

# Evaluation of the World Bank's Role in the Transition: Hungary

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This report is a background paper to OED's Evaluation of World Bank Assistance to the Transition Economies.

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## **Evaluation of the World Bank's Role in the Transition: Hungary**

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This report evaluates the World Bank's role in the Hungarian transition by following a frame of reference in which the evaluation focus has the following elements:

- the relevance of the Bank's objectives in the context of the countries' development constraints,
- the choice and design of instruments,
- the efficacy and efficiency with which the Bank's programs achieved their objectives,
- the institutional development impact,
- the sustainability of the program's benefits, and
- the lessons of experience.

Because the Bank has at least four major functions (analysis and policy advice, global regulation, lending, and technical assistance), the elements of the evaluation focus will be presented according to the functions performed as well.

### **Relevance**

#### **Analysis and Policy Advice**

As a result of depleted resources to feed extensive growth of the centrally planned economies and of severe economic restrictions made by the Hungarian government after the oil price shock of the 1970s, economic growth slowed from 6 percent to 2 percent in the second part of the 1970s and the economy started to show signs of structural imbalance.

In 1982, Hungary was again on the brink of insolvency when the political leadership decided to join to the World Bank and the International Monetary Fund (IMF), against the opposition of the Soviet Union. With the help of loans from the two institutions, the Hungarian economy entered a consolidation period for the next four years.

As a first country from the Council of Mutual Economic Assistance (CMEA) and the Warsaw Pact, the importance of Hungary's membership was far greater than its size would imply. Hungary became a member country of the Bank although its eligibility for loans was approved only in September 1982. Soon after, an intensive joint priority setting started on the basis of project proposals made by a Hungarian interministerial committee. As a result, a "honeymoon" started in the cooperation between Hungary and the Bank.

The cooperation was based on the agreed objectives of modernizing Hungary's production potential and economic structure through ensuring the high content of convertible currency

imports for investments and attaining energy efficiency and promoting efficient export production as well as economic (institutional) reforms.

- First, in line with these objectives, programs for efficient export production, chemical industry, energy, agriculture, and transportation were selected for financing.
- Second, because of the urgent need for financial resources and support for structural and institutional reforms, Hungary applied for a structural adjustment loan as early as 1983. The government considered this an important element of the development program of the five-year plan for 1986–90. In 1986, after some hesitation, the Bank approved the proposal for the Fine chemical project, which was followed by more complex industrial adjustment loans in the second part of the 1980s. The Bank refused to make structural adjustment loans in the early 1980s for both political and professional reasons. As regards the political reasons, the Hungarian economy was considered relatively developed, on the one hand, but not resistant enough against the expected shocks of the implementation on major reform programs, on the other. The professional counter-arguments might be listed as follows: structural adjustment lending is for the medium term, but Hungary’s eligibility for borrowing from the World Bank is still not known; this lending might not be more than 50 percent of the annual lending quota of the Bank for Hungary (about US\$200 million) and, consequently, the amount is not enough for financing major reform steps; the advantage inherent in fast access to the loan could be ensured by the available cofinancing, as well. For these reasons, the so-called “hybrid” industrial adjustment and investment lending came into practice as an intermediary solution.

The Industrial Sector Adjustment Loan signed in 1988 was the first one based only on economic policy commitments (matrix).

Taking into account the important reform steps (two-level banking system, introduction of the VAT, liberalization of foreign trade, and the like), in 1989, Hungary suggested that comprehensive structural adjustment loans (SALs) would be the main instrument for the cooperation with the Bank. Again, after a certain hesitation because of the deteriorating equilibrium situation and the coming election, the Bank proved to be a good cooperative partner in following the changing political and economic landscape in Hungary. As a result, the SAL programs were fulfilling liberalization and accelerating deregulation and privatization. In the early phase of the transition, further large-scale loan packages were identified to support the transformation of the financial sector, the export of agriculture, the modernization of communication, the human resources and product markets, and the restructuring of companies.

The Bank’s support for privatization was of great importance among the objectives. It was agreed that support for privatization would be dealt with in the SAL agreements in 1990–92; however, the Bank did not intervene in the forms of realization. The SAL agreement signed in July 1988 already paid attention to the change in enterprise ownership. It formulated the following expectation: “Enactment of a law of associations and related legislation which would permit: (a) State enterprises to convert themselves into joint stock companies; (b) individuals to hold negotiable share in joint stock companies; and (c) individuals to form limited liability and joint stock companies.” As early as 1990–92, all three SAL agreements dealt with privatization.

In these years, the Bank also paid special attention to bank consolidation. As a consequence of the so-called transitional crisis, the state provided hundreds of billions of forints for the

consolidation of the banks to make them privatizable. However, the banks in turn generated further and further losses, at great cost to the public finances. This is why the Bank continuously criticized the programs of recapitalization between 1990 and 1994 for being ill advised, poorly executed, and based on soft budget constraints on banks associated with public ownership. The Bank's suggestions helped the government to develop a new strategy for bank reform with the following aims:

- to privatize state banks, preferably with the participation of a foreign strategic investor;
- to improve bank governance through enforcement of business plans generated toward active loan recovery;
- to strengthen the supervisory and regulatory framework; and
- to prepare needed amendments to the Banking and Bankruptcy Laws.

Thanks to the Bank's analysis of Hungary's development needs, the broad objectives were also rightly identified in the mid-1990s: helping to maintain macroeconomic stability, strengthening and privatizing Hungary's financial and enterprise sectors, reforming social policies and strengthening the human resource base, and improving environmental management. These were fully in line with the second phase of structural reforms.

The Bank focused first on completing the public sector reforms, the implementation of the new pension system in particular, and second on supporting the reform of higher education in Hungary. Also, in light of the objective of Hungary's European Union (EU) accession, the Bank started to work intensively with the government to strengthen Hungary's readiness for EU membership.

Since the implementation of the stabilization program in 1995–96, Hungary has returned to a sustainable growth path and has access to cheaper private capital, and the country has less and less interest in using the lending services of the Bank. Both Hungary and the Bank have come to the conclusion that the pregraduation assistance program will therefore be limited to analytic and advisory services, as suggested by the new Country Economic Memorandum (CEM) in 2002. It appears to be welcome that Bank activities are to focus on areas where significant policy issues remain, the Bank has a comparative advantage, and the Bank will not duplicate the efforts of other partners.

As underpinnings for the design of adjustment programs and the selection of priorities, the Bank rightly put great emphasis on economic and sector work, including reviews of the environment (1992) and agriculture (1995), a poverty assessment (1996) and *Hungary: On the Road to the European Union, a World Bank Country Study* (1999).

The Bank's work on poverty largely contributed to the understanding of poverty in Hungary, in particular its extent and the impact of reforms on the poor. It was also useful that the Bank's follow-up to the poverty assessment for Hungary and the analysis of the labor market in 1997 closely linked the operational work in municipal development with the access of the poor to services. By the mid-1990s, social cohesion occupied its proper place in the Bank's economic and sector work, but it had lagged behind until this period.

The Country Study published in 1999 reviewed Hungary's progress during its transition in the 1990s and the prospects for EU accession. The first Country Study by the Europe and Central Asia (ECA) Region pointed out rightly that Hungary, beyond the return to a fast and sustainable growth path, has to continue its structural reforms in the health sector and

transport, in particular. Here, the relevant issues identified were the large gap in health status between Hungary and the EU; the need for improvement in institutional structures and policies, including correction of perverse incentives; and the potentially large financial pressures in the medium term, on the one hand, and the large investment needs, restructuring of major state-owned companies to privatize many of them as soon as possible, and regulatory reform, on the other hand.

This discussion suggests the following conclusions with regard to relevance of the analytic and policy advice function:

- The Bank has had a deep understanding of the changing political and economic landscape, however, its understanding of the social landscape should be more moderately qualified as fairly good. Although the needed reform of the social system was permanently on the agenda, the fight against poverty was not among the objectives of the Bank's cooperation with Hungary in the 1980s. The initiation and partnership to establish an adequate social security system came only in the mid-1990s. At the beginning of the decade, the Bank largely contributed to preventing and managing unemployment. Later, however, the Bank considered unemployment to be an inevitable by-product of economic growth. Consequently, the high social cost of the economic transformation could not be adequately mitigated.
- The Bank's priorities were well in line with the country's development priorities. No critical areas were missed. The selection was permanently based on a dialogue between the government and the Bank and was particularly efficient when an elaborated development plan served as a basis for it. For example, in the 1980s, for political and administrative reasons, the Bank appeared to be reluctant to approve proposals to use new instruments such as SALs. It was done only after a certain delay, in 1983–85 and 1989–90. Of course, the Bank was not right to delay. The political and professional counter-arguments discussed above proved to be unworkable in light of experience gained later. Its impact on the country was counter-productive in terms of both economic modernization and implementation of a reform agenda;
- The Bank's economic and sector work was of high quality both in terms of the incorporated knowledge and views from within the country and of practical recommendations. It reached the experts and decision-makers in good time and was followed with great attention.

### **Global Regulation**

In the field of global regulation, the Bank, closely cooperating with the IMF, used its Financial Sector Assessment Program (FSAP) to review the stability of the financial sector and the workings of state supervision of financial institutions in 2000–01. The recent trends in financial globalization and the fragility of the international financial system made this joint project of utmost importance.

Although the Hungarian financial system was found to be fundamentally sound, there are challenges ahead:

- Hungary's financial markets are still relatively shallow.
- The profitability of the banks is low.
- The newly consolidated Hungarian Financial Supervisory Authority (HFSA) does not have the power to issue regulations and set its own budget and staffing levels.

- Financial market development appears to be hampered by problems in the laws and legal practices concerning collateral and foreclosure.

By identifying these bottlenecks, the Bank encouraged the Hungarian authorities to further strengthen the financial system and facilitate access to the EU single market and, later, to the Economic and Monetary Union.

### **Lending Program**

Overall, the development of the lending program closely followed the Bank's priorities in the last two decades.

The sectoral structure of the Bank's portfolio for the period between 1982 and April 30, 1994 is shown in Table 1. For purposes of international comparison, the table presents the structures for the ECA Region and for the World Bank as a whole (up to June 30, 1994).

In general, the Bank's commitments for Hungary followed the trends of the Bank's portfolio. However, the higher share of multisectoral loans in the case of both Hungary and the ECA Region indicates that they were playing an important role in crisis management through economic reforms. Another remarkable difference was the higher share of industrial loans in Hungary than in the ECA Region and the world as a whole, due to the fact that the Bank's assistance was largely to the so-called complex (industrial) development programs of national plans in the 1980s. The third major difference was the higher share of loans for public sector management. A fourth difference: within infrastructure, the Hungarian share of loans in telecommunications was higher, and that of energy and transportation lower, than in the ECA Region or in the world as a whole.

The mentioned country-specific characteristics of the lending program were in full harmony with Hungary's critical needs in the 1980s. Industry was in the forefront of the development policy. In public sector management, three projects served the development of enterprise reform, the social insurance system, and the tax administration. As for infrastructure, the higher share of telecommunications was a result of a development policy that, taking into account the traditional backwardness in this field, relied more on sectoral development resources (in terms of changing the tariffs, as well) than on budgetary supports. Also, this orientation of the development policy explains the lower Hungarian share of transportation in the portfolio.

Table 1. *The World Bank's Portfolio by Sector, 1982-April 30, 1994*

<i>Sector</i>	<i>Hungary</i>		<i>ECA</i>	<i>World Bank</i>
	<i>Commitments (US\$ million)</i>	<i>Percentage</i>		
Agriculture	558.5	16.5	17.7	17.9
Education	150.0	4.4	2.8	4.8
Energy and envir. protection	493.0	14.6	19.4	21.0
Finance	66.0	2.0	10.8	10.6
Industry	523.6	15.5	9.6	6.7
Mining	-	-	-	1.3
Multisector	650.0	19.3	17.5	9.1
Population, health, and nutrition	91.0	2.7	1.1	1.5
Public sector management	361.0	10.7	1.8	1.4
Social sector	-	-	-	0.1
Telecommunications	220.0	6.5	1.4	1.8
Transportation	260.0	7.7	12.6	15.1
Town development	-	-	2.0	4.2
Water supply and sanitation	-	-	3.3	4.5
Total	3,373.1	100.0	100.0	100.0

*Source:* Hungary: National Bank of Hungary; ECA, World Bank: World Bank Annual Report 1994, p. 228.

In the second part of the 1990s, two SALs supported the financial sector (with a 1997 Enterprise and Financial Sector Adjustment Loan, or EFSAL) and pension reform (with a 1998 Private Sector Adjustment Loan, or PSAL). The Bank helped to strengthen public institutions during this period, too. Another major shift was a US\$550 million commitment for five operations in the field of human development (Human Resources Development in 1991, Pensions Administration and Health in 1993, Health Services and Management in 1993, Youth Training in 1998, and Higher Education in 1998), of which more than half was cancelled. The two major cancellations, amounting to about US\$140 million, were the undrawn parts of the Higher Education Reform and the Youth Training projects.

By the end of the last decade, Hungary's financial relationship with the Bank had changed radically because of cheaper access to financial markets and low-cost funding from EU institutions. Furthermore, Hungary began prepaying Bank loans (about US\$1.5 billion in the years 1997–98). Consequently, Hungary's US\$2.4 billion outstanding obligations at the end of 1995 were reduced to US\$0.5 billion in the spring of 2002, leaving US\$12 million undisbursed for only one project.

Beyond the cost factor, the introduction of a unified budget system in 1998, which eliminated the “additionality” of Bank-funded expenditures, also contributed to the declining interest in borrowing from the Bank on behalf of the beneficiary ministry or agency.

### **Technical Assistance**

Closely linked with the function of analysis and policy advice, technical assistance has played an important role in Hungary's transition in both knowledge generation and problem solving. These two objectives were well served when, in line with government demands, technical assistance supported the design of reforms of the pension system, the health sector, and higher education. It was valuable even though, in the latter sectors, the implementation of the adopted reform programs was cancelled, mainly because of changing government policies. This suggests that there is need for greater flexibility on behalf of the Bank to safeguard the design and program elements built up jointly with the former government.

The need for pension reform appeared in loan agreements and other Bank studies at an early stage. In the first period, goals were established to reduce the ratio of pensions in social expenditures, diminish the number of pensioners, and correct some deficiencies in the existing system. After 1992, the reduction of expenditures continued to be found in loan agreements, although the idea of privatization also appeared in other Bank documents. In 1994, the World Bank published and widely publicized a monograph entitled “Averting the Old Age Crisis,” which set forth in detail the multipillar proposal that served as a basis for the design of the three-pillar system in Hungary.

Recently, in the context of pregraduation and a draft plan laying out a framework for World Bank collaboration with the leading EU accession countries of Central Europe and the Baltic region, technical assistance has come to play a new, greater role. The proposed framework adequately takes into account both the needs of candidate countries and the current thinking in the World Bank. Also, it would be justified to ask a country to pay (either directly or indirectly—for example, through requesting allocations of EU funds) for at least a part of the technical assistance costs.

In the perspective of cost sharing, there is even more need for greater flexibility in the Bank's technical assistance in the future. This might be the case for countries in the pregraduation period—for example, in Hungary, where the substantial technical assistance from the Bank might appear to be too expensive, but the dissemination to developing countries of Hungary's rich experience in dealing with the Bank during the past decade might have a certain market value, as well.

## **The Choice and Design of Instruments**

### **Analysis and Policy Advice**

As discussed in the previous section, the elaboration of the lending program was based on well-designed and sound analytical work. The program was also based on CEMs and developed in discussions by experts during the joint project preparation meetings, which manifested in individual project decisions in the 1980s and in a more organized form through the Country Assistance Strategies (CASs) in the 1990s. Although the latter proved to be an efficient instrument, too much attention was given to the possible medium-term policy scenarios and prospects in 1995 and 1997. Of course, the CASs served as an indispensable background for the lending program. However, better timing and synchronization could have made the country's agreement much easier, and more time could have been given to a more detailed elaboration of the lending program itself instead of to time-consuming economic policy coordination.

### **Lending**

As far as the Bank's use of appropriate instruments is concerned, there was an adequate, balanced use of lending and nonlending services, on one hand, and of adjustment lending and investment lending, on the other hand. From the program funding totalling US\$3.7 billion as net commitments, the share of SALs was 39 percent and that of investment projects was 61 percent. Within the adjustment share, the size of the so-called hybrid industrial adjustment and investment loans was 7.5 percent.

The majority of the 42 projects and programs signed represented investment lending and only 10, adjustment lending. Within the latter group, 6 fell into the real adjustment and 4 into the hybrid lending category.

The Bank's program of assistance contained adequate safeguards, except for the complex reform programs. Here, because of the need for a strong political consensus, sometimes the temptation was high for the new government to postpone them. As mentioned above, this happened in the case of the health sector and higher education.

It is important to note that Hungary joined the Multilateral Investment Guarantee Agency (MIGA) in 1985, and its current maximum liability stands at US\$34 million. By providing political risk coverage, MIGA could play a greater role in infrastructure development projects.

## **Efficacy**

### **Analysis and Policy Advice**

The efficacy of this function can be seen in its contribution to intellectual debates, particularly in the debates on pension reform and higher education.

The World Bank's monograph entitled "Averting the Old Age Crisis" generated wide public debate over the issue of pension reform. An unprecedented professional and public dialogue emerged on the introduction of the three-pillar pension system. There was no previous example of such a vivid discussion of policy issues among government experts, stakeholders, and individuals in Hungary. The government and the parliament finally passed the three-pillar pension system bill in the fall of 1997, and it became effective as of January 1, 1998.

Although the public discussion on education did not result in the implementation of a joint higher education program, the Bank's contribution was valuable. The Bank played an important initiating role in Hungarian educational reform and urged its permanent implementation.

Two loans directly served educational objectives. The first financed the Human Resources Project, which was signed in 1991 and produced very positive results. The loan contributed to the building of labor market organizations, development of adult education and retraining, and qualitative changes in secondary and higher education. The second loan—the Higher Education Reform Loan—was signed in 1998 and was aimed at assisting the development of the technical, organizational, and substantial conditions of a modern higher education system, with some positive and several questionable elements. The educational recommendations made valuable contributions to the improvement of technical, organizational and substantial conditions, but their implementation caused several problems, because they overemphasized copying the experiences of developed countries. This, together with the increasing cost of the loan, led to the government decision to cancel the Higher Education Reform Loan. Consequently, the higher education reform program could not become a model prototype in Hungary, as was the case with pension reform. The cancellation of this loan seems to be justified only for financial reasons, because of the high cost of the unused loan. Although the delay in the implementation of the program might be explained by the restructuring of several of its elements, the delay was much longer than expected. However, despite the cancellation, the suggested reforms are being implemented, for example, the student loan system and the planned investments aiming at the development of five higher education institutions financed by budgetary resources.

### **Lending**

Two periods in the effectiveness of the lending program can be distinguished: the 1980s and the 1990s. In the 1980s, the Bank's loans served well the modernization of Hungary's production potential and economic structure and through it the improvement of the current account balance situation. Because of the loans' dispersed direct and indirect effects, it is hard to trace them by using macroeconomic indicators. However, their important contribution to economic growth and export promotion appears at the microeconomic level. The major contributions can be identified as :

- access to long-term investment resources—in particular, badly needed convertible currency imports;
- thorough analysis and forecasting of economic efficiency based on the Bank's methodology;
- experience with international tender procedures;
- teaching Hungarian experts how to work with foreign advisers, in connection with the needed screening; and
- application of an overall development strategy instead of direct export criteria in promoting export production.

The Bank's projects and programs also fulfilled their other major function, that is, the promotion of economic reforms such as privatization, deregulation, and liberalization. This contribution, coming mainly from the SALs, placed the Hungarian economy in a more favorable position for the transition at the beginning of the 1990s.

Social policy became a broad objective only in the 1990s. Here, one has to face again a measurement problem. However, despite the mainstream paradigm of a "premature welfare state," which led to a 10 percentage point drop (from 38 to 28 percent, relative to GDP) in social expenditure between 1991 and 1998, the World Bank proposed a detailed concept of reform of the large social systems. Briefly, its main elements were:

- The public health strategy of the Bank was built around three elements: cost efficiency, access, and quality. Also, the Bank proposed several times that very high health charges not be imposed on employers and employees and that taxes be used in the financing of public health.
- The Bank supported educational development in recognizing that the system was inefficient, was wasting resources, and was almost fully financed from public money. After advice from the World Bank and the EU, the number of students in high schools and universities more than doubled.
- The recommendations of the Bank concerning children and families emphasized the prevention and reduction of child poverty by means of well-targeted subsidies. The proposal implied both individual targeting and the practice of group targeting.

The efficacy of the Bank's program was increased by the Bank's coordination with other donors to attract cofinancing.

Cofinancing has helped Hungary to mobilize some US\$1.2 billion via six commercial syndications for Bank-assisted operations between 1983 and 1985, with a Bank contribution of US\$136 million. The Bank's involvement improved the terms and introduced Hungary to commercial banks, from which it had not previously borrowed. The first Expanded Cofinancing Operation (ECO) in August 1990 enabled Hungary to access the Eurodollar market (to which it returned in 1991 without World Bank assistance) and extend maturity of its US\$200 million bond issue through a guarantee of principal.

The Bank also helped attract cofinancing for other projects in the early 1990s. The Export-Import Bank of Japan cofinanced both SALs, and the European Investment Bank (EIB) cofinanced the first power project and the second telecommunications project.

In the area of the Bank's cooperation with other institutions, the cooperation with the IMF deserves special attention. In this particularly close cooperation, Hungary has viewed the

Bank's role as very positive for two reasons: first, the Bank emphasized helping Hungary to formulate the painful adjustments in socially acceptable ways through the reforms of large social systems, in the mid-1990s in particular, and, second, the Bank reviewed the inclusion of structural measures in standby arrangements of the IMF at a highly professional level.

To conclude the discussion of efficacy, it follows from what has been said above that the Bank's assistance (lending and nonlending services) has effectively achieved progress toward its stated objectives, such as modernization of the Hungarian economy, promotion of export production, implementation of economic reforms, and consideration of social dimensions in development policy. There have been no cases of major shortcomings, for example, unintended social costs, environmental damage, and so forth.

### **Process/Efficiency**

The good process/efficiency of the Bank's programs helped to achieve their objectives through all types of assistance. In accordance with the best practice, the Bank's dialogue with the government and civil society played a major role.

In general, the dialogue with the government has always been intensive and of high quality. Thanks to the good cooperative spirit among the Hungarian state authorities, the shift of the coordination function from the National Bank of Hungary in the 1980s to the Ministry of Finance in the 1990s has ensured the proper continuity in the relationship with the Bank.

The missions (teams) from headquarters were highly professional and helpful. Despite this, however, the Hungarian representatives often felt that the process of preparing the loan agreements was too difficult and long, due to, among other reasons, the overstaffed missions and complicated bureaucratic arrangements. This was particularly pronounced in light of a more "businesslike" attitude of other international financial institutions.

Hungary is greatly satisfied that the World Bank set up the Budapest hub to provide close support not only for Hungary, but also for a number of Central and Eastern European clients. This has made it possible to maintain a close professional and personal relationship between the experts' teams and between the country director and leading figures in the Hungarian government.

As for the dialogue with the civil society, in April 1997, Hungary's government agreed to join the Structural Adjustment Participatory Review Initiative (SAPRI), in which civil organizations, with the World Bank and national governments, assessed and analyzed the economic and social impacts of the SALs contracted by the seven participating countries and the Bank.

Four research groups were established, to which the nongovernmental organizations (NGOs) and the World Bank delegated their experts and consultants. On behalf of the Hungarian NGOs, almost 1,500 experts participated in field studies and prepared 150 reports. The Second National Forum in 2000 discussed the preliminary version of the study, which was approved by the Hungarian National Steering Committee.<sup>1</sup>

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<sup>1</sup>As a representative of the government in the SAPRI project, the author was a member of the committee.

The summary of the final report reflects the common ground of understanding of the NGOs, the government of Hungary, and the World Bank. It was a common understanding that the recommendations of the Bank (and the IMF), the Bank loan conditionalities, and its reports about Hungary created an intellectual framework in the transition. Within this framework, in many cases, Hungary's governments had broad room for economic policy maneuvering. However, according to the NGOs' view, domestic economists that favored the international neoliberal view influenced the governments and the parliament. This played a major role in the introduction of the reforms necessary for the transition to a market economy and free market rules within a few years, although neither Hungary's economy nor Hungarian society was prepared for that. Contrary to this view, Hungarian government and international experts and the World Bank reports note that Hungary's transition caused much less shock and took place more gradually than the transition in the surrounding countries, where revolution, shock therapy, and hyperinflation took place, and those countries later experienced a bigger drop of GDP and a still stagnating economy.

The other parts of the final report reflect the view of the NGOs only. On the role of the World Bank, the NGOs pointed out that in the 1980s, the society knew very little about the Bank's activity in Hungary, but in the 1990s, people might have considered its (and the IMF's) activity to be more important than it was in reality. The distribution of labor between the IMF and the World Bank was unclear not only for outsiders, but also for many Hungarian politicians and experts.

The NGOs found that World Bank (and IMF) policies determined only in part the economic and social policy of the government. In many cases (e.g., the liberalization of foreign trade and prices, privatization), the recommendations of the Bank and the IMF have given a broader framework within which the government has had greater freedom of action. Because of this, the market economy reforms were carried out more radically and impatiently than expected by the international financial institutions. An example is the liberalization of foreign trade, which happened without the usual defense of domestic enterprises. Import liberalization without any transitional defense of the domestic economy (besides the real, effective revaluation of the forint), together with the implementation of the strict Act of Bankruptcy, restrained both exports and import-substituting domestic production while import demand increased.<sup>2</sup> In connection with this, it should be mentioned that the Bank's experts interpreted the realization of import liberalization under the above-mentioned circumstances as a voluntary undertaking that well exceeded the practice of countries in Eastern and Central Europe implementing shock therapy.

There is opposition between the World Bank and civil organizations over the adopted economic philosophy. An essential element of the difference of views lies in the social policy concept, because in the recommendations of the Bank, the notion of social policy was confined to a narrow concept limited to giving assistance to the poor and to those who have lost out. However, civil organizations acknowledged that the Bank proposed efficient and effective means to assist the poor, as can be seen from the suggested concept of the reform of large social systems. (See "The Choice and Design of Instruments" above.)

Also, taking into account that the international financial institutions (IFIs) primarily influence economic policy not by their direct recommendations, but by orienting the generally accepted basis of economic thinking, the Hungarian NGOs suggested the formulation of a new "post-

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<sup>2</sup>Oblath, Gábor. 2000. "The Liberalization of Imports in Hungary." Summary paper for the Hungarian SAPRI Coordination Office. .

Washington consensus.” The new consensus would revalue the role of the state and the importance of democratization of decision-making, and place greater emphasis on surmounting poverty. The correction of the economic policy instrument should be accompanied by the establishment of social protection and welfare systems and mechanisms. Appropriate emphasis must be placed on the development of human resources as well as on technological progress and technology transfer.

The Hungarian NGOs’ opinion of the results of World Bank programs and their corresponding proposals can be summarized as follows:

- It would be reasonable and expedient to make clear to the population the improvement in economic efficiency.
- The acceleration of reforms inspired by the programs increased economic and social tensions in many respects, and in the short run; it would be expedient to put forward measures that slow the decline and return to the population in a sensible way some results of the resumed growth..
- The programs and reforms should have been prepared and executed in a more transparent way, thoroughly informing and involving the population. More transparency and social participation would not only improve public opinion, but also could increase the efficiency of execution and contribute to a socially just distribution of resulting surplus resources.

The Hungarian NGOs highly appreciated that the World Bank was the first international financial institution to initiate real social dialogue. They hope that the dialogue will be maintained in the future.

The government of Hungary appreciated the high-level professional analysis of the 1990’s made by the NGOs. However, it could hardly accept the following main conclusions:

- The existence of the “Hungarian model of privatization”: It is true that state property was privatized faster in Hungary than in other transition countries, but recently the ownership structure of the Czech and the Polish economies appears to be more and more similar to the Hungarian one.
- It is true that the Hungarian economy faced serious difficulties in terms of changes in economic structure, economic equilibrium, unemployment, and standard of living. However, these problems appeared to be transitional in light of the recent fast growth of the GDP and exports, and increasing real incomes.
- Concerning social policy, the analysis of the NGOs contradicts itself by suggesting a decrease in social contributions, on the one hand, and stating that there is no relationship between the size of the contribution to the expenditures of the state budget and the level of services, on the other hand.

### **Institutional Development Impact**

In performing their functions, the World Bank and the International Finance Corporation (IFC) helped to strengthen the capacity of public institutions in Hungary.

### **Lending**

During the 1980s, the Bank's lending program helped to build foundations for economic liberalization, strengthen the rigorous economic and financial principles needed for the foundation of an efficient private sector in Hungary, and facilitate an environment friendly to foreign direct investment in the field of institutional development. Among these impacts, the second was largely supported by the introduction of a comprehensive methodology of economic efficiency into the analytical work of the enterprises. Although its importance was generally recognized, the enterprises often found it too demanding because of its greater complexity. Despite this, remarkable progress was made in the application of alternative approaches in development policies.

During the 1990s, the Bank's portfolio shifted to macroeconomic adjustment and human resources development. The former was supported by four structural adjustment loans extended by the Bank in the early 1990s and by two sector adjustment loans promoting the development of the enterprise and financial sector and the pension reform (EFSAL in 1997 and PSAL in 1998). The EFSAL broadened the enterprise privatization effort and forced a very clear, hard budget constraint in loss-making enterprises, bank-led workout programs, improved bank governance, and accelerated bank privatization. Through these, the loan helped to establish a diversified and competitive financial sector. The PSAL helped the government defray the costs of transition to the new pension system, which comprises two basic elements. First, the existing public pay-as-you-go (PAYG) system was reformed by changing indexation rules and tightening the link between contributions and benefits. Second, a new three-pillar system was introduced that will be mandatory for all new entrants to the labor force and voluntary for all other workers. This new system comprises the first pillar, also publicly managed and PAYG, and a second pillar, privately managed and fully funded. A voluntary third pillar, also privately managed and fully funded, is to continue operating.

In the field of human resource development, the Pension Administration and Health Project contributed to improving the institutional capacity of the social insurance system to manage its financial resources more effectively, thereby contributing to its financial viability even though most of the loan funds were cancelled. The Health Services and Management Project, because of the cancellation of more than US\$50 million of the US\$91 million loan amount, could reach its three objectives only partly. The three main objectives were (a) to contribute to improving the health status of the Hungarian population by supporting public health programs aimed at reducing risk factors contributing to the high prevalence of noncommunicable diseases, (b) to support the government's program of health sector restructuring with the aim of improving internal efficiency, and (c) to provide more efficient and higher-quality care by strengthening the institutional capacity of the health sector in policymaking, management, and evaluation. The Youth Training Project helped adolescents and young adults to make the transition from school to work, thus reducing youth unemployment. In several counties, the project expanded the use of the improved vocational orientation curriculum in secondary schools in place of the former, excessively narrow secondary-level vocational training programs and provided a better basis for improved productivity and improved job mobility as the economy continues to evolve.

The Bank also helped to strengthen public institutions in Hungary through the Tax Administration Modernization project. In terms of software development, hardware procurement, countrywide implementation, and training, the project helped to modernize tax administration through the institutional strengthening of the Tax Administration Agency (APEH) to optimize revenue performance in a sustainable and equitable way.

Hungary joined the IFC, a member of the World Bank Group, in 1985. The IFC has successfully expanded its investment portfolio in the relatively small-size, typical industrial investment. Since 1985, 33 program fundings have been signed, totalling more than US\$300 million. This investment lending contributed much to the development of the private sector.

During 1985–91, the IFC set regional precedents: (a) helping create capital market institutions, including the Budapest Stock Exchange, a first private commercial bank, a first international fund, and a joint venture investment bank; and (b) establishing six "model" joint ventures of companies.

During 1992–95, IFC played a major role in providing advice and financing for telecommunications projects. It also established a forint-denominated medium-term note (MTN) program for local currency on-lending by IFC to IFC-financed projects, established a private equity fund for Hungary, and pursued various opportunities to participate in banking privatization.

From 1996 to the present, the IFC has assisted in structuring financing for the privatization of the Hungarian airline and implemented the Hungary Energy Efficiency Co-Financing Program, which uses funds from the Global Environment Fund (GEF) and aims to build the energy-efficiency financing capacity of Hungarian financial institutions.

As far as the pipeline is concerned, the government of Hungary has indicated that IFC could play a major role in structuring and mobilizing long-term financing for key privatizations in the agribusiness and power sectors and in privatization and reform of the state banking sector. Furthermore, responding to the energetic growth in economic activity in Hungary, the IFC has evaluated possible financial assistance to potential projects in the Internet, Internet banking, health, education, investment in a private university, financing of small and medium enterprises (SMEs), and joint ventures of Hungarian companies in neighbouring countries.

### **Technical assistance**

Beyond its active lending, IFC has played an important role in privatizing two small state banks and catalyzing the development of new institutions such as a mortgage bank. Furthermore, the Foreign Investment Advisory Services (FIAS), at the request of the government, extended its activity on programs to strengthen domestic supplier companies and increase backward linkages from foreign direct investment. The suggested activities of a Supplier Strengthening Program have helped the elaboration of a long-term national development plan (the Széchenyi Plan).

Besides the implemented pension reform, the World Bank's contribution to other elements of the government's program for rationalizing the role of the state has been also important. The Bank supported the program with the implementation of the Public Finance Management Project, which helped to improve budget preparation, treasury operations, debt management, and public finance management. Also, the Bank has engaged with the government in a project to modernize tax administration; the U.S. Treasury, the EU Poland and Hungary Assistance for Economic Restructuring Programme (PHARE), and other bilateral donors are also involved in improving tax compliance.

Because regional economic disparities are a major concern of the government and will be a focus of EU accession strategies, the Bank's technical advisory support on subnational development (via the Subnational Development Program, or SNDP) has been a key element of Bank assistance to Hungary. The program will support the government's efforts to develop a regional development strategy that will strengthen the capacity of regional authorities to channel resources, and in particular EU structural funds, to support economically viable investment projects designed and implemented at local levels in a sustainable framework. In this context, the dialogue will focus on the need to avoid top-down, infrastructure-dominated regional investment programs and ensure long-term sustainability through local efforts and increased factor mobility.

In a wider sense, the World Bank's institutional development impact might also be valuable as a result of its advice to other donors, especially in light of the importance of accession to the EU. The possibility of this is given in a "Memorandum of Understanding on Cooperation for Pre-Accession Preparation of Central and Eastern European Countries," signed jointly with the EU and the European Bank for Reconstruction and Development (EBRD) in March 1998. Hungary welcomed this initiative and also its manifestations in the CASs and the selection of "the challenge of EU accession" as the main theme for the recent CEM. Also, Hungary attaches great importance to the possible cofinancing of the EU's PHARE grant resources with those of the IFIs as well as other collaborative efforts. To make the cofinancing workable, however, greater efforts are needed to make the procurement provisions of the EU and the World Bank compatible.

### **Sustainability of the Program's Benefits**

In all likelihood, the development benefits Hungary has achieved from cooperation with the World Bank will be maintained. These development impacts can be identified as follows:

- a well-functioning market economy based on a solid institutional framework, thanks to successful economic reforms;
- the return of the modernized Hungarian economy to a sustainable growth path; and
- the discovery of the value of social dialogue.

### **Lessons**

The most important lessons drawn from Hungary's cooperation with the Bank should also be relevant for future Bank assistance:

- The Bank's high-level economic and sector work has been an indispensable part of its assistance. Using it as a starting point and respecting the borrowers' priorities, it is the way to focus on the right priorities. Two further conditions could help such planning: first, the existence of a development plan elaborated by the borrower, and second, a close, permanent relationship between the domestic staff and the Bank professional staff.
- On the basis of Hungary's participation in the FSAP, further participation in all global programs aimed at improving the ability to detect sources of vulnerability and to propose timely corrective measures can be justified.

- Taking into account the need for economic reforms and structural adjustment, the share of SALs in total lending can be at least 30 percent in most transition countries. This suggestion is based on the experience of Hungary, where the government has been highly willing to reform in the last two decades. Following such a model might be efficient in the case of less developed and nonreforming transition countries, too.
- Technical assistance has to remain the Bank's important service in the future, too. Its role might even be greater in the EU accession countries, because the Bank focuses on development areas not explicitly covered by the EU *acquis communautaire*.
- The World Bank's Structural Adjustment Participatory Review Initiative (SAPRI) inquiry for Hungary, the two-year policy dialogue, and the reports prepared gave a good basis for sharing the lessons from and the assessment of Hungary's structural adjustment with the representatives of other Central and East European countries.