

# The Challenges of Fiscal Risks in Transition: Czech Republic, Hungary, and Bulgaria

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AN ESSENTIAL STEP IN controlling the expansion of government contingent liabilities and reducing fiscal risk is being able to identify and measure them. In this chapter we discuss how this may be done, and we demonstrate how an assessment of fiscal adjustment may change substantially when a broader picture of government obligations is included. The chapter is based on a 1999 analysis of fiscal adjustment in the Czech Republic, Hungary, and Bulgaria.

The Czech case provides an example of officially balanced government budgets and of the extensive use of guarantees and other forms of off-budget support. The case study shows how to deal with some difficult conceptual and measurement issues when estimating government contingent liabilities and the unreported portion of fiscal deficit. In contrast to the Czech Republic, Hungary internalized most fiscal risks in the government debt and constrained off-budget fiscal activities. While the Czech Republic internalized almost all off-budget

faced high budget deficit and debt levels. Less-visible aspects of fiscal adjustment, however, pull the comparison of the fiscal performance of the two countries in the opposite direction. Somewhat like Hungary, Bulgaria maintained low, transparent government exposure to fiscal risk. And somewhat like the Czech Republic, Bulgaria has been committed to low budget deficits and macroeconomic stability—since 1997 at least, after having introduced a currency board arrangement. In contrast to both the Czech Republic and Hungary, however, Bulgaria has been slow in the transition process and has yet to meet the fiscal challenges of the needed enterprise restructuring and investment in infrastructure and environment.

Although each of the three countries has taken a different path to fiscal adjustment, economic realities and opportunities may lead to more similar behavior in the future. As the Czech Republic's hidden liabilities came to light in 1998, the government faced pressure to impose discipline in resolving old and taking on new fiscal risks. As for Hungary, the favorable fiscal performance in the second half of the 1990s emboldened the government to take on greater liabilities than it had been able to handle during the adjustment period. With the Czech government taking a tougher stand on contingent liabilities and the Hungarian government showing signs of loosening its established controls, a comparison of the two countries in the future may show a different pattern than that evident at the end of the 1990s. Bulgaria's recent favorable fiscal performance has yet to be tested by the tradeoff of fiscal prudence versus a more aggressive strategy toward the country's development and accession to the European Union (EU). All three countries consider their accession to the European Union a key policy priority, and their motivation to meet the EU accession requirements (including requirements on the quality of infrastructure and environment) is high.

The three sections that follow apply the Fiscal Risk Matrix (presented in Chapter 1 of this volume) and analyze the "true" fiscal position of the Czech Republic, Hungary, and Bulgaria. The main conclusions and suggestions for future work are summarized in the final section.

### Measuring the True Fiscal Deficit of the Czech Republic

The Czech Republic has been known for its balanced government budgets. In contrast to most countries, however, fiscal performance in the Czech Republic encompasses a significant number of government activities financed outside the budgetary system. These activities gener-

visible, because state guarantees and agencies that are either explicitly or implicitly guaranteed by the government have generated significant claims on the budget (see Table 9.1).

Given the magnitude of off-budget activities, fiscal analysis in the Czech Republic should identify all the main activities of a fiscal nature

Table 9.1 Fiscal Risk Matrix, Czech Republic

Sources of obligations	Direct liabilities (obligation in any event)	Contingent liabilities (obligation if a particular event occurs)
<i>Explicit</i>		
Government liability as recognized by a law or contract	<ul style="list-style-type: none"> <li>Foreign and domestic sovereign debt</li> <li>Budget expenditures</li> <li>Future legally binding expenditures</li> </ul>	<ul style="list-style-type: none"> <li>State guarantees</li> <li>Liabilities and other obligations of Konsolidacni Banka</li> <li>Obligations of Ceska Exportni, EGAP (an export guarantee fund), and Deposit Insurance Fund</li> </ul>
<i>Implicit</i>		
A "moral" obligation of government that reflects public and interest group pressures	<ul style="list-style-type: none"> <li>Future investment expenditures to meet EU accession requirements</li> <li>Future recurrent expenditures related to public investment projects</li> <li>Military expenditures as required by North Atlantic Treaty Organization (NATO)</li> </ul>	<ul style="list-style-type: none"> <li>Obligations of National Property Fund (own debt, guarantees, and obligations to Ceska Inkasni, Land Fund, and similar entities)</li> <li>Liabilities of Ceska Financni and Czech National Bank (result of the central bank's nonstandard operations)</li> <li>Liabilities of banks (Komerčni Banka, Ceska Sportelna)</li> <li>Further losses and defaults of large enterprises (Czech Railways)</li> <li>Obligations of PGRLF (an agricultural credit and guarantee fund)</li> <li>Liabilities and other obligations of subnational governments</li> <li>Liabilities of credit unions (Kampelicka) and private pension funds</li> </ul>

Note: The liabilities listed refer to the fiscal authorities of the central government. Because the government is legally obliged to pay future public pensions (a public pay-as-you-go pension scheme), future pensions constitute a direct (expected with certainty) explicit (legal) liability. The expected investment expenditures that are needed to meet EU accession requirements are the major direct implicit liability. State guarantees and financing through state-guaranteed institutions are key examples of explicit contingent liabilities. And, like that of many other countries, the financial system represents the most serious source of implicit contingent liabilities for the Czech government.

in order to determine the "true fiscal deficit." Excluding the quasi-fiscal activities of the central bank, the Czech National Bank, the "hidden" part of the fiscal deficit comprises two main components: (a) net spending on programs of a fiscal nature by special off-budget institutions—Konsolidacni Banka (KOB), Ceska Inkasni (CI), Ceska Financni (CF),<sup>1</sup> and the National Property Fund (NPF); and (b) implied subsidies extended through state guarantees. For the financial relationships of the special institutions, see Figure 9.1 (developed by the Ministry of Finance of the Czech Republic).

For any given year, net public spending by these institutions includes cash outlays on new programs in the form of directed credits and asset purchases,<sup>2</sup> and interest expenditures. This spending is adjusted for debt collection, interest revenue, and other revenue from programs. Table 9.2 shows the components of the "hidden" deficit. In the remainder of this section, we explain each row of this table in detail.

Figure 9.1. Financial Relationships of Special, Off-Budget Institutions, Czech Republic

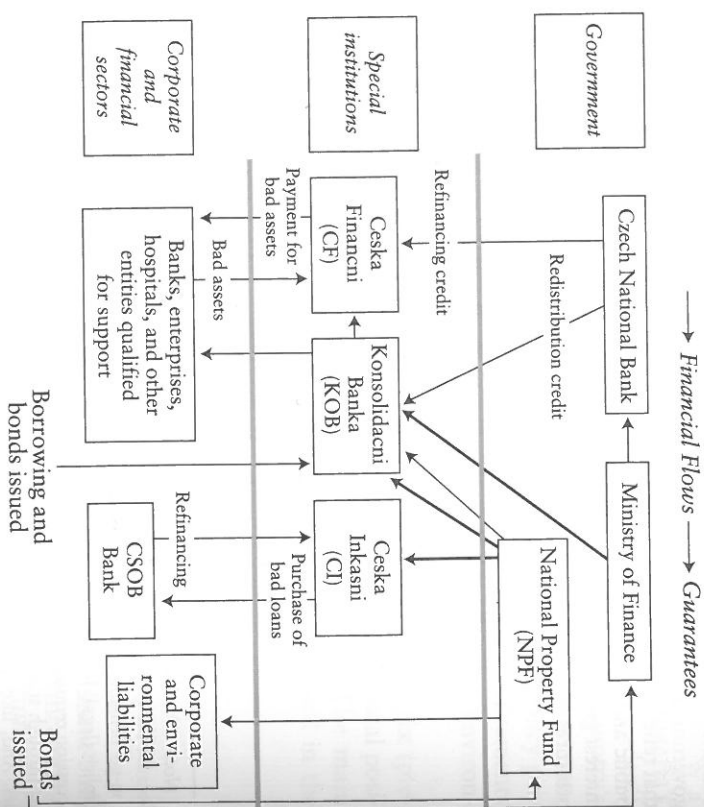


Table 9.2 Sources of "Hidden" Deficit in the Czech Republic, 1993–98

	1993	1994	1995	1996	1997	1998
(billions of Czech koruny)						
Konsolidacni Banka (KOB) <sup>a</sup> (net public expenditures)	7.7	7.3	4.5	0.9	10.6	28.8
Ceska Inkasni (CI) (net public expenditures)	20.1	6.6	4.9	4.8	3.1	2.7
Ceska Financni (CF) (net public expenditures)	n.a.	n.a.	n.a.	n.a.	0.6 <sup>b</sup>	1.8 <sup>b</sup>
National Property Fund (NPF) (net public expenditures, excluding KOB and CI)	4.2	8.2	4.3	1.9	2.0	2.6
State guarantees ("hidden" subsidy, risk-adjusted)	0.1	-0.4	1.3	14.9	51.5	26.7
Total (% of GDP)	3.2	1.9	1.1	1.5	4.1	3.5

n.a. Not applicable.

a. Activities of KOB include a credit to finance stabilization program of CF. Therefore, table includes only interest payments by CF (which are reported as interest income of KOB).

b. These figures are interest payments to KOB on credit taken by CF from KOB to finance stabilization program. In addition, CF paid interest to CZK0.8 billion and CZK2.8 billion in 1997 and 1998, respectively, to Czech National Bank on its credit from Czech National Bank to finance consolidation program.

Sources: Ministry of Finance, Konsolidacni Banka, Ceska Financni, National Property Fund, and calculations by the authors.

Until 1993, off-budget programs dealt mainly with pretransition problems inherited by the banking sector. These programs had been financed through Konsolidacni Banka. This bank was capitalized by the National Property Fund (the privatization agency whose revenues are derived from asset sales and borrowing on domestic markets) and borrowing from the Czech National Bank.<sup>3</sup> In 1995 the Ministry of Finance established Ceska Inkasni, a nonbank financial institution with the mandate of cleaning up the portfolio of a state-owned bank, the CSOB. Covered by a guarantee issued by the National Property Fund, Ceska Inkasni obtained a credit from the CSOB and used this credit to purchase CSOB's bad assets at face value.

During 1996-98, a new bank consolidation and stabilization program was launched to deal with newly emerging problems in the banking sector. In order to implement these programs, the Czech National Bank established Ceska Financni, another nonbank financial institution. In 1998 Ceska Financni had in its portfolio nonperforming assets purchased at face value from small and medium-size banks (in the amount of about CZK50 billion, or 3 percent of GDP). It financed the purchase through borrowing (one-third) from Konsolidacni Banka and (two-thirds) from the Czech National Bank.

The Czech National Bank also financed other bank rescue operations, which became the source of a further addition (CZK161 billion, over 9 percent of GDP) to its portfolio of substandard assets in 1998. Of the total amount of substandard assets held by Czech National Bank, the government covered the risk for 12 percent of the assets. A further 22 percent of these assets were in the form of a credit from the Czech National Bank to Konsolidacni Banka and thus were indirectly also covered by government.

Aside from the bank rescue operations, Konsolidacni Banka and, less directly, the National Property Fund financed government programs to support troubled health insurance companies, public hospitals, and the Czech Railways, to build infrastructure, and to clean up industrial enterprises for privatization (see Table 9.3). The National Property Fund financed these programs partly from privatization revenues but also partly from its debt issuance. The contributions to the "true" fiscal deficit by the National Property Fund exclude principal repayments and thus do not reflect the ongoing financing of pre-1993 programs by the National Property Fund. In addition, both Konsolidacni Banka and the National Property Fund accumulated their own contingent liabilities in the form of various guarantees on environmental liabilities.<sup>4</sup>

The impact of guarantees on the hidden deficit is estimated as the net implicit subsidy provided through guarantees in a given year from the portfolio of guarantees issued in that year. This estimate is the potential fiscal cost of government obligations, which will emerge from the guarantees in the future. If the amount of this subsidy had been transferred to a guarantee reserve fund the same year the guarantee was issued, it would have covered potential future claims emerging from the guarantee. The cost of default would be paid from the guarantee reserve fund and thus would not affect the budget and the deficit.

Our assessment of each guarantee and its underlying project provided the basis for estimating their future fiscal costs. Projects were ranked according to their risk. Accordingly, the default risk of each guarantee was estimated. The probability of default was determined by careful consideration of each loan. Table 9.4 shows the amounts of

*Table 9.3 Programs Covered by National Property Fund, Czech Republic, 1993-98*  
(billions of Czech koruny)

	1993	1994	1995	1996	1997	1998
Financing environmental rehabilitation	..	0.1	0.8	1.0	1.4	2.1
Financing development of railway route	n.a.	n.a.	n.a.	0.1	..	0.2
Support to state-owned enterprises	2.1	0.5	0.9	0.3	0.2	0.3
Support to agricultural businesses	n.a.	6.1	1.0	n.a.	n.a.	n.a.
Bond interest	2.1	1.5	1.6	0.5	0.4	0.5
National Property Fund's "hidden" fiscal deficit <sup>a</sup>	4.2	8.2	4.3	1.9	2.0	2.9
Others, already included in hidden deficit calculation:						
Health insurance companies (through KOB) <sup>b</sup>	n.a.	n.a.	n.a.	0.8	0.4	0.4
Support to aviation companies (through KOB) <sup>b</sup>	n.a.	n.a.	n.a.	n.a.	0.1	..
Provisions to Ceska Inkasni (CI) <sup>b</sup>	n.a.	n.a.	3.4	10.3	5.5	6.0
Stabilization program of CF (through KOB) <sup>b</sup>	n.a.	n.a.	n.a.	n.a.	0.6	1.8
Others, included in reported budget deficit:						
Transfers according to state budget law <sup>b</sup>	9.5	19.4	10.7	n.a.	n.a.	n.a.
n.a. Not applicable.						
.. Negligible.						

Note: KOB = Konsolidacni Banka; CF = Ceska Financni.

a. Excluding transfers to KOB, CI, and CF and transfers according to state budget law.

b. These items are excluded from the "true" deficit calculation. National Property Fund's expenditures related to KOB, CI, and CF are accounted for as financing items of these institutions.

Sources: National Property Fund's annual reports and calculations by the authors.

**Table 9.4 Risk of Guarantees Issued, Czech Republic, 1993-98**  
(face values, billions of Czech koruny)

Risk	1993	1994	1995	1996	1997	1998
Very high (90%)	0.0	0.0	0.0	10.8	51.7	31.0
High (30%)	0.0	0.0	0.0	16.2	20.3	0.0
Medium (15%)	5.0	0.0	13.3	3.0	5.8	7.8
Low (5%)	3.7	0.0	1.8	0.0	0.0	87.0
Total	8.7	0.0	15.1	30.0	77.8	125.8

Sources: Ministry of Finance and calculations by the authors.

guarantees issued according to their risk ranking. The implicit subsidy (risk-adjusted) imbedded in state guarantees is calculated by multiplying the loan amount for which a guarantee was issued by the default risk. To avoid double counting, the net implicit subsidy, or the net contribution to the hidden deficit in a given year, is defined as the total implicit subsidy provided in a given year minus guarantee claims paid from the budget and reported in the budget that year. Table 9.5 provides the risk-adjusted amounts of guarantees issued each year and the claims paid from the budget on guarantee defaults each year.

Estimates of the "true" fiscal deficit in the Czech Republic (Table 9.6) indicate that, contrary to the widely accepted view, the Czech Republic's fiscal performance has not been noteworthy for its fiscal restraint. Moreover, demands on new guarantees and programs to be financed through various off-budget agencies have been growing. If left to grow as in the past, the off-budget risk to future fiscal stability

**Table 9.5 Contribution of Guarantees to "Hidden" Deficit, Czech Republic, 1993-98**  
(billions of Czech koruny)

Risk	1993	1994	1995	1996	1997	1998
Very high (90%)	0.0	0.0	0.0	9.7	46.5	27.9
High (30%)	0.0	0.0	0.0	4.9	6.1	0.0
Medium (15%)	0.7	0.0	2.0	0.4	0.9	1.2
Low (5%)	0.2	0.0	0.1	0.0	0.0	4.4
Subtotal	0.9	0.0	2.1	15.0	53.5	33.4
Budget paid out (-)	-0.8	-0.4	-0.8	-0.1	-2.0	-6.7
Total	0.1	-0.4	1.3	14.9	51.5	26.7
(as % of GDP)	0.0	-0.0	0.1	1.0	3.1	1.5

Sources: Ministry of Finance and calculations of the authors.

**Table 9.6 Czech Republic "True" Fiscal Deficit, 1993-98**  
(percent of GDP)

	1993	1994	1995	1996	1997	1998
Reported fiscal deficit	-0.5	-1.3	0.3	0.5	1.1	1.4
"Hidden" fiscal deficit in the special institutions (KOB, CI, CF, and NPF)	3.2	1.9	1.0	0.5	1.0	2.0
"Hidden" fiscal deficit in guarantees (net hidden subsidy, risk-adjusted)	0	0	0.1	1.0	3.1	1.5
"True" fiscal deficit	2.7	0.6	1.4	2.0	5.2	4.9

Source: Calculations of the author.

would increase significantly. By mid-1999, the government had only begun to develop an institutional mechanism to keep a check on its off-budget obligations and the ensuing fiscal risk.

*The sharp increase in the amount and risk of guarantees issued by the state is troubling.* The bulk of the increase has emerged from the government's support of the banks and the Czech Railways. In 1997 and 1998 the government issued a CZK22 billion (1.4 percent of GDP) guarantee to Czech National Bank on some of its very risky lending for bank restructuring and a CZK31 billion (nearly 2 percent of GDP) guarantee to a bank (CSOB) on its claim against a Slovak financial institution (Slovenska Inkasni). To support the Czech Railways, the government issued two guarantees, each over CZK20 billion with a very high default risk in 1996 and 1997 on railway modernization. The hidden cost of the guarantees has already started to show as a growing claim on the budget emerging from guarantee defaults. Claims on the budget increased from about CZK1 billion annually during 1993-96 to CZK2 billion in 1997 and almost CZK7 billion in 1998.<sup>5</sup>

Another related, troubling fact is the *rapidly increasing level of hidden public liabilities*. Stocks of these liabilities have been accumulating outside the budgetary system as a result of the hidden deficits (annual flows), mainly in the form of borrowing by the special institutions to finance their government programs.<sup>6</sup> Table 9.7 shows the approximate levels of hidden public liabilities, excluding the nonguaranteed quasi-fiscal operations of the Czech National Bank. Comparison of the figures of hidden deficits in Table 9.2 with the resulting hidden liabilities in Table 9.7 illustrates the extent of cross-financing among the special institutions and of the use of privatization revenues to partly cover the cost of off-budget programs.

*Off-budget programs*, such as guarantees and support extended through Konsolidacni Banka, the National Property Fund, PGRLF (an

**Table 9.7 Hidden Public Liabilities, Czech Republic, 1993–98**  
(billions of Czech koruny)

	1993	1994	1995	1996	1997	1998
Konsolidacni Banka <sup>a</sup>	79	81	79	70	86	98
Ceska Inkasni <sup>a</sup>	20	27	25	17	8	7
National Property Fund <sup>a</sup>	29	33	40	22	17	15
State guarantees <sup>b</sup>	3	3	6	28	74	107
Hidden public liabilities <sup>a</sup>	131	144	150	137	185	226
<b>Hidden public liabilities</b> (% of GDP) <sup>a</sup>	13.1	12.1	10.8	8.7	10.9	12.4
Reported gross government debt	159	162	154	155	173	194
<b>Reported gross government debt (% of GDP)</b>	15.8	13.7	11.2	11.2	10.3	10.6

a. Activities of Konsolidacni Banka include financing of the stabilization program of Ceska Financni. Therefore, the table does not include Ceska Financni as a separate entity. All figures are net of provisions and reserves.

b. Guarantees outstanding at the end of each year adjusted for risk.

Sources: Konsolidacni Banka, Ceska Inkasni, National Property Fund, and calculations of the authors.

agricultural credit and guarantee fund), and other, possibly new agencies and guarantee funds, *impose costs on taxpayers with a delay but with no discount*. As has already begun to happen, past hidden deficits and servicing of the hidden government debt outside the budgetary system generate claims on the government budget.

*State guarantees generate significant budget claims.* Assuming that no new state guarantees are issued, the budget may need to cover about CZK4 billion annually in future years and CZK33 billion in 2002 if the debt of Slovenska Inkasni to CSOB is not resolved. Table 9.8 builds on Table 9.5, and, taking into account individual guaranteed debt repayment schedules, it shows the expected guarantee claims on future budgets. Figures in Table 9.8 are obtained by multiplying the default risk by the annual scheduled payments. More conservative assumptions of default risk would increase the estimated claims on budget resources.

*Another source of future claims on the budget is Konsolidacni Banka.* It experienced a loss of about CZK14.4 billion in 1998 that later was covered by a state bond issue. New programs, however, have required further borrowing and continue to generate losses. Claims on the state budget reached CZK80 billion during 1999–2000.

Without further privatization revenues, the National Property Fund will need to borrow further to meet its commitment for Ceska Financni, Ceska Inkasni, environmental recovery, and railway development and to cover principal repayments for its obligations.<sup>7</sup> Analy-

**Table 9.8 Estimated Guarantee Claims on the Budget, Czech Republic, 1999–2030**  
(billions of Czech koruny)

Guarantees outstanding in 1998	Average default risk	Expected total claims	1999–2030						
			1999	2000	2001	2002	2003	2030	
284.8	38%	107.4 <sup>a</sup>	3.3	4.9	5.4	33.3	3.7	50.5	97.8

a. The government guarantees both interest and principle repayments. The figure shown is the net present value of guarantee claims on future budgets.

Sources: Ministry of Finance and calculations of the authors.

sis of the National Property Fund's commitments, excluding those for Konsolidacni Banka, suggests that, to meet its obligations, the fund will need about CZK15 billion a year during 1999–2003 and about CZK33 billion in 2004.

In the medium to long term, off-budget financing of government activities, guarantees, and other contingent liabilities surfaces as increases in government debt. In the Czech Republic, the expected increase in the public debt by the amount of hidden public liabilities (estimated in 1999 at around 12.4 percent of 1998 GDP as shown in Table 9.7) is significant but not disastrous. What appears as disastrous is the dynamic in the rise of the hidden public liabilities. Clearly, the levels of new guarantees issued and the new government programs entrusted for financing to Konsolidacni Banka are not sustainable. Their continued growth at the current pace would in a few years endanger fiscal stability and thus play against the country's objective of EU accession. The situation will appear more serious if "implicit" government liabilities are included in the deficit and debt calculations.

Finally, it remains questionable to what extent off-budget programs contributed to achieving the main policy objectives of the government. In some instances, these programs substituted for structural reforms. For example, instead of preventing problems in the banking sector from recurring, bailouts of banks and enterprises paid for failures likely to occur again. Sometimes programs that did not qualify for budgetary support (for example, an additional subsidy to the Czech Railways) did qualify for assistance outside the budget (such as a very risky guarantee extended to the railways). Moreover, often these programs implied that government would help again in the event of future failures, and thus may have generated moral hazard among market agents, reducing their incentives to improve productivity and competitiveness.

Because EU accession and integration with European markets are the highest policy priority, the government has a powerful incentive to

periodic reporting on contingent liabilities and fiscal risks, new laws on budget management and state asset management, consolidation of the assets and liabilities of Ceska Financni and Ceska Inkasni in a single portfolio under Konsolidacni Banka, a law restricting the functions of Konsolidacni Banka, privatization of the large state-owned banks, the planned introduction of a medium-term expenditure framework that would reflect off-budget fiscal risks, and a new capacity in the Ministry of Finance to analyze and manage fiscal risks. If implemented, these initiatives should significantly narrow the gap between the reported and true budget deficit and improve the overall effectiveness and efficiency of the use of public resources.

### Transparency and Containment of Fiscal Risk in Hungary

Compared with the Czech Republic, Hungary emerged in 1990 with a much larger government debt and a higher expenditure-to-GDP ratio. But Hungary has been more determined and successful in managing fiscal risk. In liquidating old contingent obligations and undertaking new ones, the government has been guided by two principles: explicit risks should be identified, and new risks should be undertaken within the approved budget framework. These principles—transparency and containment—have not always been applied consistently, but they have put the government in a better position to withstand economic setbacks.

Transparency has been achieved as the risks and costs of past policies have been made explicit and, where appropriate, funds have been set aside to pay for them. The pension system is an example. Restructuring the pension system compelled the government to recognize costs that had long been concealed and make provisions in the budget for them. Containment has proceeded along two tracks: liquidating preexisting risks through pension reform, bank consolidation, and enterprise consolidation, and regulating the volume of new risks through the rules and procedures discussed in the previous section of this chapter. Although these controls are on a cash basis and do not use sophisticated risk assessment techniques, they may nevertheless be effective.

Recent fiscal performance attests to the prudent management of risk. The amount set aside in the budget for calls on individual and institutional guarantees is less than 1 percent of total budgeted expenditures. The amount paid out in actual calls has consistently been less than the budgeted amount. The contingent liabilities of state institutions are barely half of the authorized level. Conservative estimates of calls from outstanding guarantees of all types are less than 2 percent of budgeted expenditures. Government and state institutions have established *conservative reserve funds* to cover fiscal risks, including a deposit

insurance fund, the private pension guarantee fund, and funds provisioned by various institutions to pay for calls on the risks they hold. The draw on these funds has been very small thus far. Risk in the financial sector has been diversified and transferred (in most cases) to foreign investors. Financial markets have given Hungary a much more favorable rating than in the past, as reflected by the government's success in floating longer-term bonds.

Like in the Czech Republic, early in the transition, fiscal stability in Hungary was undermined by the *banking system* and its large volume of nonperforming loans. To finance bank restructuring and encourage privatization, the government issued bonds and guarantees (Table 9.9). Because they bypassed the budget, bonds and guarantees created "hidden deficits." Only guarantees, however, in a very small amount, generated a hidden debt.

Table 9.9 Fiscal Cost of Banking Problems, Hungary, 1991–98  
(billions of Hungarian forints)

	1991	1992	1993	1994	1995	1996	1997	1998
Bonds issued <sup>a</sup>	0.0	0.0	285.6	47.0	6.0	9.0	0.0	182.0
Guarantees issued	10.4	0.0	0.0	0.0	0.0	16.5	27.8	44.0
Total "hidden" deficit	10.4	0.0	285.6	47.0	6.0	25.5	27.8	226.0
Amortization of bonds from budget	0.0	0.0	0.0	0.0	0.0	0.0	85.9	0.0
Interest paid on bank consolidation bonds	0.0	0.0	0.0	54.5	96.6	102.7	86.5	50.5
Guarantees called	0.0	2.3	0.4	0.0	6.8	2.9	11.8	6.2
Guarantees recovered	0.0	0.0	0.0	0.0	-0.2	-0.1	0.0	-1.1
Total realized fiscal cost	0.0	2.3	0.4	54.5	103.2	105.5	184.2	55.6
Total realized fiscal cost <sup>b</sup> (% of GDP)	0.00	0.08	0.01	1.25	1.85	1.53	2.16	0.58

a. Bank consolidation was largely financed directly from new debt issues, bypassing the budget. Bonds issued in 1993 to finance bank consolidation (over 8 percent of GDP) partly also served debtor (enterprise) consolidation.

b. The total realized fiscal cost, as shown through the government budget, is calculated on a cash basis as payments on bond amortization and interest plus payments on guarantees called, minus revenues from guarantees recovered. The amounts of bonds and guarantees issued suggest how the fiscal cost of bank consolidation will affect future budgets.

Sources: Ministry of Finance and Government Debt Management Agency.

In its first stage, reform of the banking sector did not contain fiscal risk nor was its fiscal cost transparent. The first stage involved government acquisition of a substantial portion of the bad debt held by banks. The loan strategy transferred risk from the banks to the government, but the true cost was concealed by treating the transactions as asset purchases rather than as subsidies. Although some of the acquired loans were sold or restructured, most were transferred to state agencies (such as the Hungarian Development Bank) or written off. The second stage of reforms entailed risk-sharing, with assisted banks required to sign consolidation agreements spelling out the measures they would take to improve their financial condition. This strategy was mainly financed from 20-year bonds. In the 1994–96 period, annual interest payments on these loans averaged approximately 1.5 percent of GDP. Successful consolidation set the stage for privatization of most banks,<sup>8</sup> allowing the government to transfer most of the risk into foreign hands.

However, the government violated its transparency rule in the case of Postabanka. A run on the bank in 1997 prompted the government to provide new equity capital and loan guarantees. The government channeled most of the assistance through the Hungarian Development Bank and the State Privatization and Holding Agency, thereby creating not only a "hidden" fiscal deficit but also a hidden debt (liabilities accumulated in these two agencies in exchange for low-quality assets). In late 1998 the government was compelled to recapitalize Postabanka by injecting HUF150 billion (1.5 percent of GDP) from government bonds and to compensate the Hungarian Development Bank in the amount of HUF40 billion for Postabanka-related losses.

Compared with the Czech Republic, Hungary chose a more transparent approach to *enterprise privatization and to the use of privatization revenues*. Most of privatization proceeds were used to repay foreign debt (see Table 9.10). As for the privatization process itself, Hungary proceeded slowly, company by company, restructuring and managing them before selling them, and insisted on cash sales rather than on vouchers and other noncash transactions implemented in the Czech Republic. The State Property Agency has not warranted the future financial condition or performance of privatized enterprises, nor has it indemnified the new owners for the cost of meeting new environmental standards. It has issued several types of guarantees in the privatization process, but maintains a reserve fund, which appears sufficient to cover expected claims.

Hungary's *pension reform of 1997* reduced the government's largest implicit liability and made it explicit.<sup>9</sup> The reform required new workers to enroll in a fully funded, privately managed, defined-contribution system and gave most existing workers the option of remaining in the government-operated, defined-benefit program or migrating to the new system. The reform significantly reduced the government's

Table 9.10 Use of Privatization Revenues, Hungary, 1990–98  
(billions of Hungarian forints)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Government debt repayment	0.5	22.4	51.5	57.5	151.7	218.4	22.9	254.8	39.0
Transfers to state budget	0.0	0.0	0.0	0.0	0.0	150.0	100.0	0.0	0.0
Municipalities	0.0	2.3	4.8	3.4	6.0	6.1	21.6	26.4	0.0
Direct privatization costs	0.0	1.1	6.2	7.6	25.3	33.6	33.0	36.1	46.3
Reorganization costs	0.0	0.0	8.7	49.5	8.0	9.8	16.8	12.1	13.5
Guarantees	0.0	0.0	5.8	7.8	7.0	3.7	33.2	16.0	51.6
Total	0.5	25.8	77.0	125.8	198.0	421.6	227.5	345.4	150.4
(% of GDP)	0.02	1.1	2.6	3.6	4.5	7.5	3.3	4.1	1.5

Sources: Ministry of Finance and State Property Agency.

future fiscal exposure, but it raised the short-term budget deficit by requiring the government to make up shortfalls in the old pension fund. The more workers who switched, the greater the reduction in future liabilities, but the greater the loss of income in the old fund, the greater the reported budget deficit.

To build public support for pension reform, the government guaranteed that each participant in the new, privately managed pension funds would receive benefits equal to at least 93 percent of the pension that would have been paid by the old system. Because only workers below the age of 47 had the option of joining the new pension system, the government will not face any call on this guarantee for at least 15 years, when the first cohort of participants in the defined-contribution plan retire. If the guarantees are called in the future, payments will be made by the new Private Pensions Guarantee Fund, which accumulates reserves for this purpose by charging privately managed pension funds fees for various services. There is some risk that these guarantees may spur participants to enroll in funds that promise the highest yields, without concern about whether the funds will have sufficient resources to cover their promises. To guard against undue risk-taking, the government has introduced various regulatory measures to oversee the privately managed funds.

Throughout the transition process, Hungary also has taken *new fiscal risks* by guaranteeing loans, indemnifying importers and exporters, and taking other steps to promote investment and entrepreneurial

behavior. Moreover, Hungary has authorized a number of quasi-independent institutions to issue guarantees, including Eximbank, MEHIB (Hungarian Export Credit Insurance Ltd.), the Credit Guarantee Company, the Rural Credit Guarantee Foundation, and the Hungarian Development Bank, and thus has accumulated contingent liabilities (see Table 9.11).

Overall, Hungary's government has been prudent in issuing guarantees directly or through state-established institutions. Compared with the Czech Republic, Hungary has maintained a set of strict controls that limit the volume of guarantees, making provision in the budget, and require assessment of risks prior to the execution of guarantee contracts and timely reporting on the risks of outstanding guarantees (see Box 9.1). The controls are cash-based; they limit the volume of new guarantees or the total outstanding amount and set aside cash in

**Table 9.11 Contingent Liabilities Outstanding and Expected Claims, Hungary, as of 1998-99**  
(billions of Hungarian forints)

Type	Ceiling	Out-standing	Average risk (%)	Expected claims
<i>Individual guarantees</i>				
Individual guarantees (within the limit)	28 <sup>a</sup>	120	30	36
Individual guarantees (beyond the limit)	158 <sup>b</sup>	125	5	6
<i>Guarantees to activities of specific institutions</i>				
Hungarian Development Bank	80	32	5	2
Eximbank	75	52	7	3
MEHIB—Hungarian Export Credit Insurance Ltd.	185	76	8	6
Credit Guarantee Co.	49	42	5	2
Rural Credit Guarantee Foundation	23	10	5	1
Total	n.a.	457	n.a.	56 <sup>c</sup>

n.a. Not applicable.

Note: The table excludes guaranteed loans from international financial institutions.

a. The 1998 ceiling on the issue of new guarantees.

b. Total amount of individual guarantees beyond the percentage limit.

c. Because the government guarantees both interest and principal repayments, this figure roughly represents the net present value of future claims. The 1998 budget appropriated HUF11.8 billion for guarantee calls and actually paid HUF7.9 billion. The 1999 budget set aside HUF12 billion for calls on individual guarantees and another HUF9.5 billion to cover guarantees issued by state institutions.

Sources: Ministry of Finance and calculations of the authors.

### Box 9.1 Hungarian Public Finance Institutions Designed to Constrain the Accumulation of Contingent Liabilities

Hungary's Public Finance Act is the legal basis for issuing and budgeting for guarantees. It provides that the annual budget limit the volume of guarantees undertaken during the fiscal year. It also requires that funds be set aside in the budget for calls expected during the year. And it requires the government to publish information on borrowers, the reasons for issuing specific guarantees and the amounts, and the risk and the conditions pertaining to the guarantees. The government must report each guarantee to the State Audit Office, and the closing accounts for each fiscal year must include all guarantees undertaken and payments made.

The next link in the control process is the annual budget, which limits the volume of guarantees to be issued (or outstanding) during the year and sets aside funds for guarantees that may be called. At present, the budget limits the total of new guarantees to 1 percent of budgeted expenditures. The government generally has stayed within the limit, but for several reasons it issues guarantees or incurs related obligations well in excess of the limit. The limit applies only to individual guarantees issued directly by the government; it does not cover guarantees issued by state institutions. Guarantees for various strategic purposes (such as for oil and gas imports) and for loans contracted with international finance institutions are exempt from the limit. The limit may be exceeded during the year by a decision of the parliament.

The budget contains numerous provisions regulating the issuance of guarantees by the government and state institutions. The following are among the most important. The government may charge an origination fee of up to 0.5 percent of the value of its commitment. The budget limits the amount of guarantees that each state institution may have outstanding at any time during the year. (In some cases, the limit is adjusted annually to accommodate increased credit activity. For example, the 1999 budget raised the ceiling for the Hungarian Export Credit Insurance Ltd. to HUF250 billion from the HUF185 billion designated the previous year.) The government may reinsure up to a specified percentage of the obligations of various state institutions (for example, it reinsures 70 percent of the obligations of the Credit Guarantee Company and the Rural Credit Guarantee Foundation). The budget provides for guarantee programs such as new student loan guarantees, and it appropriates a fixed amount to cover potential calls during the year.

The third link in the control chain is a decree prescribing the procedures to be used in undertaking individual guarantees. The decree currently in effect designates the minister of finance as guarantor on behalf of the state and specifies the form and content in which proposed guarantees should be presented to the government for decision. The proposal

(Box continues on the following page.)

periodic reporting on contingent liabilities and fiscal risks, new laws on budget management and state asset management, consolidation of the assets and liabilities of Ceska Financni and Ceska Inkasni in a single portfolio under Konsolidacni Banka, a law restricting the functions of Konsolidacni Banka, privatization of the large state-owned banks, the planned introduction of a medium-term expenditure framework that would reflect off-budget fiscal risks, and a new capacity in the Ministry of Finance to analyze and manage fiscal risks. If implemented, these initiatives should significantly narrow the gap between the reported and true budget deficit and improve the overall effectiveness and efficiency of the use of public resources.

### Transparency and Containment of Fiscal Risk in Hungary

Compared with the Czech Republic, Hungary emerged in 1990 with a much larger government debt and a higher expenditure-to-GDP ratio. But Hungary has been more determined and successful in managing fiscal risk. In liquidating old contingent obligations and undertaking new ones, the government has been guided by two principles: explicit risks should be identified, and new risks should be undertaken within the approved budget framework. These principles—transparency and containment—have not always been applied consistently, but they have put the government in a better position to withstand economic setbacks.

Transparency has been achieved as the risks and costs of past policies have been made explicit and, where appropriate, funds have been set aside to pay for them. The pension system is an example. Restructuring the pension system compelled the government to recognize costs that had long been concealed and make provisions in the budget for them. Containment has proceeded along two tracks: liquidating preexisting risks through pension reform, bank consolidation, and enterprise consolidation, and regulating the volume of new risks through the rules and procedures discussed in the previous section of this chapter. Although these controls are on a cash basis and do not use sophisticated risk assessment techniques, they may nevertheless be effective.

Recent fiscal performance attests to the prudent management of risk. The amount set aside in the budget for calls on individual and institutional guarantees is less than 1 percent of total budgeted expenditures. The amount paid out in actual calls has consistently been less than the budgeted amount. The contingent liabilities of state institutions are barely half of the authorized level. Conservative estimates of calls from outstanding guarantees of all types are less than 2 percent of budgeted expenditures. Government and state institutions have estab-

insurance fund, the private pension guarantee fund, and funds provisioned by various institutions to pay for calls on the risks they hold. The draw on these funds has been very small thus far. Risk in the financial sector has been diversified and transferred (in most cases) to foreign investors. Financial markets have given Hungary a much more favorable rating than in the past, as reflected by the government's success in floating longer-term bonds.

Like in the Czech Republic, early in the transition, fiscal stability in Hungary was undermined by the *banking system* and its large volume of nonperforming loans. To finance bank restructuring and encourage privatization, the government issued bonds and guarantees (Table 9.9). Because they bypassed the budget, bonds and guarantees created "hidden deficits." Only guarantees, however, in a very small amount, generated a hidden debt.

Table 9.9 Fiscal Cost of Banking Problems, Hungary, 1991–98  
(billions of Hungarian forints)

	1991	1992	1993	1994	1995	1996	1997	1998
Bonds issued <sup>a</sup>	0.0	0.0	285.6	47.0	6.0	9.0	0.0	182.0
Guarantees issued	10.4	0.0	0.0	0.0	0.0	16.5	27.8	44.0
Total "hidden" deficit	10.4	0.0	285.6	47.0	6.0	25.5	27.8	226.0
Amortization of bonds from budget	0.0	0.0	0.0	0.0	0.0	0.0	85.9	0.0
Interest paid on bank consolidation bonds	0.0	0.0	0.0	54.5	96.6	102.7	86.5	50.5
Guarantees called	0.0	2.3	0.4	0.0	6.8	2.9	11.8	6.2
Guarantees recovered	0.0	0.0	0.0	0.0	-0.2	-0.1	0.0	-1.1
Total realized fiscal cost	0.0	2.3	0.4	54.5	103.2	105.5	184.2	55.6
Total realized fiscal cost <sup>b</sup> (% of GDP)	0.00	0.08	0.01	1.25	1.85	1.53	2.16	0.58

a. Bank consolidation was largely financed directly from new debt issues, bypassing the budget. Bonds issued in 1993 to finance bank consolidation (over 8 percent of GDP) partly also served debtor (enterprise) consolidation.

b. The total realized fiscal cost, as shown through the government budget, is calculated on a cash basis as payments on bond amortization and interest plus payments on guarantees called, minus revenues from guarantees recovered. The amounts of bonds and guarantees issued suggest how the fiscal cost of bank consolidation will affect future budgets.