. Of the state-owned companies 98 will probably remain long-term state assets. In this group the state has one golden share in 8 firms. In December 1999, the Hungarian Privatization and State Holding Company (ÀPV Rt.) held company assets in the book value of HUF 745 billion (USD 3 billion). Of this, HUF 333 billion are assets that are planned to be kept in state ownership in the longer term, the rest, HUF 412 billion (USD 1.6 billion) is earmarked for privatization in the near future.[3]

In 1990-1999 the expansion of the genuine private sector (domestic and partly or fully foreign-owned firms, founded originally as private firms) proceeded rapidly. This process, together with privatization, resulted in gradual shrinkage of the state-owned sector in the economy. In 2000 the share of the private property in total equity capital of the corporate

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[3] *Privatization Monitor* (December 1999).

sector may have amounted to 79%; of this, equal proportions fall on domestic and foreign owners, respectively.[4]

Concluding, ten years after the fall of the communist regime, the transition of the economy from planned to market economy is practically completed in Hungary. The institutions of the market economy are in place. Capital and labour markets are functioning without significant restrictions. Property relations correspond to those in other OECD countries.

3 The thorny path from transitional recession to sustainable growth

The recession 1990 to 1993

The early reforms did not help too much to ease the pains of Hungary in the early stage of its transition to a market economy. In the four years 1990 to 1993, registered GDP declined by about 20%. In 1990-1993 the contraction of the economy was stronger than in the years of the 1929-1933 depression when the rate of the GDP decline had amounted to 10.6%. Between 1990 and 1993, gross industrial production dropped much more (by 30%) than GDP. In agriculture the decline amounted to 33%. The unemployment rate jumped from a negligible level in 1990 to over 13% in 1992. Average real net monthly earnings dropped by 16% in the course of 1990-1993.

In these years the losers of the transition outnumbered the winners. In 1989 11-12% of the population had lived below the subsistence level, in 1992/93 this share was about one third. These figures, based on official statistics, are however biased and paint a picture worse than the real situation: unreported economic activities were playing an increasing role in Hungary, with growing hidden incomes for a very broad stratum of the society.

Despite the considerable rise of prices in the early transition period, inflation was kept under control. The highest rate of consumer price inflation was registered in 1991 (35%); in the subsequent two years it dropped to 22-23%, and in 1994 to less than 19%.

First, failed attempt to take off (1994 to early 1995)

By 1993 it seemed that Hungary had overcome the difficulties of transformation. From about the second half of that year on, in view of the approaching elections, the government tried to help the takeoff of the economy by a generous income policy (7.2% real wage increase in 1994) and by raising budgetary expenditures. The central bank relaxed the rigorous monetary policy (efforts were made to push down the interest rates). In addition, the government insisted on an anti-inflationary exchange rate policy from 1991 on which

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[4]   GKI Economic Research (2000b), p. 50.

led to a real appreciation of forint and gradually undermined the competitiveness of the export sector. Economic growth began, but both the fiscal balances and the foreign equilibrium seriously deteriorated. The GDP increased by 2.9% in 1994, but simultaneously the current account deficit, at USD 3.9 billion, reached 9.5% of the GDP. The general government deficit jumped to 8.4% of the GDP.

Despite the above-outlined efforts, the conservative government lost the elections in spring 1994. The new socialist-liberal government headed by Gyula Horn initially hesitated to undertake the unpopular task of stabilization. By early 1995 the situation became unsustainable: foreign financing became very expensive, clearly indicating that the international financial community's confidence in Hungary had slowly been evaporating.

Eighteen months of stabilization

In early March 1995 the government appointed a new minister of finance, Lajos Bokros, who announced a radical stabilization programme. Parts of the package were a 9% devaluation of the forint, a reform of the exchange rate regime introducing a pre-announced crawling peg, an 8% surcharge on all imports except for investment goods and energy, radical cuts in fiscal expenditures, and a deep cut of real wages in the public sector which spread over to the whole economy. Although some important issues of the package were later rejected by the Constitutional Court, the remaining part was sufficient to trigger a radical turnaround. With a 12.2% real wage decline in 1995, private and public consumption decreased and net exports expanded. Measured in unit labour costs, the international competitiveness of Hungarian exporters improved substantially.

As a consequence of these measures, domestic and the foreign equilibrium improved spectacularly. The current account deficit dropped to 5.3% in 1995 and to less than 4% in 1996. Net foreign debt amounted to USD 14.3 billion at the end of 1996, USD 4.6 billion less than at the end of 1994. Net *public* foreign debt came down to USD 7.9 billion. Net interest payments on foreign debt as a per cent of exports of goods and non-factor services dropped from 12% in 1994 to 6.3% in 1996. The improvement in the public finance equilibrium also was impressive: the general government budget deficit declined to 6.8% of the GDP in 1995 and 3.3% in 1996. The consolidated public debt (domestic and foreign) decreased from 86% of GDP in 1994 to about 74%. Despite the strong decline of domestic demand, the GDP did not cease to grow, though growth rates were marginal both in 1995 (1.5%) and 1996 (1.3%).

Although the stabilization proved to be successful, the price that had to be paid was high. Following the devaluation, inflation accelerated to close to 30% in 1995, and even in 1996 it was higher than prior to the stabilization programme. Investment, with an over 12% growth rate in 1994, before the stabilization, declined by over 5% in 1995, although one of

the main targets of the package had been to compensate declining consumption by a strong investment increase. The decline in investment can primarily be explained by the cancellation of several big government-financed projects in the framework of the cuts in budgetary expenditures. Beyond the macroeconomic impact, the social one was also serious. Declining net wages in general and especially strong cuts in the public sector placed a huge part of the population in a desperate situation.

Recovery and entering a new growth path (mid-1996 to 1998)

While in the first half of 1996 the GDP stagnated and the whole year's growth amounted to 1.3% only, the 1997 annual growth rate was already 4.6% and in 1998 it reached 4.9%. Exports underwent a buoyant expansion in 1996-1998. Within three years the volume of deliveries abroad increased by 66%, to developed industrial countries by 75%. Exports of engineering products expanded by as much as 124%. The export-based development is reflected in the industrial data of these years. Industrial output (in real terms) increased by 38% in the period concerned, but domestic sales of industry remained at the 1995 level while export sales more than doubled. This pattern is even more extreme in the engineering branch, with a 5% increase in domestic sales over three years compared to an over 300% expansion of export sales in the same period.

Inflation jumped to 28.2% (CPI annual average) in 1995 as a consequence of the considerable devaluation of the forint. Within the subsequent three years inflation decreased by 13.9 percentage points to 14.3% by 1998 (annual average). This spectacular performance is the result of the careful monetary policy trying to balance between the requirement of rapid disinflation, maintenance of economic growth and preserving the attractiveness of the Hungarian market for foreign investors. The crawling peg introduced in the 1995 stabilization package proved to be a helpful tool in achieving this goal. The monthly rate of crawl was 1.2% in 1996 and up to the end of March 1997. After several reductions (0.1 percentage point on each occasion) the rate dropped to 0.7% a month in the last quarter of 1998.

After the massive decline in real incomes in 1995-1996 the danger was considerable that wage earners, especially those groups who lost the most in 1995-1996, would call for substantial wage increases in the wake of the accelerating economic growth. This was eventually avoided; real wages grew less than 4% in 1996-1998. This led to a significant shift in the proportion of accumulation and consumption, favouring the former.

In 1996-1998 the general government deficit/GDP ratio dropped to tolerable levels (3.0%, 4.8% and 4.8%, respectively). One of the long-term problems of public finance was solved through the successful launch of the pension reform replacing the 'pay-as-you-go' by the

'three-pillar' system. No progress, however, was achieved in the field of health services reform.

A specific feature of the 1996-1998 growth period is that, for the first time in decades, accelerating growth did not immediately trigger a serious deterioration of the current account and the economy did not enter a new stage of a stop-go cycle. The three-year average of the current account deficit/GDP ratio was 3.5%. Net FDI inflow covered the current account deficit in two of the three years. The relatively bad current account deficit/GDP ratio in 1998 (4.8%) was caused by the extraordinarily high profit repatriation by foreign companies. Gross foreign debt of the country (excluding inter-company loans) remained at the same level on average in the period concerned.

Sustainability of growth tested: the impact of the Russian crisis, the war in Kosovo and weak growth in the EU

The economic turbulences in Russia in summer 1998 had a serious impact on the Budapest Stock Exchange (BSE). After a world third best performance in 1997 and a historical top of 9023 points attained in April 1998, the BUX dived in several steps over August and September to a low of 3775 points on 21 September 1998. Capitalization of the Stock Exchange (shares only) in April still amounted to USD 17.1 billion; in September it dropped to below USD 10 billion. In the critical days an estimated USD 750 million was withdrawn by foreigners from forint-denominated government securities, about half of the stock owned by foreigners and 7-8% of the total value of state bonds.

It was obvious that the reasons for this devastating stock price fall were to be found outside the country. The macroeconomic situation gave no cause for concern, the first half-year reports of the listed companies showed an impressive increase of profits.

The withdrawal from the market put the Hungarian currency under strong pressure. Between March 1995 (when the crawling peg regime was introduced) and the stock exchange crisis, the forint had stuck nearly always to the strong side of the +/–2.25% intervention band; in the second half of 1998 it was mostly on the weak side of the band. The National Bank of Hungary had to intervene several times to support the exchange rate of the forint.

Apart from the Russian crisis another, in fact more important negative external impact hit the economy, namely the weakening growth performance in the EU, primarily in Germany, the main export market of Hungary. Finally the negative impact of the war in Kosovo must be mentioned; it manifested itself in diminished transit revenues (mainly from shipping on the Danube), missed export opportunities and an increased risk for foreign investors.

The slowdown of economic growth was a result of varying performance in the individual segments of the economy. In gross fixed investment the slowdown was strong, in industrial production and exports moderate.

A three-fold external shock (Russian and emerging markets crisis, weakening economic growth in main export partners, the Kosovo war) thus did affect the economic performance seriously; nevertheless even the slower growth rate was twice as high as that of the EU(15) and substantially better than that of the other CEECs, where the same shocks led to a stronger slowdown of economic growth (except for Slovenia). The indicators of this four-quarter-long episode carry an important message about the new resilience of the Hungarian economy to external shocks and the sustainability of the post-stabilization growth path of the country.

2000: back to high growth

The GDP growth rate of about 6% in the first half of 2000 was the highest since the transition process began. Although the high growth rate in the first quarter of 2000 can partly be explained by the relatively weak base in the previous year (and the growth rate for the whole year will be substantially lower), output indicators testify that the Hungarian economy has entered an especially dynamic phase of economic development.

Industrial output increased by 21% in the first eight months of the year compared to the respective 1999 period, export sales expanded by 31% and domestic sales by 11%. This latter is a new, positive phenomenon, in so far as any marked dynamism in industry over the past four years had been solely confined to export sales; domestic sales either declined or increased only marginally. In 2000 industrial growth has spread to almost all sub-branches and all geographical regions of the country. Nevertheless the earlier differences in growth performance have not faded away. Once again, the expansion in the engineering sector (63%) was well above the industrial average; within the sector, manufacture of telecommunication devices, electronic components and electrical parts for transport vehicles increased especially dynamically. Industrial output grew at a more rapid pace in regions where industrial production has been dynamic for years (western Transdanubia, central Transdanubia) but the growth rate was also above 10% in regions that performed poorly ever since transition began. While employment in industry grew by 1.5%, productivity jumped by 18.8%.

Earlier bursts of growth in Hungary were usually brought to a halt by rapidly increasing current account deficits. In the year 2000 this previous pattern does not seem to apply; in the first three quarters of the year the current account deficit was smaller than in the corresponding 1999 period. Obviously helped by the upturn in the business cycle in the EU, merchandise exports (BOP) in current euro prices increased by 35.9%, imports by

33.1% and the deficit in the trade balance practically remained at the level of the corresponding 1999 period. The balance of services showed considerable improvement, on account of higher net revenues from tourism.

## 4   The past four and a half years – a separate chapter in Hungary's economic history?

The period from mid-1996 to 2000 may one day get the label 'the golden years' of the economic history of the country. In the four and a half years in question considerable economic growth was coupled with steadily decreasing inflation. Growth was driven by an upturn in investment activities and relied on an unprecedented structural upgrading in the composition of the industrial output and the exports. And, perhaps the most important feature of the period has been that contrary to earlier experiences external equilibrium did not deteriorate parallel to accelerating growth. External net debt decreased from 36.9% of the GDP in 1995 to 24.6% in 1999. Without inter-company loans these figures are 34.9% and 18.7%, respectively.[5]

Compound growth of the GDP in the period concerned amounts to 22-23%. Gross fixed investment increased by over 50%, industrial output expanded by close to 70%. Exports nearly doubled, with an expansion from USD 15.7 billion in 1996 to about USD 28 billion by 2000. In industry a small structural revolution took place. In 1996-2000 engineering output increased at an average annual rate of 40%, export sales of the branch by over 50%. In the period concerned engineering output increased to more than the fourfold, export sales to over the sevenfold of the 1995 value. The share of engineering in total industrial output, less than 18% back in 1995, jumped to over 40%, and the branch became the main driving force of modernization in the country. As the source of this rapid output growth in the engineering sector has been a group of companies, all affiliates of big multinational companies possessing of huge well-organized international trade networks, it is no wonder that the share of engineering products in Hungary's exports increased to a considerable extent. There was a fundamental rearrangement in patterns of trade with the EU: here the share of engineering products jumped from 28% in 1995 to over 60% by 1999. (In 1986 this share had been a mere 12%.) (See Figure 1)

The new growth path has been characterized by a marginal increase in wages in dollar terms compared to the monthly level of approximately USD 300 back in 1995. Due to this and the rapidly increasing productivity, competitiveness measured in unit labour costs did not deteriorate. In 1990, at the beginning of the transition, Hungary's unit labour costs amounted to 28% of those of Austria, in 1999 to 27% only (measured in PPP).

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[5]   National Bank of Hungary (2000a), p. 133.

Figure 1

Hungary: Labour productivity, wages and ULC in industry[1]
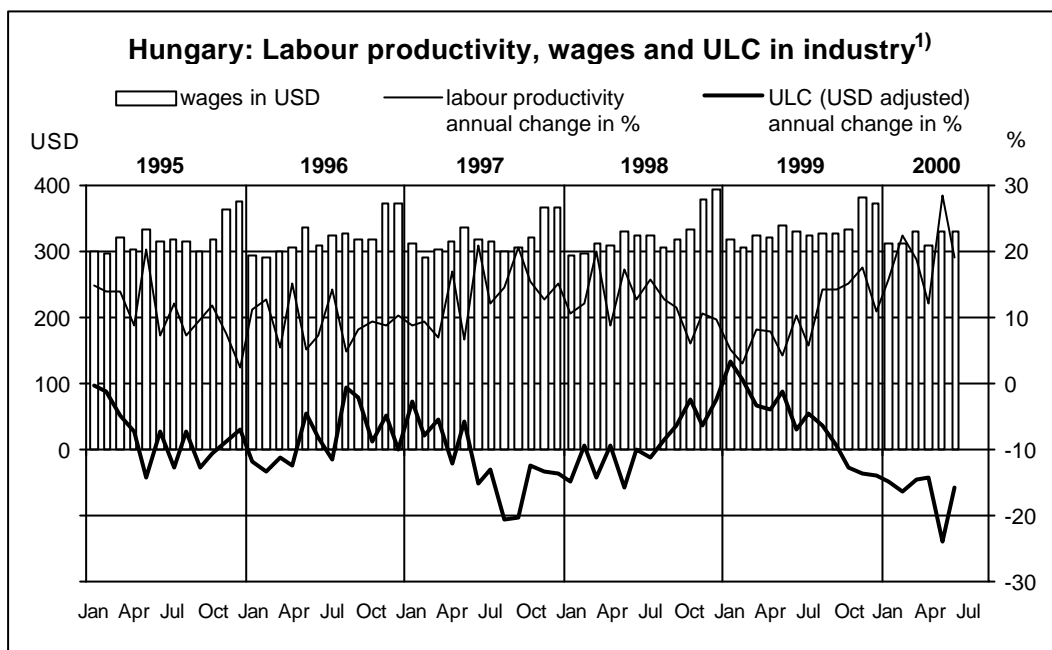
Note: Enterprises employing more than ten, from 1999 more than five persons.
Source: WIIW Database.

Astonishing as the recent performance of the Hungarian economy may have been, the other side of the coin must not remain unmentioned. The dynamism of the economy has been confined to a small group of multinational firms, other segments of the Hungarian business sector have not been able to fully join the boom. This dualism is reflected in the huge regional disparities. Real earnings and social benefits increased much more slowly than the economy, and so did household consumption. In standard of living terms the new growth period has not brought too much for the population as yet. Corruption and the presence of criminal elements in the business sector cast a shadow on the achieved results.

5 Factors determining the development of the Hungarian economy

The European integration process and Hungary

In December 1991, Hungary and the European Union signed an Association Agreement which laid the foundations for Hungary's new, western orientation. The Association Agreement envisions free trade of industrial commodities to be implemented by the year 2001, and created a framework for economic co-operation that goes much beyond free trade. The application for full membership in the European Union was submitted as early as 1 April 1994. Accession negotiations began in March 1998. The first stage, the so-called screening, had started on 31 March 1998 and was closed on 2 July 1999. An

additional screening of the new developments of the acquis in agriculture was put on the agenda and was accomplished in October 1999. The actual negotiations, based on the results of the screening, began on 10 November 1998.

With the opening of the negotiations on the Agriculture chapter at the ministerial meetings on 14 June 2000, all thirty chapters (except for institutions[6]) have been opened. Of these, fourteen were provisionally closed by mid-November (Fisheries, Common foreign and security policy, External relations and development aid, Small and medium-sized enterprises, Science and research, Education and training, Industrial policy, Statistics, Telecom and information technologies, Consumer and health protection, Company law, Economic and monetary union, Social policy and employment, Financial control).

In the third Regular Reports on the candidate counties' progress towards accession (published on 8 November 2000) Hungary, together with Estonia and Poland, got the best evaluation of the candidate countries both concerning the fulfilment of the economic criteria of membership and the adoption of the acquis communautaire. Although the Regular Report pointed out several problems yet to be overcome until the accession, there can be no doubt that Hungary has the best odds to be among the first applicant countries to join the EU.

In 1992 Hungary, together with Czechoslovakia and Poland, established the Central European Free Trade Agreement (CEFTA) with the purpose to implement industrial free trade not later than it will be in place with the European Union. In 1996 Slovenia, in 1997 Romania, and finally in 1998 Bulgaria joined CEFTA.

Apart from the institutional aspects of integration into Europe, which will culminate in accession to the EU together with the other CEFTA countries, the factual integration has progressed rapidly in the last decade. 76% of Hungary's exports are destined for the EU and 8% for the CEFTA countries, while 64% of imports originate in the EU and 7% in the CEFTA. Over the last couple of years Hungary's export structure underwent dramatic changes, in the course of which the composition of goods supplied by Hungary became more and more similar to that of the more developed members of the EU.

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[6]   The Institutions chapter cannot be negotiated as long as the decisions of the intergovernmental conference on EU institutional reforms have not been concluded (expected in December 2000).

Figure 2

Hungary: Foreign trade by region

in % of total

Exports
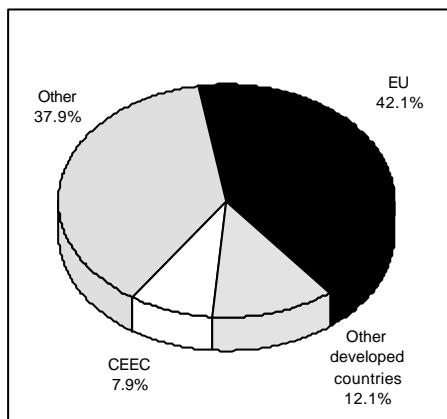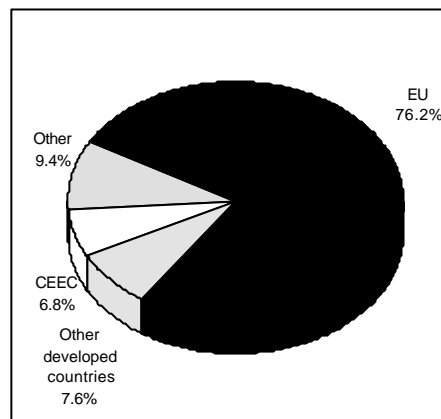
1990

1999

Imports
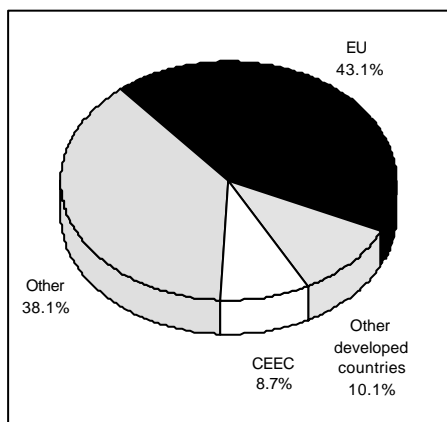
1990
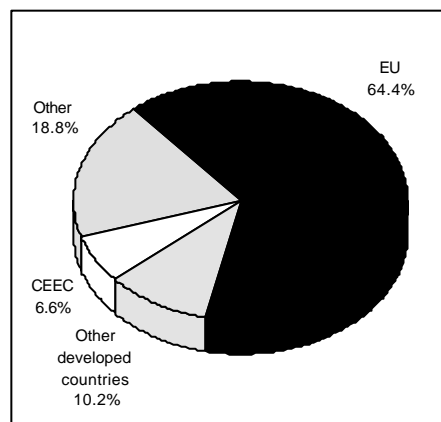
1999

Source: WIIW Database.

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Figure 3

Hungary: Foreign trade by SITC commodity group

in % of total

Exports

	1990	1999

Values for 1990 Exports: 2.6, 19.8, 10.7, 1.3, 4.7, 3.1, 1.2, 12.4, 18.5, 25.6

Values for 1999 Exports: 0.1, 7.4, 0.6, 2.0, 1.6, 0.4, 6.2, 11.5, 12.9, 57.3

1990 **1999**

Imports

Values for 1990 Imports: 7.8, 0.4, 6.3, 0.8, 5.3, 14.2, 0.1, 14.9, 15.5, 34.6

Values for 1999 Imports: 11.1, 0.0, 2.7, 0.4, 2.1, 6.1, 0.2, 9.5, 17.7, 50.2
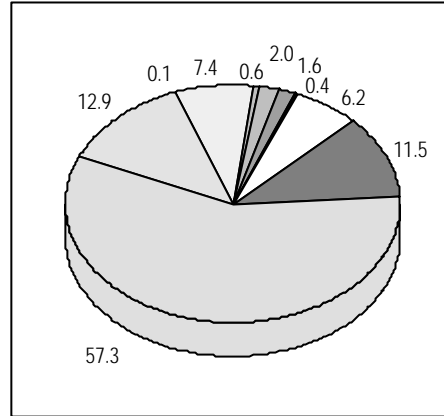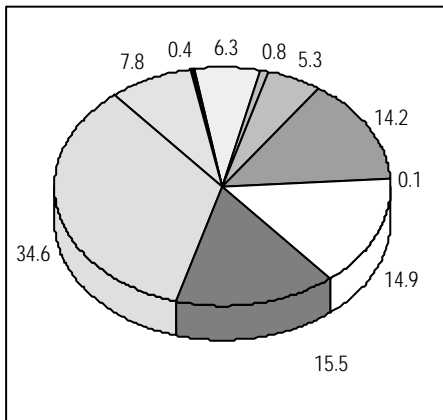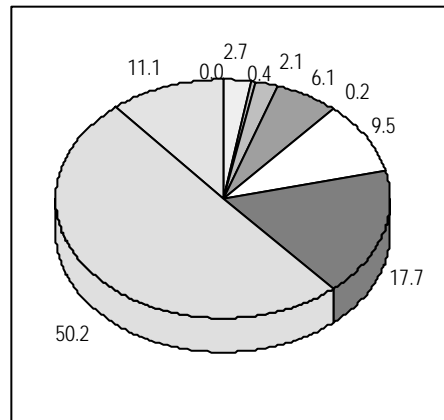
1990 **1999**

Food and live animals	Chemicals and chemical products
Beverages and tobacco	Basic manufactures
Crude materials, non-edible, except fuels	Machinery and transport equipment
Mineral fuels, lubricants, etc.	Miscellaneous manufactured goods
Animal and vegetable oils and fats	Commodities not classified by kind

Source: WIIW Database.

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The role of foreign capital

Hungary has been one of the favourite targets of foreign direct investment and portfolio investment since the beginning of the transition. Per capita FDI in Hungary was highest among the former socialist countries in each year in 1990-1997, the second highest in 1998 and the third highest in 1999.[7] FDI stocks as a percentage of the GDP were with 39.4% the highest in the region in 1999. (The respective figures for the Czech Republic are 31.8%, for Poland 18.3% and for Slovenia 15.3%.)

Hungary's leading position has a threefold explanation. First, in the early years of the transition Hungary had the reputation of being a country where the planned economy, after several waves of economic reforms, had less deep roots than in other former socialist countries. The regulatory framework was also more mature and supportive of FDI projects than in other countries in the region. This motivated potential investors to choose Hungary as the site for the first projects in a mostly unknown region. Second, the high foreign debt and the consequently fragile external economic position of the country at the beginning of the transition and once again in 1994-1995 forced the respective Hungarian governments to be supportive towards foreign investors. The annual inflow of hard currency via FDI was badly needed to counterbalance the deficit on the current account. The third explanation is closely related to the second: the way and speed of privatization in Hungary allowed and supported the active participation of foreign investors, contrary to other countries of the region where privatization was either slower or applied methods (voucher privatization) which made foreign participation less easy.

FDI projects have a decisive role in the rapid modernization of the country. Economic growth since 1996 has been export driven, and has relied primarily on fast expansion of manufacturing, and here especially engineering output. The unprecedented export boom of cars and car components, computers and telecommunication devices is the merit of affiliates of huge multinational firms in Hungary (such as IBM, Audi, General Motors, General Electric, Philips, Suzuki – to mention just the biggest ones). Foreign investment enterprises employed about 45% of the employees in the manufacturing industry in 1998. They possessed of 73% of the equity capital of manufacturing companies and accomplished 79% of investment. In 1998 not less than 86% of export sales of manufactures fell on foreign investment enterprises. These shares are much higher than in any of the other transition countries and unique in the world economy.

The secondary effects of the multinationals' presence can be seen in the improvement in managerial culture and productivity. Sales per employee are 2.9 times higher in foreign investment enterprises than in domestic ones.

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[7] The source of data on FDI in this chapter is Hunya and Stankovsky (1999) and Hunya (2000).

By the end of 1999 the stock of registered FDI surpassed USD 21 billion. This sum fell on approximately 25,000 projects. At the end of 1998 companies from EU member countries had a share of about 70% in the stock of FDI, Germany alone 25%. Austria had about 11%, the Netherlands about 14%. The non-EU country with the highest share was the USA (15%).

As privatization will slowly be completed, one earlier very important channel of FDI flows phases out. In 1990-1996 47% of the FDI inflow was forex revenue from privatization, in 1997-1999 this share dropped to 20%. The increase of greenfield investments and new investment into earlier established foreign affiliates seems to compensate this shift. In 1996-1999 the annual FDI inflow was about USD 2 billion.

Many of the important foreign-owned companies operate in customs-free zones. By the time of Hungary's EU accession these zones will have to be either closed or their rules must comply with those in the EU. Though the experience of companies that left the customs-free zones for the 'normal' economy has so far been positive, the Hungarian government will have to make efforts to ensure a smooth transition in this field.

The banking sector

Hungary's two-tier banking system was set up already in 1987. Three new big banks split from the National Bank of Hungary (Hungarian Credit Bank, Commercial and Credit Bank and Budapest Bank) which, together with the National Savings Bank (OTP) and the Hungarian Foreign Trade Bank, made up the core of the emerging Hungarian commercial banking sector. Right after the re-birth of the Hungarian financial sector a radical rearrangement of market shares took place. The three big 'successor' banks have been losing in significance over the years.

In 1992, under the newly introduced banking and accounting law, banks were required to build up the necessary reserves for classified debts. This constituted a serious challenge because of inherited bad debts and the business sector's rapidly deteriorating financial position. By autumn 1992, it became clear that without state intervention the largest Hungarian banks would soon go bankrupt. The consolidation of the banking system took place in more steps and lasted up to the end of 1994. By the end of 1995 the situation of the banking sector improved considerably. It was, however, clear that the improvement was provisional, and that without further capital injection and much improved quality of services supplied the problems might soon return. In this sense, the consolidation was the prelude to privatization of the banks.

The 1991 law on financial institutions provided for lowering the state's property share in individual banks to a maximum of 25%, to be attained by 1997. The first major step took

place in the summer of 1994, with the sale of the majority ownership of the Hungarian Foreign Trade Bank. This sale was followed by several others during 1994-1997, a new, diversified ownership structure emerged at the end of the process with representatives of different international banking cultures (US, German, Austrian, Dutch, Belgian, Irish, Italian.) By 1999 less than 20% of the banking sector's capital remained in state ownership. A further 13% was the share of Hungarian private owners (of this 6% credit institutions) thus Hungarian ownership amounted to a total of 32%. More than 65% fell on foreign owners, of which more than 50% on credit institutions and 15% on other foreign owners.[8]

At the end of 1999 there were 43 credit institutions as incorporated companies. The ratio of the banking sector's cumulated balance sheet to the GDP amounted to 67.8%.[9] This is still well below the ratio characterizing the economies of the OECD members (about three times higher).

Concluding, the transformation of the banking sector is completed, and despite problems with a few individual banks[10] and considerable reserves in the expansion of financial intermediation the banking sector has reached the maturity to support economic growth in the coming years.

Industry

The driving force of the take-off in the present growth period have been the rapid structural changes in industry, more exactly in manufacturing. First of all the proportion of domestic and export markets in total sales of industry changed dramatically. The share of domestic sales decreased, from about 75% in 1994 to 51% in 1999. The 1994 share (75%) had practically been the same over decades before.

The second fundamental change took place in the branch structure of industry. The engineering sector (manufacture of machinery and equipment) jumped from 22% in 1990 to over 45% in 1999.

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[8]   National Bank of Hungary (2000b), p. 17. The missing part to 100% consists of preference and repurchased shares, respectively.

[9]   End-of-year balance sheets, 1999.

[10]   In 1998-1999 Postabank and Realbank got into a difficult situation that required state intervention.

Table 1

Hungary: Production structure in manufacturing

at current prices, in %

		1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
D	Manufacturing total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DA	Food products; beverages and tobacco	20.9	24.2	25.4	29.1	28.1	28.3	25.9	25.6	21.5	18.9	17.0
DB	Textiles and textile products	6.7	6.2	5.6	5.4	5.3	4.9	4.5	4.2	3.6	3.7	3.6
DC	Leather and leather products	1.9	1.7	1.7	1.3	1.3	1.2	1.0	0.9	0.8	0.8	0.8
DD	Wood and wood products	0.9	1.0	1.3	1.6	1.6	1.7	1.7	1.7	1.5	1.4	1.2
DE	Pulp, paper & paper products; publishing & printing	3.2	3.5	3.8	4.8	5.1	4.6	5.2	4.5	4.3	4.0	4.3
DF	Coke, refined petroleum products & nuclear fuel	5.4	6.7	7.7	10.5	9.4	8.1	7.4	7.6	6.7	5.8	4.9
DG	Chemicals, chemical products and man-made fibres	10.9	10.7	11.1	11.1	10.9	10.7	11.0	10.0	9.7	8.0	7.0
DH	Rubber and plastic products	2.7	2.6	2.9	2.8	2.9	3.4	3.7	3.8	3.6	3.5	3.5
DI	Other non-metallic mineral products	3.5	3.9	3.8	3.6	4.0	3.9	3.7	3.6	3.3	3.2	2.9
DJ	Basic metals and fabricated metal products	15.3	14.8	12.2	10.5	10.8	11.6	12.1	11.0	10.0	9.3	8.1
DK	Machinery and equipment n.e.c.	7.6	7.3	7.8	6.5	6.0	5.9	5.8	5.6	5.2	4.8	4.7
DL	Electrical and optical equipment	12.1	10.3	9.3	6.9	7.2	8.4	8.5	11.3	16.7	19.5	23.6
DM	Transport equipment	6.3	4.7	5.2	4.1	5.4	5.7	8.1	8.7	11.7	15.7	17.0
DN	Manufacturing n.e.c.	2.7	2.5	2.4	1.8	1.9	1.6	1.5	1.4	1.2	1.3	1.2

Sources: 1989-1991: UNIDO Database, from 1992 national statistics.

The main winner, the engineering branch, also underwent an extraordinary structural rearrangement. Computers and other office machinery had a 19% share in the engineering branch output in 1998; six years earlier this sub-branch had been practically non-existent. The share of road transport vehicles nearly doubled to 38%, just as that of telecommunication products, rising to 15%, between 1992 and 1998. The share of traditional engineering sub-branches, such as the production of non-electrical machinery, dropped to one third of the 1992 figure, the share of electronic machinery nearly halved and that of instruments dropped to one third of the earlier share.[11]

The fourth remarkable change in industry took place in the composition of products according to the technological level they incorporate. Compared to 1993, the share of high-tech products increased considerably by 1998, both in production and exports of industry (in output from 12% to 22%, in exports from 20% to 34%). A similar development can be observed in the case of medium-tech products. Consequently the share of low-tech products decreased, in production from 63% to 47%, in exports from 47% to 25%.[12]

We can conclude that the last few years witnessed an exceptionally intense structural change in Hungarian industry, and data for the first three quarters of 2000 indicate that the process continues at the same speed. Certainly such a rearrangement will come to a halt at some point, but at the moment it cannot be foreseen when the recent explosion-like output and export expansion of selected engineering products will switch over to a 'normal' rate of growth.

6 Medium-term outlook

The period in question

Accession to the EU at the earliest possible date has been top priority of all Hungarian governments since the political changes in 1989/90. The national programme for taking over the acquis communautaire and fulfilling all other conditions of accession were originally planned to be completed by 31 December 2001, implying that Hungary would be ready to join the EU on 1 January 2002. In the light of the slow progress of the internal reforms of the European Union this target date for accession was revised to 2003. However, the slow pace of the accession negotiations, the slow progress of the EU internal reforms and, last but not least, the multiple political uncertainties surrounding the case of EU eastern enlargement in general make the envisaged accession date of 2003 quite unlikely. The present forecast reckons with 1 January 2004 as a possible, but not very probable accession date, and with 1 January 2005 as the most likely date of Hungary's accession – as seen from an autumn 2000 perspective. This assumption for the most likely

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[11] ECOSTAT (1999), p. 14.

[12] GKI Economic Research (2000a), pp. 33-35.

date of Hungary's EU accession determined the time frame of this forecast; it ranges from 2000 to 2004. These years can be best labelled as the *pre-EU-accession period* of the Hungarian economy.

External conditions of growth

Hungary is a small open economy, and growth depends to a large extent on the growth performance and import expansion of the country's main trading partner, the EU, and here primarily of Germany and, to much smaller extent, of Austria and Italy. In this outlook it is assumed that the European Union's economic growth will range between 2% and 3% on average in the period 2000-2004, which roughly corresponds to the growth performance registered in the previous five years (annual average 1995-1999: 2.3%). That also corresponds to the 2.5% forecast growth rate for the EU in 2000-2006 in the 'Agenda 2000'. For Hungary this assumption implies that the single most important external condition for continuing its export-driven growth will prevail.

The relatively painless absorption of the external shock caused by the Russian crisis indicates that the vulnerability of the Hungarian economy vis-à-vis its former main trading partner Russia (and other CIS countries) has diminished significantly. The negative impact of a crisis in that region would rather be indirect via weakening the confidence in emerging economies in general. This risk will diminish, at the earliest, after Hungary's accession to the EU (and more specifically, after joining the EMU and adopting the euro at a later point).

The other transition countries in Central Europe play a relatively minor role in Hungary's external economic relations, and this will probably not change in the foreseeable future. Therefore no immediate economic impact from the region, either negative or positive, can be expected. More important are the indirect economic and political aspects. Political stability in the region's countries and good economic performance may substantially upgrade the whole region's attractiveness relative to other clusters of emerging markets in the world economy. The result may be increased foreign investment, both FDI and portfolio, benefiting Hungary as well. In this outlook the present level of political stability is forecast for the period in question.

The South East European region's stability is a not to be neglected component of the external conditions of Hungary's growth. The lasting political stalemate, and the potential danger of war and civil war in former Yugoslavia may hurt Hungary through diminished tourism incomes (as in 1999) and missing willingness of foreign investors to spread their activities to regions of Hungary along the Yugoslav border. In case of the hoped-for democratization of Yugoslavia after the fall of the Miloševiæregime a significant positive impact can be expected. The reconstruction process in the Balkans would open up

old-new markets for Hungary. Moreover, stepped-up western assistance would necessitate a logistical background that could be partially provided by Hungary.

Summarizing, no major change in the external conditions of growth is expected in the period concerned compared to those, basically favourable ones, prevailing in the last five years.

Assumptions about factors determining the growth path of the Hungarian economy in 2000-2004

The last ten years brought about fundamental changes in the Hungarian economy. After a painful adjustment process, and mainly due to the near-omnipresence of foreign-owned businesses, the economy's ability to provide competitive goods and services (both in price and quality terms) is now much better than in the 1980s or in the first half of the 1990s.

In the last few years, growth derived almost exclusively from increasing productivity. Participation rates fell dramatically in the first years of transition and have remained below 60% ever since. That is far below the average EU level of 68%[13] and is also lower, by about 10 percentage points, than in the other CEECs[14]. All that means that despite the relatively low unemployment rate (about 6%) expanding production can rely on latent labour reserves, though the skill structure of the available labour source does not necessarily match the required one.

Taking into consideration the rapid replacement of technology following the increasing penetration of foreign capital, there is no point in searching for major hindrances to sustainable growth on the *supply side* of the economy.

The decisive factors influencing growth in 2000-2004 are to be looked for on the *demand side*. Before going into details concerning the various components of demand, it is important to refer to some circumstances which will strongly influence the development in different years within the period concerned.

First, in spring 2002 *general elections* will be held in Hungary; this involves a political business cycle with immediate impact (stepped-up consumption) mainly in 2001 but partly in 2002 as well.

Second, 2003 and 2004 are likely to be the last two years prior to EU accession. That implies *accelerated investment activity* related to the programme to achieve compliance

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[13] In 1998; source: European Commission (1999).

[14] European Commission and Eurostat (2000).

with the acquis; this programme will most probably be already fixed in Hungary's EU Accession Treaty, which, by that time, will have been in the process of ratification by the EU incumbents. An acquis compliance-related upturn in investment is hardly avoidable in 2003 and 2004, as any delay in the programme would already mean a violation of the Accession Treaty, a very bad message to the incumbent countries' parliaments voting for or against Hungary's accession. These stepped-up investment programmes are almost certain to deteriorate the balance of trade (goods and services).

Third, over the whole period concerned the requirement for a sustainable level of deficit in external balances will set the major constraint on growth. Due to the strongly export-oriented character of the new production capacities, exports of goods and services are assumed to grow much faster than GDP. Whether this will be sufficient to keep the deficit at a tolerable level will depend, on the one hand, on consumption-generated imports (heavily influenced by the political business cycle) and, on the other hand, on investment-generated imports. In the latter case the approaching EU accession will dictate the pace of expansion. Whether the deficit in external balances is maintainable or not will be decisively influenced by the way how the deficit can be financed: via debt-creating or non-debt-creating capital inflows.

Two scenarios

In this forecast two scenarios were elaborated; in both cases the forecast was based on assumptions on individual components of demand. The GDP growth rate is a resultant of the changes assumed in that aggregates.

Scenario A, or the *baseline scenario*, reckons with a moderate political business cycle related to the general elections in 2002, which – despite the likely unavoidable 'mood-improving measures' – remains under control of the government. The rise of real household incomes is assumed to lead to an upturn of household consumption in 2001. In that year household consumption increases somewhat more rapidly than the whole economy. As a consequence, the rate of import growth is about 1.5 percentage points higher than that of export growth, leading to a considerable deterioration of the trade balance in that year. In 2002 the brakes are expected to be pulled, household consumption still grows to a considerable extent but slower than in the previous year or than the whole economy. There is a slight deceleration in the expansion of gross fixed investments. Consequently the export and import growth rates would be levelled, slowing down the deterioration of the trade balance. Developments in 2003 and 2004 are determined to a large extent by the activities related to the EU accession in 2005. The programmes to achieve compliance with the acquis necessitate a considerable growth of fixed investment, the growth rate of which rises from 8-10% in 2000-2002 to 11-13% in 2003 and 2004. Household consumption will have to adjust to the new situation and its growth rate declines

to 4-4.5%. Yet imports again grow more rapidly than exports and the trade balance deteriorates in both of the last years of the period in question. Government consumption is assumed to rise more slowly than GDP or household consumption, at an annual rate of about 3% in the whole period. The resultant in this scenario is an annual 5% GDP growth, except for 2000 when growth attains 5.5%. The implicit assumption of this scenario is that the country's external financial position remains maintainable, despite a deterioration of net exports in the national accounts. That means that the deficit in the current account is roughly compensated by non-debt-creating financing (for details on this see below).

Table 2

Estimation of selected indicators of economic growth in Hungary, 2000-2004

real growth rates in %

Scenario A

	2000	2001	2002	2003	2004
Private consumption	4.5	5.5	4.5	4.5	4.0
State consumption	3.0	3.0	3.0	3.0	3.0
Gross fixed investment	8.5	9.5	8.5	11.5	12.5
Exports	12.0	12.5	11.0	11.0	11.0
Imports	11.0	14.0	11.0	12.2	12.2
GDP	**5.5**	**5.0**	**5.0**	**5.0**	**5.0**

Source: Author's estimates. The growth rates were calculated in constant forint prices. For details see Annex Table A/2.

Scenario B is pessimistic compared to scenario A. Its central assumption is that due partly to the elections and partly to the radicalization of wage demands in various segments of the society household consumption grows relatively rapidly in 2001 and 2002. Domestic use and GDP growth deviate from each other to a considerable extent and the trade balance deteriorates in both years so that stabilization measures have to be introduced in late 2002 or early 2003. Due to the obligation undertaken in the EU Accession Treaty to achieve compliance with the acquis there is no way to postpone the necessary investments, thus fixed investment is assumed to expand much more rapidly than GDP. The burden of accommodation will have to be borne by household and government consumption. Consequently, there may be only marginal growth of consumption in 2003, and also in the subsequent year consumption grows just moderately, by 3%. The resultant GDP growth is less dynamic than in the baseline scenario; its rate falls below 4% from 2002 on, though attaining about 3.5% in any year of the period in question. This scenario involves an increase in foreign debt.

Scenario B operates with two unfavourable assumptions: first, that the growth of household consumption becomes excessive in 2001 and 2002, and second, that the deterioration of the net export position cannot be compensated by transfers in a way allowing a

sustainable magnitude of the deficit in the external balances. The necessity to improve the external equilibrium is assumed to put a brake on economic growth. Scenario B brings about a revival of the *stop-go cycles* of the Hungarian economy, even if in a milder form than in the last episode of such cycles in 1993-1996, and it also would turn around the trend of declining foreign debt since 1996.

Table 3

Estimation of selected indicators of economic growth in Hungary, 2000-2004

real growth rates in %

Scenario B

	2000	2001	2002	2003	2004
Private consumption	4.5	6.5	5.0	1.0	3.0
State consumption	3.0	3.0	1.0	1.0	3.0
Gross fixed investment	8.5	9.0	8.0	9.0	12.0
Exports	12.0	12.0	11.5	11.5	11.0
Imports	11.0	15.0	13.5	10.0	13.0
GDP	**5.5**	**4.6**	**3.6**	**3.5**	**3.5**

Source: Author's estimates. The growth rates were calculated in constant forint prices. For details see Annex Table A/3.

Certainly, in actual fact the individual figures may deviate from those in Tables 1 and 2. The two scenarios are intended to illustrate two remarkably different development paths the Hungarian economy may follow in the next four years, with one possible set of estimated indicators for the main aggregates of the GDP in each scenario.

The probability of the realization of the two scenarios is not considered equal. *The realization of scenario A (the baseline scenario) is thought to be twice as likely as that of scenario B.*

The sustainable level of external disequilibria

With a history of high foreign debt and several instances of 'near-insolvency' situations over the past decades, the country's external position has been and will remain, at least until EU accession, a central issue of any forecast and risk assessment of the Hungarian economy. In this context the direction and extent of change in net exports in the national accounts provides only a rough first approach towards the change in the external equilibria: First, the methodology of calculating exports of goods and services is different in the national accounts and the balance of payments statistics; second, national account statistics say nothing about the financing of the deficit, without which we cannot gain a clear picture about the maintainability of the external position of the economy in any given period.

Table 4

Selected indicators of Hungary's external equilibrium, 1999-2004

USD billion, per cent of GDP

Scenario A

	1999		2000		2001		2002		2003		2004	
	USD	% / GDP	USD	% / GDP	USD	% / GDP	USD	% / GDP	USD	% / GDP	USD	% / GDP
Trade of goods												
Exports	21.6	44.9	24.2	47.7	27.2	51.0	30.2	54.0	33.5	57.0	37.2	60.3
Imports	23.8	49.5	26.4	52.0	30.1	56.5	33.4	59.7	37.1	63.2	41.6	67.4
Net	-2.2	-4.6	-2.2	-4.3	-2.9	-5.4	-3.2	-5.7	-3.6	-6.1	-4.4	-7.1
Services												
Net exports	1.4	2.9	1.8	3.5	1.8	3.4	1.8	3.2	1.8	3.1	1.8	2.9
Incomes												
Net	-1.6	-3.3	-2.0	-3.9	-2.0	-3.8	-2.2	-3.9	-2.3	-3.9	-1.7	-2.8
of which: interest payments, net	-0.7	-1.5	-0.7	-1.4	-0.7	-1.3	-0.8	-1.4	-0.8	-1.4	-0.9	-1.5
Profit	-0.9	-1.8	-1.3	-2.6	-1.3	-2.4	-1.4	-2.5	-1.5	-2.5	-0.8	-1.3
Unrequited transfers												
Net	0.3	0.6	0.4	0.8	0.5	0.9	0.7	1.3	0.8	1.4	0.8	1.3
of which: transfers from the EU			0.1	0.2	0.2	0.4	0.4	0.7	0.5	0.9	0.5	0.8
I. CURRENT ACCOUNT	-2.1	-4.4	-2.0	-3.9	-2.6	-4.9	-2.9	-5.2	-3.3	-5.6	-3.5	-5.7
FDI, net	1.4	2.9	1.7	3.3	1.7	3.2	1.7	3.0	1.9	3.2	2.5	4.1
Portfolio inv. in equity, net	1.2	2.5	0.0	0.0	0.5	0.9	1.0	1.8	1.2	2.1	1.7	2.8
II. NON DEBT GENERATING. FIN.	2.6	5.4	1.7	3.3	2.2	4.1	2.7	4.8	3.1	5.3	4.2	6.8
Change in the external position, I. - II.	+0.5	+1.0	-0.3	-0.6	-0.4	-0.8	-0.2	-0.4	-0.2	-0.3	+0.7	+1.1

Source: For 1999 WIIW database, for 2000-2004 author's estimates.

Note: Indicators for 2000-2004 are calculated in 1999 US dollar prices.

Table 5

Selected indicators of Hungary's external equilibrium, 1999-2004

USD billion, per cent of GDP

Scenario B

	1999		2000		2001		2002		2003		2004	
	USD	% / GDP	**USD**	% / GDP	**USD**	% / GDP	**USD**	% / GDP	**USD**	% / GDP	**USD**	% / GDP
Trade of goods												
Exports	**21.6**	*44.9*	**24.2**	*47.7*	**27.1**	*51.0*	**30.2**	*54.8*	**33.7**	*58.9*	**37.4**	*63.1*
Imports	**23.8**	*49.5*	**26.4**	*52.0*	**30.4**	*57.2*	**34.5**	*62.6*	**37.9**	*66.3*	**42.8**	*72.2*
Net	**-2.2**	*-4.6*	**-2.2**	*-4.3*	**-3.3**	*-6.2*	**-4.3**	*-7.8*	**-4.2**	*-7.3*	**-5.4**	*-9.1*
Services												
Net exports	**1.4**	*2.9*	**1.8**	*3.5*	**1.8**	*3.4*	**1.8**	*3.3*	**1.8**	*3.1*	**1.8**	*3.0*
Incomes												
Net	**-1.6**	*-3.3*	**-2.0**	*-3.9*	**-2.4**	*-4.5*	**-2.7**	*-4.9*	**-2.9**	*-5.1*	**-2.2**	*-3.7*
of which: Interest payments, net	**-0.7**	*-1.5*	**-0.7**	*-1.4*	**-0.9**	*-1.7*	**-1.1**	*-2.0*	**-1.3**	*-2.3*	**-1.4**	*-2.4*
Profit	**-0.9**	*-1.8*	**-1.3**	*-2.6*	**-1.5**	*-2.8*	**-1.6**	*-2.9*	**-1.6**	*-2.8*	**-0.8**	*-1.3*
Unrequited transfers												
Net	**0.3**	*0.6*	**0.4**	*0.8*	**0.5**	*0.9*	**0.7**	*1.3*	**0.8**	*1.4*	**0.8**	*1.3*
of which: transfers from the EU			**0.1**	*0.2*	**0.2**	*0.4*	**0.4**	*0.7*	**0.5**	*0.9*	**0.5**	*0.8*
I. CURRENT ACCOUNT	**-2.1**	*-4.4*	**-2.0**	*-3.9*	**-3.4**	*-6.4*	**-4.5**	*-8.2*	**-4.5**	*-7.9*	**-5.0**	*-8.4*
FDI, net	**1.4**	*2.9*	**1.7**	*3.3*	**1.7**	*3.2*	**1.7**	*3.1*	**1.9**	*3.3*	**2.5**	*4.2*
Portfolio inv. in equity, net	**1.2**	*2.5*	**0.0**	*0.0*	**0.0**	*0.0*	**0.0**	*0.0*	**1.0**	*1.7*	**1.7**	*2.9*
II. NON DEBT GENERATING. FIN.	**2.6**	*5.4*	**1.7**	*3.3*	**1.7**	*3.2*	**1.7**	*3.1*	**2.9**	*5.1*	**4.2**	*7.1*
Change in the external position,												
I. - II.	**+0.5**	*+1.0*	**-0.3**	*-0.6*	**-1.7**	*-3.2*	**-2.8**	*-5.1*	**-1.6**	*-2.8*	**-0.8**	*-1.3*

Source: For 1999 WIIW database, for 2000-2004 author's estimates.

Note: Indicators for 2000-2004 are calculated in 1999 US dollar prices.

The sustainability of external imbalances depends on various factors. In a first approach the current account deficit is expected to be compensated by non-debt-creating financing of the economy. If these two aggregates are roughly compensating each other, the extent of the current account deficit does not pose a serious threat. If the current account deficit substantially exceeds the value of non-debt-creating financing, the consequence is increasing foreign debt. The costs and availability of debt-creating financing determine the modalities of economic policy measures to stop the deterioration of external disequilibria. Nevertheless this first approach provides no basis for a forecast of the two aggregates; their components must in fact be analysed one by one. (See Table 5)

Trade in goods

Changes in the balance of commodity trade have been by far the most important determining factor of the current account position in Hungary. In five of the seven years in the period 1993-1999, the difference between the value of the two aggregates was less than +/- 8%. In case of current account problems in Hungary, economic policy measures are focused on improving the trade balance.

In *scenario A*, the year 2001 brings about a deterioration of the trade balance and the tendency carries on, in a dampened way, in 2002. From 2003 on the trade balance deteriorates again to a significant extent due to the increase in imported inputs for investment projects related to the forthcoming EU accession. In *scenario B* the trade balance deteriorates much more strongly in 2001 and 2002 than in the baseline scenario, to over 6% and nearly 8% of the GDP in the respective years. The deterioration stops in 2003, following the radical stabilization measures assumed to be introduced, but carries on in 2004 in connection with the forthcoming EU accession.

Trade in services

This is a composite position with excessive changes from one year to another. For the sake of simplicity a net surplus of over 3% of the GDP, a possible average in the period investigated, was chosen for both scenarios in each year.

Interest payments

In *scenario A* net interest payments grow marginally in the period concerned but their 1999 ratio to the GDP, -1.5%, remains roughly at the same level. In *scenario B* increasing foreign debt is reflected in growing net interest payments, reaching in 2004 a level twice as high as in 1999.

Profit repatriation

With a stock of over USD 21 billion foreign capital, Hungary has been one of the most important target areas of global investors over the past decade. Due to this and the high

profitability of the companies concerned, profit repatriation has increased in recent years and there is no reason to reckon with a turn in that process. Both scenarios were calculated with increasing profit repatriation, independently of changes in other positions of the current account. In scenario A, profit repatriation may range from 1.3% of the GDP in 2000 to 2.5% in 2002 and 2003, in scenario B from 1.3% in 2000 to 2.9% in 2002. A turn in this respect can be expected in 2004, the assumed last year before EU accession, when re-investment of profits realized in Hungary is assumed to increase significantly.

Unrequited transfers

This position is equal in both scenarios. The net surplus in this position continuously increases over the years due to increasing transfers (ISPA, SAPRA, PHARE) from the EU in the framework of the pre-accession assistance. These transfers are assumed to remain below 1% of the GDP even in 2004, the last year before accession, as a consequence of likely emerging discrepancies between allocated and disbursed funds due to inexperience in Hungary and bureaucratic difficulties on both the Hungarian and the EU side.

Current account

As a resultant of the changes in the main components described above, the current account deficit will continuously increase from about 4% of GDP in 2000 to 5.7% in 2004 in *scenario A*. In *scenario B* the current account deficit/GDP ratio will jump to over 6% in 2001 and over 8% in 2002. The stabilization assumed to follow this deterioration drives back the ratio to below 8% by 2003, but in 2004, this time related to the forthcoming EU accession, the deficit will again rise above 8% of the GDP.

Foreign direct investment

It is assumed that net FDI will supply additional resources (slightly above 3% of GDP) in each of the years 2000-2003 in both scenarios. As in the case of profit repatriation of foreign-owned companies, it is assumed that these transfers are practically indifferent to short-tem business cycles and related economic policy measures. The years 2003, but mainly 2004 are assumed to represent a turning point, just as in profit repatriation, with a considerable increase of FDI inflow (to over 4% of GDP) due to the forthcoming EU accession.

Portfolio investment in equity securities

Unlike FDI, it is assumed that these flows are highly sensitive to business cycles, short-term prospects and economic policy measures applied. Portfolio investments are extremely volatile and changes may be very abrupt; thus predictions even for a few months ahead are quite uncertain. In *scenario A* a zero balance is assumed for 2000, and a gradual real upturn is expected from 2001 on, but especially in 2003 and 2004 – due to a stock exchange boom in Hungary that is expected drawing from the experience of other

EU entrants before their accession in earlier rounds of EU enlargement. In *scenario B* a zero net inflow is predicted for the years 2000-2002 due to missing confidence in economic policy. A revival of portfolio investments is assumed to take place in 2003 and 2004 for the same reasons as in scenario A.

The current account deficit and its financing

In none of the two scenarios is non-debt-creating financing sufficient to cover the current account deficit in the coming years. The difference between the two scenarios is striking yet.

In the *baseline scenario* net debt slightly increases, but due to the more rapid expansion of GDP the net debt/GDP ratio (without inter-company loans) will even decline from 19% in 1999 to 15-16% in 2004.

Scenario B reckons with a considerable growth of foreign debt from 2001 on in each year of the period concerned. Within that period the strongest increase in net debt, related to the political business cycle due to the elections, is assumed to be recorded in 2002. The net debt/GDP ratio (without inter-company loans) will deteriorate to a considerable extent, from 19% in 1999 to 26-27% by 2004. This value is comparable to those in the years 1996-1997 and is much smaller than in the last pre-stabilization year 1994 (43%).

Despite the obvious deterioration no difficulties are expected in raising credits to finance the current account deficit. First, Hungary received good ratings in recent years from the credit-rating agencies;[15] second, the extent of the deterioration is considerable but remains manageable by any criterion; and finally, the approaching EU accession places the whole debt issue into a new context by the end of the period.

Inflation and exchange rate

The continuous disinflation of the last four years will come to a halt in 2000, primarily due to the high international energy prices and the higher than projected price rises in domestic food products. The *baseline scenario* reckons with a moderate decline of inflation to 8-9% (annual average) in 2001 and to 6-7% in 2002. These figures reflect the assumption that oil prices will decline from the present level to about USD 25/barrel in 2001 but that there may be some inflationary pressure from the demand side due to the upturn of household consumption. By 2003 and 2004 inflation may drop below the 'magic' 5%, beyond which the higher-than-EU-average inflation can be compensated by the difference in Hungarian productivity growth rates, and no further devaluation of the forint will be necessary to

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[15]   In late autumn 2000 reputed credit-rating agencies upgraded Hungary's qualification to the investment category.

preserve the competitiveness of the tradables producing sector. Nevertheless, the abolition of the crawling peg may take place much earlier, even in 2001 – either for political considerations (to abolish an important component of the 'Bokros package', loathed by the ruling coalition) or simply by opting for another approach to the exchange rate policy, preferring the floating of the forint in a wider band to the pre-announced crawling peg.

In *scenario B* the inflationary pressure will be stronger than in the baseline scenario because of the more rapid increase of household consumption, though the main impact will yet be additional import growth. CPI inflation is assumed to remain around 10% in both 2001 and 2002. In the wake of the stabilization measures expected to be taken in late 2002 or 2003, inflation starts declining again. CPI inflation may drop to the 5% level in 2004 or 2005.

Fiscal balance

In *scenario A* the annual average GDP growth of about 5% and growth-related revenues leave the necessary manoeuvring room for the government to keep the general government/GDP ratio between 3% and 4%, at least in 2001 and 2002. The favourable situation caused by the rapid economic growth would allow the implementation of at least some of the uncompleted reforms in health care, education, taxes and local governments. In 2003 and 2004 the uncertainties concerning public finance increase to a considerable extent. First, state-financed investments related to Hungary's compliance with the acquis have to be stepped up. Second, the inflow of transfers from the various EU sources attains a higher level than in preceding years and necessitates serious reorganization in the central and local governments as EU-financed projects need co-financing. Tensions may emerge between areas preferred by the EU and supported by additional domestic sources and areas where the resources vanish under the new situation.

In *scenario B* fiscal problems may emerge already in 2001-2002, as a decisive part of the excessive consumption growth is assumed to originate from quickly increasing incomes of public sector employees (for details see below). This development may raise the general government deficit to a considerable extent. The stabilization measures in late 2002 or early 2003 are expected to deal a hard blow, just as in 1995, to the real earnings of employees in the public sector. Stabilization measures may consolidate the fiscal balances only temporarily; as soon as the issues related to the forthcoming EU accession (mentioned in the baseline scenario above) appear, new tensions are created, replacing those related to the 2002 elections. In this scenario the chances for the completion of the structural reforms of public finance are substantially smaller than in the baseline scenario.

7 Risk assessment

The probability of excessive consumption growth in 2001-2002

As already mentioned, general elections will be held in Hungary in the spring of 2002. It is a quite common phenomenon that governments relax their income policy prior to elections. The question is to what extent increasing incomes of the households may endanger the domestic and external equilibrium of the given country. In Hungary, in *scenario A*, the elections-related household consumption growth is not sufficiently strong to derail the economy. In *scenario B* excessive household consumption leads to increasing foreign debt, painful stabilization measures and lower growth. In which circumstances could household consumption growth become excessive compared to GDP growth ?

Reasons for excessive household consumption growth may be a change in the consumption behaviour of households coupled with a strong revival of real earnings and social benefits. This latter may take place partly intentionally, in connection with the forthcoming elections; partly, however, it may be an unintended outcome of enforced wage rises, especially in the public sector, due to spillover effects following the increase of the minimum wage to HUF 40,000 in 2001.

As growth has been driven by both exports and investment in recent years, household consumption growth has remained far behind that of the GDP. A comparison of the respective indicators is telling; while compound growth of the GDP amounts to about 22-23% in the five years 1996-2000, household consumption increased by only about 12%. Real earnings and social benefits lag even further behind, with a mere 9% expansion in the period concerned. That means that the fruits of the recent 'golden years' in terms of economic growth have not been yet harvested by large segments of the population. Significantly increasing household incomes in 2001 and 2002 and growing confidence in a lasting good performance of the economy may together make wide strata of the population believe that the 'seven lean years' are indeed over and encourage them to make up for long-postponed investments in consumer durables or other items of consumption (e.g. holidays). This possible change has an important psychological component that can hardly be influenced. Relatively high real deposit rates and favourable financial investment facilities for households may decelerate the consumption growth to some extent.

Certainly the key issue will be the extent of real earnings growth in 2001 and 2002. The government only has direct influence on wages in the public sector, but these strongly influence the development of earnings in the business sector. This year, for the first time in Hungary's history, the government prepared a biannual budget draft. The figures published there should give no reason for concern. Nominal wages in the public sector may increase by 8.75% in 2001[16] with consumer price inflation targeted at a 5-7%. (In the light of the

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[16]   In some areas (education, health care, etc.) over 16%.

most recent inflation data, both the projected inflation and the public sector nominal wage rises will be revised.) The problem is that important parameters on which the budget figures are based are quite uncertain, such as inflation, oil prices and the dollar/euro relation. Any important or apparently important change may require adjustments in the budget, which, with regard to the two-year period involved, creates a substantial manoeuvring room for the government to realize its political goals free of parliamentary control. The opposition parties, but also independent experts are warning that the government deliberately underestimated the inflation in 2000 in order to be able reallocate the unplanned revenues without parliamentary control (there was no supplementary budget). That may be repeated in 2001-2002. With regard to the low popularity of the coalition parties, reflected in recent public opinion polls, relative to the situation right after the elections two years ago the temptation may be strong to try to regain popular support with the help of resources saved in the budget. That may be realized in the form of higher than originally projected nominal wage rises, non-recurrent supplementary payments for selected groups of public sector employees or supplementary incomes for broad segments of the society, e.g. through tax allowances for families with children or investment-related tax allowance for small and medium-size enterprises, etc.

In the coming two years the government will most probably be in a position to increase household incomes beyond a reasonable level in order to win the next elections. But will the government indeed do that ? On the one hand, the government misses no opportunity to verbally attack the 1995 stabilization package introduced by the previous socialist-liberal government and to refer to the income loss the stabilization measures caused to the population. On the other hand, the income policy practised since the present government has been in office has also been fairly restrictive; for instance, real wages will hardly grow in the public sector in the year 2000 despite the 5-6% growth of the economy. It is important to point out to the discrepancy between the communicated and implemented income policies of the government. Whether the soberness the government has shown in its wage policy in the last two years will be preserved in 2001 and 2002 remains an open question.

Apart from government intentions, pressure for higher wages may yet emerge. The mood of the employees in the public sector is quite depressed. Wages are especially low in some segments (e.g. health care, education, cultural establishments) compared to wages in the business sector. The trade unions of the public sector employees will most probably use the opportunity of the media-related 'vulnerability' of the government in a pre-election or election year to try to catch up to other segments of the society in terms of wages. In this context the government's intention to introduce a guaranteed minimum wage of HUF 40,000 may turn out to be a boomerang.[17] In the business sector only a few

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[17]   HUF 40,000 represents 57% growth over the minimum wage level in 2000.

sub-branches are really involved (textile, leather, shoe industry, agricultural and food industry) as in other branches the share of employees earning less than HUF 40,000 a month is fairly low. In budgetary institutions the impact is much stronger; for instance, in the social care area nearly half of the employees earn less than the minimum wage to be introduced.[18] In the exposed sectors the wage structure will suddenly become much more flat than it was before. That may trigger avalanche-like demands for higher wages for employees who earn more than the new minimum wage to restore the earlier proportions of the wage structure in the given segment.

Summarizing, it seems that there will be a certain pressure from 'below' and a simultaneously temptation from 'above' to allow an excessive growth of real earnings and, indirectly, of household consumption in the coming two years – with the consequences predicted in scenario B. Nevertheless the odds are thought to be stronger that the government will eventually not risk a departure from the present growth path and afford a revival of the stop-go cycles.

Political risk and external financing

Non-debt-creating financing is of decisive importance to compensate for the outflow through the current account deficit. Its two components, FDI and portfolio investment in equity securities, are sensitive to political risks, even if to various ones and to a different extent.

For FDI investors long-term political stability, transparency and stability of the legal fundamentals are the main points. In this respect no perceivable risks are to be reckoned with in Hungary. Consequently, the same value for the FDI inflow is predicted both in scenario A and scenario B.

For portfolio investors short-term changes are much more important. In this respect top priority is the stability or at least predictability of the regulatory environment in instances which influence the prompt value of their assets. Government interventions which are either unpredictable or contradict the logic of markets are considered a factor increasing the risk of portfolio investors. Scenario A and scenario B have deviating values for portfolio investment.

In *scenario A* it is assumed that government interventions in price formation, as witnessed in 2000 first of all in the case of gas prices and prices of pharmaceuticals, will be reduced to a minimum level and the mistrust of investors in this respect vanishes. In this case a gradual recovery is predicted for 2001 and 2002 after the 'lost' year 2000. A stronger inflow

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[18]   KOPINT-DATORG (2000), p. 141.

is assumed to take place in 2003 and 2004 related to the expected pre-EU-accession boom on the Budapest Stock Exchange.

Early this year the government set an ultimatum for the Hungarian pharmaceutical companies (among others Egis, Richter Gedeon, Humán, the most important pharmaceutical companies listed on the Budapest Stock Exhange), warning them not to raise their output prices by more than 6%, otherwise it would re-introduce the central price regulation for pharmaceutical products. Representatives of the pharmaceutical companies pointed out that the prices of medicaments increased recently not because of higher producer prices but due to the decreasing (in real terms) subsidies provided by the state in order to keep medicament prices at a tolerable level. (See http://www.pro-patiente.hu/sajto/archive/2504.html 2000-01-20, and http://www.pro-patiente.hu/sajto/archive/0300/0281.html 1999-08-19)

In *scenario B* government interventions will remain and/or the perception of potential investors concerning interventions will not improve. This is assumed to lead to an 'ice age' at the stock exchange in 2001 and 2002. From 2003 on the momentum of the forthcoming EU accession (and likely already EU-complying market regulation) will lead to an increased inflow through this channel as well.

The Hungarian state has a 25% stake plus one golden share with special rights in MOL rt. (the second biggest company in the country), the national oil/gas and petrochemical company enjoying a monopoly position in the refinery branch and a major distributor of hydrocarbon products. The government has the right to regulate the gas price. Natural gas is partly imported and partly produced in the country, and MOL is monopoly distributor. In early 2000 the government declared that gas prices may not grow more than 6% this year, i.e. the officially estimated CPI inflation for 2000. This policy remained unchanged up to mid-October, which means that the actual gas prices in Hungary corresponded to a 15 USD/barrel oil price, and not to the 30 USD/barrel valid in the world markets. The restrictions by the government caused serious losses to MOL and let the value of MOL shares dive, causing an estimated loss of USD 350 million to the company. (*Magyar Hírlap*, 30 September 2000.) In mid-October the government revised its policy and, after talks with MOL, announced the introduction of a dual price for gas; households, budgetary institutions and small businesses will pay further on artificially low prices, while the price will be raised by 47% for major consumers in the business sector.

Agriculture: the big 'unknown'

While industry performs well above the pre-transition level, agricultural output collapsed to somewhat below 70% of the 1990 level by 1993 and has been only marginally growing since then – true, with much less subsidies than under the communist regime. Compared to 1990 the share of agriculture in the economy shrank to a considerable extent in the last decade according to all important indicators: from 15.8% to 4.8% in the GDP, from 15.3% to 7.1% in employment, from 9.1% to 3.3% in investment and from 22.5% to 8.4% in

exports[19]. Nevertheless the shrinking of this branch has a much bigger significance than measured just by the shares in GDP or other aggregates. Problems in agriculture are interwoven with problems of the Hungarian countryside; 1.8 million households own a piece of land; agriculture has not only a historical tradition in Hungary but has a potential in the future as well, due to the favourable natural endowments. Last but not least, agriculture is one of the most important channels of potential transfers from the EU already prior to, but especially after accession.

The structure of land ownership after the restitution is characterized by a huge number of land owner households, typically with very small plots. Only 43,000 households, 2.4% of all households with land, have more than 10 hectares, the minimum area for a household to make its living mainly from agricultural activity.[20] Most of the new owners live in urban areas and are not ready to cultivate their land, so they lease it. Only a very small fragment of land owner households possess an area over 50 hectares. Most of the farmer households cultivating larger pieces of land lease them from land owners. Transformed co-operatives have remained major players in the sector, however, since the agricultural portfolio belongs to the domains of the Smallholders Party, they are in permanent political cross-fire.

While ownership and cultivation of land is largely separated, the land market is crippled by the 1994 law which allows the purchase of land only for domestic private persons, excluding domestic firms and foreign private and legal persons. The government wishes to maintain this regulation for ten years after EU accession. The regulation blocks transactions on the land market; demand is strongly reduced due to the exclusion of most of the potential buyers. Due to low land prices, barriers to market entry and uncertainties concerning the future ownership structure, capital inflow in the branch is very limited.[21]

Uncertainties surround the impact of Hungary's EU accession on agriculture. It is not clear what will serve as a basis for setting the output quotas for Hungary's agriculture once the country joins the EU. The figures put forward in the Hungarian position paper, based on the high output (but also much higher subsidies) in the second half of 1980s, are considered too high by the EU – which intends to use the output data of the last few years or of the years immediately before accession. Moreover, it is completely unclear whether direct payments will be paid to Hungarian farmers and, if yes, under what conditions. The EU compliance of Hungarian agriculture in terms of absorption capacity is questionable. There

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[19] As far as exports of agricultural and food industry products are concerned, it is important to point out that the decreasing share of agro-food exports in the total is explained by the explosion-like expansion of the share of other items, mainly engineering products. The volume of the agro-food sector's exports, at USD 2 to 2.5 billion annually, remained more or less unchanged in the 1990s.

[20] Microcensus 1996, cited by Fertö (2000), p. 70.

[21] See Lukas et al. (2000).

is a delay in setting up institutions compatible with a modern market economy. Thus, under the foreseeable conditions, it remains an open question whether the Hungarian agriculture will gain or lose from the country's EU membership.

The lack of a clear strategy, of competent governance and of a minimum political consensus in the most crucial issues as well as the political sensitivity – due to strong emotions related to agriculture which distinguish this branch from others – make agriculture a risk factor in Hungary. The risks concerned cannot be consigned to the scenarios elaborated in this paper. In case of unfavourable circumstances the problems accumulated in this branch may cause serious political tensions and related protests, delay the modernization of the countryside and increase the already existing duality in the economy.

Risks related to acquis compliance

The accession negotiations between the EU and Hungary came to the most difficult phase only recently. There is no doubt that Hungary will apply for transitional arrangements in areas where acquis compliance requires huge investments, primarily environmental protection, transport, technical standards, etc. However, it can be assumed that up to the very last stage of the accession negotiations no details will be known about the transitional arrangements. The extent of the actual burden on Hungary in terms of additional investments depends on the length of the transitional periods allowed for. Nevertheless the Accession Treaty, which will be signed about two years prior to the formal accession[22], will already fix these terms and the adjustment process will be regulated for the two remaining pre-accession years (in this forecast 2003 and 2004). As mentioned earlier, a deviation from the programme set out in the Accession Treaty would jeopardize the ratification process. Forced implementation of the required adjustment programme may cause disturbances in the area of public finance and foreign equilibrium. The latter seems to be the smaller danger, as in the immediate pre-accession years non-debt-creating external financing will likely increase to a considerable extent, as happened in the case of earlier enlargements. The real problems may appear in public finance. Both the central and local governments will have to accommodate increasing investment outlays. Although the pre-accession aid from the EU will be helpful in this respect, it will be much smaller than the transfers expected after accession. Too high financing requirements may lead to a sharp rise in public debt.

A generous and sober attitude on the part of the EU and a proper assessment of own constraints by the Hungarian government and negotiators will decide whether or not the implementation of the acquis compliance programme will become a risk factor. Rigidity and

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[22] Ratification in the member countries takes at least one and a half years, and each accession takes place on the first of January of a given year.

short-sightedness on the part of the EU and/or efforts by the Hungarian government to access as early as possible at any price, or simply an inappropriate assessment of the implications, may turn the acquis compliance programme into a risk factor in the last years of the period analysed in this paper.

8 Conclusions

Following the successful 1995 stabilization, the Hungarian economy entered a growth path characterized by strong export and investment growth and a much less dynamic increase in consumption. Accelerating growth has not resulted in external imbalances as was invariably the case in the last decades. Growth was coupled with an exceptionally rapid pace of modernization in industry which dramatically changed the composition of industrial output and exports. The driving force of these changes has been the foreign-owned sector.

In the period 2001-2004, the elections in 2002 and the intensified preparations for EU accession (assumed to take place in 2005) are the issues which will decisively influence the medium-term prospects of the Hungarian economy. According to the baseline scenario of this forecast, there will be a moderate political business cycle in 2001-2002 with a somewhat higher increase of domestic use than the GDP growth. Following the necessary corrective measures to put a brake on household consumption growth, no further menace to the external equilibrium is in sight. It will be possible to maintain an about 5% annual average GDP growth in the whole period.

In a second scenario it was assumed that household consumption is getting out of control in 2001 and 2002. The consequent deterioration of the external equilibrium will necessitate resolute and painful corrective measures. GDP growth will be less dynamic, only 3-4% annually, and foreign debt will start to grow again.

The realization of the baseline scenario is thought to be twice as likely as that of the second, pessimistic scenario.

In the two last pre-accession years, investments are expected to increase rapidly due to the obligations related to acquis compliance. The implications for the current account are negative, but are assumed to be overcompensated by stepped-up FDI and portfolio investments typically having occurred in countries immediately before their accession to the European Union.

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About the author

Dr. Sándor Richter, born 1953 in Hungary; 1977-78 research assistant at the Institute of Economic Research, Hungarian Central Statistical Office; 1979-90 research economist at the Institute of Economics, Hungarian Academy of Sciences; 1986-90 managing director, Echo Consulting, Budapest; since 1990 research economist at The Vienna Institute for International Economic Studies (WIIW); project manager of Countdown, an online documentation centre and communication network on the European Union's eastern enlargement; key subjects: international trade, regional integration (CEECs, EU – CEECs); Hungarian economy.

ANNEX

Table A/1

Hungary: Selected economic indicators, 1990 to 2001

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 [1]	2000 forecast	2001 forecast
Population, th pers., end of period	10354.8	10337.2	10310.2	10277.2	10245.7	10212.3	10174.4	10135.4	10091.8	10044.0	10010	10000
Gross domestic product, HUF bn, nom.	2089.3	2498.3	2942.7	3548.3	4364.8	5614.0	6893.9	8540.7	10087.4	11439.0	13100	14800
annual change in % (real)	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.5	5.5	5
GDP/capita (USD at exchange rate)	3189	3228	3608	3745	4046	4367	4433	4504	4651	4788	.	.
GDP/capita (USD at PPP - WIIW)	7640	7490	7700	7960	8410	8970	9340	9940	10520	11190	.	.
Gross industrial production												
annual change in % (real)	-10.2	-16.6	-9.7	4.0	9.6	4.6	3.4	11.1	12.5	10.4	15	13
Gross agricultural production												
annual change in % (real)	-4.8	-6.2	-20.0	-9.7	3.1	2.6	6.3	-3.8	-2.1	0.1	.	.
Goods transport, mn t-kms	42072	26794	22900	16457	15249	23675	24874	24789	27144	26340	.	.
annual change in %	-9.8	-36.3	-14.5	-28.1	-7.3	.	5.1	-0.3	9.5	-3.0	.	.
Gross fixed capital form., HUF bn, nom.	402.4	522.9	584.7	670.0	878.5	1125.4	1475.5	1898.9	2384.6	2703.0	.	.
annual change in % (real)	-7.1	-10.4	-2.6	2.0	12.5	-4.3	6.7	9.2	13.3	6.6	8	11
Construction industry												
annual change in % (real)	-13.8	-12.6	1.5	3.2	12.4	-17.6	2.7	8.1	15.3	6.4	.	.
Dwellings completed, units	43771	33164	25807	20925	20947	24718	28257	28130	20323	19287	.	.
annual change in %	-15.0	-24.2	-22.2	-18.9	0.1	18.0	14.3	-0.4	-27.8	-5.1	.	.
Employment total, th pers., average [2,3]	.	.	4082.7	3827.3	3751.5	3678.8	3648.1	3646.3	3697.7	3811.5	.	.
annual change in % [2,3]	.	.	.	-6.3	-2.0	-1.9	-0.8	0.0	0.7	3.1	.	.
Employees in industry, th pers., average [4]	1282.2	1147.6	997.1	871.3	880.1	833.0	789.0	783.5	795.9	834.0	.	.
annual change in %	-5.5	-10.5	-13.1	-12.6	-6.8	-5.4	-5.3	-0.7	1.6	0.8	.	.
Unemployed, th pers., average [2]	.	.	444.2	518.9	451.2	416.5	400.1	348.8	313.0	284.7	.	.
Unemployment rate in %, average [2]	.	.	9.8	11.9	10.7	10.2	9.9	8.7	7.8	7.0	6	6
Average gross monthly wages, HUF [4]	13446	17934	22294	27173	33309	38900	46837	57270	67764	77187	.	.
annual change in % (real, net)	-3.7	-7.0	-1.4	-3.9	7.2	-12.2	-5.0	4.9	3.6	2.5	.	.
Retail trade turnover, HUF bn [5]	1078.8	1320.5	1569.5	1967.3	2053.9	2389.9	2793.2	3197.6	3682.8	4329.7	.	.
annual change in % (real) [5]	-7.6	-9.9	-2.5	2.8	-6.1	-8.1	-5.0	-1.0	12.3	7.9	.	.
Consumer prices, % p.a.	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	8.5
Producer prices in industry, % p.a.	22.0	32.6	11.5	10.8	11.3	28.9	21.8	20.4	11.3	5.1	.	.

(Table A/1 continued)

Hungary: Selected economic indicators, 1990 to 2001

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 [1]	2000 forecast	2001 forecast
Central government budget, HUF bn [6]												
Revenues	640.9	716.5	793.3	1041.1	1160.4	1418.2	2079.3	2364.6	2624.4	3227.6	.	.
Expenditures	642.3	830.6	990.4	1240.8	1513.1	1728.9	2209.1	2703.1	2994.6	3565.8	.	.
Deficit (-) / surplus (+)	-1.4	-114.2	-197.1	-199.6	-352.7	-310.8	-129.8	-338.5	-370.2	-338.1	.	.
Deficit (-) / surplus (+), % GDP	-0.1	-4.6	-6.7	-5.6	-8.1	-5.5	-1.9	-4.0	-3.7	-3.0	.	.
Money supply, HUF bn, end of period												
M1, Money	517.5	611.7	810.0	901.9	973.9	1036.3	1237.2	1528.3	1789.2	2125.1	.	.
Broad money	1009.4	1369.8	1748.3	2016.5	2279.1	2736.4	3351.1	4009.5	4619.7	5361.8	.	.
Refinancing rate, % p.a., end of period	22.0	22.0	21.0	22.0	25.0	28.0	23.0	20.5	17.0	14.5	.	.
Current account, USD mn	127	267	324	-3455	-3911	-2480	-1678	-981	-2298	-2076	-2000	-2300
Reserves total, incl. gold, USD mn	1166	4017	4380	6736	6769	12011	9718	8429	9341	10978	.	.
Gross external debt, USD mn	21505	22812	21644	24566	28526	31660	28043	24395	27280	29279	.	.
Exports total, fob, USD mn [7]	9551.2	10216.2	10678.1	8908.2	10736.2	12904.7	13119.6	19099.5	23010.0	25024.3	28000	31000
annual change in %	-1.2	7.0	4.5	-16.6	20.5	20.2	1.7	21.8	20.5	8.8	12	11
Imports total, cif, USD mn [7]	8622.2	11437.5	11120.3	12630.3	14620.0	15406.1	16176.5	21211.1	25700.7	28003.7	31000	34300
annual change in %	-2.7	32.7	-2.8	13.6	15.8	5.4	5.0	17.1	21.2	9.0	11	11
Average exchange rate HUF/USD	63.20	74.81	79.00	92.04	105.13	125.69	152.57	186.75	214.45	237.31	.	.
Average exchange rate HUF/EUR (ECU)	80.48	92.70	102.10	107.50	124.78	162.65	191.15	210.93	240.98	252.80	.	.
Average exchange rate HUF/DEM	39.14	45.18	50.60	55.63	65.04	87.84	101.40	107.68	122.15	129.25	.	.
Purchasing power parity HUF/USD, WIIW	26.42	32.27	37.08	43.39	50.63	61.31	72.55	84.76	95.01	101.79	.	.
Purchasing power parity HUF/EUR, WIIW	27.96	33.78	39.04	46.80	54.69	65.99	78.67	92.83	103.29	110.41	.	.

Notes: 1) Preliminary. - 2) Based on labour force survey. - 3) Excluding persons on child care leave; from 1998 new sample. - 4) Enterprises with more than 10, from 1999 more than 5 employees. - 5) From 1998 excluding catering. - 6) Excluding privatization revenues. - 7) Converted from the national currency to USD at official exchange rate. From 1997 including trade of firms with customs free legal status.

Source: WIIW Database incorporating national statistics; WIIW forecasts.

Table A/2

Hungary: GDP development, 1999 to 2004

in constant forint prices

SCENARIO A

	1999	2000	2001	2002	2003	2004
Growth rates						
Private consumption	.	4.5	5.5	4.5	4.5	4.0
State consumption	.	3.0	3.0	3.0	3.0	3.0
Gross fixed investment	.	8.5	9.5	8.5	11.5	12.5
Domestic use		5.1	6.0	5.2	6.0	6.0
Exports	.	12.0	12.5	11.0	11.0	11.0
Imports	.	11.0	14.0	11.0	12.2	12.2
GDP	.	**5.5**	**5.0**	**5.0**	**5.0**	**5.0**
In % of GDP						
Private consumption	63.6	63.1	63.4	63.1	62.8	62.2
State consumption	10.6	10.4	10.2	10.0	9.8	9.6
Gross fixed investment	23.6	24.3	25.4	26.2	27.8	29.8
Change in inventories	4.6	4.4	4.2	4.0	3.8	3.7
Exports	52.6	55.9	59.9	63.3	67.0	70.8
Imports	55.1	58.0	63.1	66.7	71.2	76.2
GDP	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Author's estimates.

Table A/3

Hungary: GDP development, 1999 to 2004

in constant forint prices

SCENARIO B

	1999	2000	2001	2002	2003	2004
Growth rates						
Private consumption	.	4.5	6.5	5.0	1.0	3.0
State consumption	.	3.0	3.0	1.0	1.0	3.0
Gross fixed investment	.	8.5	9.0	8.0	9.0	12.0
Domestic use		**5.1**	**6.5**	**5.1**	**3.0**	**5.3**
Exports	.	12.0	12.0	11.5	11.5	11.0
Imports	.	11.0	15.0	13.5	10.0	13.0
GDP	.	**5.5**	**4.6**	**3.6**	**3.5**	**3.5**
in % of the GDP						
Private consumption	63.6	63.1	64.2	65.1	63.5	63.1
State consumption	10.6	10.4	10.2	10.0	9.7	9.7
Gross fixed investment	23.6	24.3	25.3	26.4	27.8	30.1
Change in inventories	4.6	4.4	4.2	4.1	3.9	3.8
Exports	52.6	55.9	59.8	64.4	69.3	74.4
Imports	55.1	58.0	63.8	69.9	74.3	81.1
GDP	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Author's estimates.

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